



In preindustrial economies, finance was largely concerned with the development of a medium of exchange. Barter was inefficient, transaction costs were high, and the lack of a medium of exchange limited the extent of the market and the opportunities for specialization. With the growth of nonlocal trade, the development of payment media became linked to the financing of trade. Otherwise, apart from the financing of governments and seaborne trade, borrowing and lending were mostly informal and on a small scale.

The spread of urban society, and above all the advent of large-scale industrialization in the second half of the nineteenth century, altered the role that finance had to play. Finance was now concerned with mobilizing resources for large infrastructure projects and for investments with heavy capital requirements that exceeded the capabilities of small family firms.

The systems that emerged often suffered from fraud and mismanagement. They proved unstable and experienced frequent crises. Speculative manias, fueled by financial institutions, caused mounting concern, and after the Great Depression of the 1930s governments began to supervise their financial systems more closely. But government intervention was by no means entirely successful. It made the financial system less flexible, and although it reduced fraud it did not eliminate it. Moreover, economic agents proved adept at get-

ting around the regulations. In recent years the focus has shifted back to deregulation, partly in response to financial innovation and partly to promote competition and efficiency.

The evolution of financial systems ought to cast light on two questions that are of interest to policymakers in developing countries. What role should financial systems play in promoting industrialization and development? And what role should governments play in creating such systems?

#### **Development of payment systems**

The search for an efficient medium of exchange gradually led to the monetization of precious metals. As a result the payment mechanism became simpler and safer. The new monies facilitated trade and provided a store of value and a unit of account. Governments played an important part in this change by owning and regulating mints and thus ensuring the quality and acceptability of coins. But they were also frequently responsible for debasing coins by lowering their weight or adulterating them with less precious metals, such as copper.

Metallic payment was a big step forward. Gradually, however, paper-based instruments, which were cheaper and more convenient, came to replace coins and bullion. Payment orders, letters of credit, and negotiable bills of exchange evolved

with the expansion of nonlocal trade in Europe. These were particularly useful in triangular trade, because only net settlements had to be made in specie. Commercial bills known as *hundi* were developed in India. In Japan, the need for cash was reduced by the use of bills and rice warehouse warrants and by the development of clearing facilities.

The direct role of governments in creating paper-based credit instruments was limited—although they provided the legal framework that was necessary for their use. Governments played a greater part in the development of paper money. They were involved either directly (as in China) or indirectly (which was more common), through granting the right to issue paper money to private bankers. China invented paper money in the ninth century. The ruler, acutely aware of the problems of paper money, enforced acceptance with the threat of death and by strictly limiting issuance (see Box 3.1), although there were many later instances of overissue. Paper money was subse-

### Box 3.1 Marco Polo discovers paper money

“In this city of Kanbalu [Beijing] is the mint of the Great Khan, who may truly be said to possess the secret of the alchemists, as he has the art of producing money . . . He causes the bark to be stripped from . . . mulberry-trees . . . This . . . is made into paper, resembling, in substance, that which is manufactured from cotton, but quite black. When ready for use, he has it cut into pieces of money of different sizes, nearly square, but somewhat longer than they are wide . . . The coinage of this paper money is authenticated with as much form and ceremony as if it were actually of pure gold or silver; for to each note a number of officers, specially appointed, not only subscribe their names, but affix their seals also . . . The act of counterfeiting it is punished as a capital offence. When thus coined in large quantities, this paper currency is circulated in every part of the Great Khan’s dominions; nor dares any person at the peril of his life, refuse to accept it in payment. All his subjects receive it without hesitation, because, wherever their business may call them, they can dispose of it again in the purchase of merchandise they may require; such as pearls, jewels, gold, or silver. With it, in short, every article may be procured.”

Marco Polo  
*The Travels of Marco Polo*, Book II, Chapter 24  
(Komroff 1926, pp. 156–57)

quently introduced in Japan. In Europe, bank notes (representing promises to pay on demand) were issued in the seventeenth century by goldsmiths, notaries, and merchants, who gradually developed into bankers. Banks created by special charter, such as the Bank of England, also issued notes. In the colonies of North America, a chronic shortage of bullion led to the issue of land-backed certificates, which circulated as paper money.

The overissue of bank notes often undermined the credibility of paper money and led to financial crises and the suspension of the notes’ convertibility into bullion. This happened in the American Carolinas and France in the eighteenth century, and in several European and Latin American countries in the nineteenth century. Attempts in the nineteenth century to regulate the supply of gold-backed bank notes in England stimulated the use of checks drawn on bank deposits to make payments and thus promoted the spread of a more efficient and versatile instrument of payment. The growing use of bank notes issued by different bankers led to the creation of clearing facilities, which were later extended to cover the clearing of checks.

As central banks evolved to cope with the recurring financial crises of the latter part of the nineteenth century, they came to monopolize the note issue. This led to the eventual adoption of fiat money—that is, paper (and later credit) money not backed by bullion. Fiat money solved the problem of loss of confidence in bank notes issued by individual banks, but not the problem of overissue of paper money by the central bank. Many countries in Asia, Europe, and Latin America suffered episodes of hyperinflation after governments had used the central bank’s printing presses to finance their deficits.

The twentieth century has seen further innovation in payment instruments, including plastic cards and electronic transfers. These were developed primarily to improve the efficiency of payments rather than to promote expansion of trade. In most countries, central banks now play an important role in the payment system: they provide clearing and settlement facilities to banks and to other institutions that offer payment services.

### Development of trade finance

In preindustrial economies, governments borrowed to pay for wars, and seaborne trade was financed, as it had been since classical times, by so-called bottomry loans (a combination of loan and

### Box 3.2 Trade financing in Renaissance Italy

The businessmen and bankers of northern Italy's Renaissance city-states—particularly Genoa, Florence, and Venice—developed many of the fundamental practices of modern finance. Their innovations included double-entry bookkeeping and the provision of credit through discounted promissory notes. One of their most important innovations, however, was trade credit.

Suppose that a Florentine textile manufacturer received a potentially profitable order from Barcelona and had the means to fill it. Two things might keep him from accepting the business. First, the importer might not pay until he received the goods—perhaps not even until he had sold them. Meanwhile, the exporter would have to pay for materials, labor, storage, and shipment. Second, having produced and shipped his goods, the exporter would have to bear the risk that the importer might simply fail to pay. And there was no court to which the exporter could take the Barcelona merchant.

Commercial banks—that is, banks which specialize in financing commerce—came into being to solve such problems. By providing short-term finance (working capital), commercial banks enabled such merchants to pay for materials and labor in advance. They solved the second problem by having trusted agents in major cit-

ies. For a fee, the bank could pay the exporter as soon as the shipment embarked. The importer would then pay the bank's agent—adding a fee—when the shipment arrived. For an additional fee the same bank might even insure the shipment.

Over time, the Italian banks developed this vital trade-financing function. The leading Florentine banking family, the Medici, acquired agents or correspondents in Europe's trading cities and made itself indispensable in the continent's commerce. Probably in the thirteenth or fourteenth century, the bankers invented a variation that limited the degree to which their own capital was tied up over the course of the transaction. This was the "acceptance," or "four-name paper." The Barcelona agent (name 1) would sign a document "accepting" the liability of the importer (name 2) to the exporter (name 3), and the document would be conveyed to the banker in Florence (name 4). The banker would disburse (after subtracting a discount) to the exporter against this acceptance. The banker could then sell the acceptance at a discount in the Florentine financial market and thus replace most or all of the cash the bank had disbursed. After some weeks the importer would pay the agent, the agent would pay the bank, and the bank would repurchase the acceptance, concluding the operation.

insurance contract, which was repayable upon the safe completion of the voyage). Otherwise, borrowing and lending were mostly on a small scale and were limited to trade credit, short-term loans to farmers, and loans for nonbusiness purposes. The financial system comprised money changers and moneylenders and a few private bankers who dealt mostly with wealthy individuals, accepting deposits for safekeeping and providing loans. In addition, tax farmers helped to administer the tax system by collecting and transferring taxes, and various religious establishments offered their services as safekeepers.

The expansion of commerce was driven by the spread of trade fairs from medieval times and by advances in maritime technology in the fifteenth century. It led to the accumulation of large personal fortunes in Europe. Deposit banking and general and maritime insurance evolved to meet the growing needs of merchants and wealthy individuals. The creation of trading companies with special charters and limited liability gave rise to the issue and informal trading of company securities. The pace of financial development differed from country to country; the city-states of northern

Italy, for instance, made significant advances in trade finance (see Box 3.2).

Apart from granting charters to trading companies and note-issuing banks, governments promoted financial development indirectly, through the preservation of peace or the waging of wars and through their success or failure in maintaining macroeconomic stability. War finance was the spur for many of the innovations of this period—the creation of the Bank of England and other chartered banks, for example, and the issue of government bonds.

Urbanization and the capital requirements of infrastructure projects toward the end of the eighteenth century created a need to mobilize new financial resources. But the onset of the Industrial Revolution had relatively little impact on finance: the capital requirements of early industrial enterprises were small. Many owners came from prosperous trading or artisan families that were diversifying into manufacturing; such owners provided most of the capital from their own resources. Families, friends, and wealthy private investors provided the balance. Banks supplied mainly short-term working capital, which was routinely rolled

over. Even so, bankers and industrialists (foundry owners, brewers, textile manufacturers, and so on) developed close relationships, mainly through cross partnerships.

### The impact of large-scale industrialization

Financial development accelerated with the expansion of the railways and, especially, with the advent of large-scale industrialization in the second half of the nineteenth century. Advances in mechanical and electrical engineering and the increasing scale of production of electricity and chemicals meant that industrial enterprises needed more capital. This required a big change in industrial finance.

The possibility of incorporating joint-stock companies with limited liability made it easier for enterprises to attract the capital they needed to grow. Stock exchanges evolved to facilitate the issue and trading of debentures and shares. Banks and insurance companies expanded their operations. Several new types of institution were formed, including occupational pension funds and investment companies, although these were small to begin with. Savings banks, credit cooperatives, and farmer banks, mortgage banks, building societies, and savings and loan associations began to meet the financial needs of farmers, traders, savers, and homeowners, all of whom had been neglected by the commercial banks. Most of the financial institutions that we are familiar with today appeared before the end of the past century.

Different institutional structures and financial practices emerged among the industrializing countries. These have had a pervasive impact on the functioning of financial systems and have given rise to a persistent debate about the role of financial systems in promoting industrialization and economic development. But except in the United States, where chartering provisions prohibited interstate banking and prevented the emergence of nationwide banking, governments' involvement in shaping the organization of financial systems was limited to changing the legal framework to allow the creation of joint-stock banks and non-financial corporations and enacting subsequent regulatory changes to govern the operations of large corporations (see Chapter 6).

In Germany, several other continental European countries, and Japan, the banking sector became an important source of finance for industry. Banks operated as "universal" banks, engaging in both commercial and investment banking: they ac-

cepted deposits, made long-term loans, issued and underwrote corporate securities, and took equity positions in industry. Universal banking first appeared in Belgium and France, but it was more successful in Germany and Switzerland, where its introduction coincided with the expansion of technologically advanced industries. In these countries, the leading commercial banks developed close links with industry and played a crucial role in raising long-term industrial finance and promoting industrial concentration and efficiency.

In Japan, major legal and regulatory reforms were implemented after the Meiji Restoration in 1868. The aim was to modernize Japan's economy and promote industrialization. Traditional trading houses, such as Mitsui and Sumitomo, were able to develop into large banks alongside newly established banking groups. The emergence of *zaibatsu* groups—family-based conglomerates with wide-ranging interests in industry, commerce, banking, and finance—sped up economic development. Initially, leading banks within *zaibatsu* groups provided long-term finance to their partner enterprises and only short-term credit to others. Later on, as the *zaibatsu* firms became more self-sufficient financially, their banks provided long-term finance to other enterprises and in effect became universal banks like those in Germany.

In Britain, the preference of the big joint-stock banks for short-term self-liquidating investments limited their provision of long-term finance for industry. A relatively high concentration of private wealth fueled equity and bond finance, initially through informal channels but later through organized securities markets. But weaknesses in the British securities markets (and especially the use of misleading prospectuses by undercapitalized and often unscrupulous company promoters) undermined investors' confidence in new industries such as electricity and chemicals. This delayed large-scale industrialization. Traditional industries that could finance their investment from internal funds continued to prosper, however.

As noted above, chartering restrictions prevented commercial banks from developing into nationwide institutions in the United States. As a result, the New York Stock Exchange became a substantial source of finance for industry. The repayment of the federal debt after the American Civil War and the accumulation of bank balances and trust funds in New York increased the supply of investment funds. Private banks, which were allowed to operate as universal banks, maintained considerable influence well into the twentieth cen-

ture. They assisted in the formation of America's big industrial groups, as did the large New York joint-stock banks and the trust and life insurance companies. Until at least the turn of the century, leading American commercial banks operated more like German universal banks than British deposit banks, and their relations with industry were much closer than in Britain.

Stock exchanges developed from informal trading in the shares and debentures of chartered trading companies, which appeared in Britain, the Netherlands, and other countries in the sixteenth and seventeenth centuries. By the middle of the nineteenth century, stock exchanges were dominated by domestic and foreign government bonds and, to a lesser extent, by the bonds and shares of railway and other public utilities. The securities of industrial companies were relatively unimportant, except on the New York Stock Exchange. However, all the major countries had informal sources of equity and long-term debt finance for industry. Stock exchanges became a more important source of industrial finance as industry's capital requirements grew in the second half of the nineteenth century.

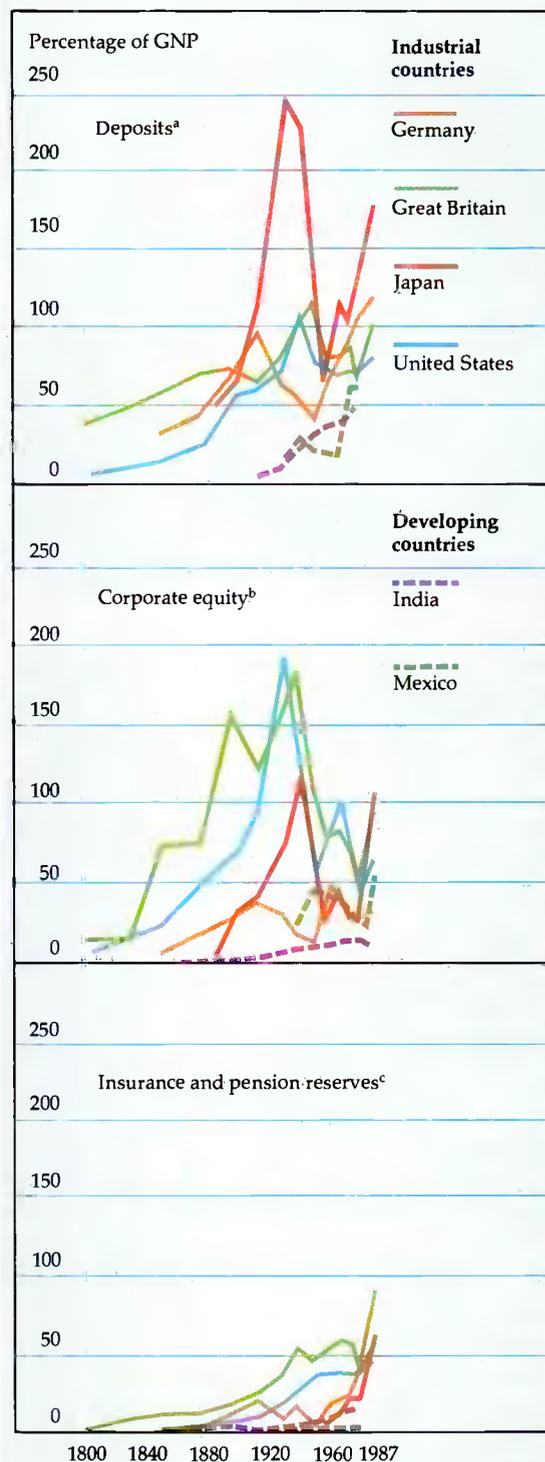
At the turn of the century, bond and equity markets were already well developed in Britain and the United States. But much like the present situation in most developing countries, the financial systems of the big industrial economies were dominated by commercial banks (see Figure 3.1). Insurance companies and other institutions accounted for only small shares of total financial assets.

### Financial crises

In preindustrial economies financial crises were usually caused by war, natural disaster, or the debasement of the currency—although in the few centuries before the Industrial Revolution, the failure of private or state-chartered banks had sometimes precipitated wider financial instability. With the growth of banking and the expansion of securities markets in the nineteenth century, however, a system's stability began to depend on the soundness of its institutions. Ways therefore had to be found to provide liquidity to institutions in distress. Bigger and more complicated loans, extended over longer maturities, increased the risks of default and fraud on both sides. This underlined the need for prudential regulation and for laws to make financial contracts easily enforceable.

Financial crises often began as speculative manias, linked as a rule to foreign conquest; discov-

**Figure 3.1 The evolution of financial assets in selected countries, 1800 to 1987**



Note: There are some differences in definitions and coverage across countries.

a. Deposits with banks and other institutions.

b. Data refer to both listed and unlisted companies.

c. Accumulated reserves with insurance companies and pension funds.

Source: For 1800–1965: Goldsmith 1985; for 1965–87: central bank reports.

### Box 3.3 Financial swindles

Swindles have taken many forms, from chain letters to wildcat banking, from penny stock scandals to insider trading. A typical swindle is the Ponzi scheme. It takes its name from Carlo Ponzi, a Bostonian of the 1920s. His idea was to lure investors by promising very high returns on the basis of a plausible but fictitious plan. He used the capital provided by latecomers to pay earlier investors. The scheme collapsed when the inflow of new money was inadequate to cover the outflow.

Few swindles are pure Ponzi schemes. Most mix genuine investment with insider trading. An early example of insider trading was the South Sea Bubble of 1720. John Bull and other managers of the South Sea Company borrowed from the company to buy its shares. As share prices rose, they made excellent profits. But to prevent the bubble from bursting, the company needed to raise capital at an accelerating rate and to see the price of its shares move continuously

upward. When the bubble burst and the share price collapsed, the directors of the South Sea Company were held in breach of trust and ordered to make good the losses of investors out of their own funds.

Penny stocks are stocks that sell for pennies but have great potential according to their promoters. Modern swindlers use telemarketing (thanks to cheap long-distance phone rates and computerized telephone dialing) to reach thousands of people. By manipulating stock prices and exaggerating the prospects of their companies, they induce greedy and gullible investors to part with their money. When investors want to sell, the promoters pressure them not to; if the investors insist, the promoters may refuse to accept their sell orders or to answer their calls. Today schemes of this kind are operated on an international scale. Swindlers are evidently part of the trend toward global finance.

eries of land, gold, and other natural resources; technological breakthroughs; or economic deregulation. Sometimes financial swindles were the cause, as in the first recorded insider-trading scandal, the South Sea Bubble of 1720 (see Box 3.3). Spectacular crises were common during the nineteenth and early twentieth centuries. In 1816 and again in 1825 banks failed in England when they were unable to redeem their notes or meet the withdrawals of their depositors. In 1857 many banks collapsed in the United States. In 1866 the failure of Overend, Guernsey, one of the largest discount houses in the City of London, caused a crisis that had extensive repercussions throughout the world. In 1873 major banking crises occurred in both Germany and the United States. In 1890, Baring Brothers, a British private bank that suffered losses from underwriting a failed issue of Argentine securities, came close to collapse. In 1931–33 a massive crisis devastated the banking system of the United States. Banks in several European countries also failed.

To contain the damage caused by such crises, central banks (notably the Bank of England and the Bank of France) developed the lender-of-last-resort facility. Initially, they acted as bankers to the government but not to other banks. Gradually, prompted by the need to provide liquidity in times of trouble, they evolved during the nineteenth century into bankers' banks. The development of the lender-of-last-resort facility was bedeviled by

the conflicting requirements of providing support to the system without bailing out imprudent or fraudulent banks.

After the Great Depression, governments in several countries introduced new regulations. The toughest measures were taken in the United States. New rules prevented banks from holding equities in industrial and commercial companies on their own account, from engaging in investment banking, and from paying interest on demand deposits. The Federal Deposit Insurance Corporation was created to provide insurance for depositors' funds, and the Securities and Exchange Commission was set up to supervise the securities markets. Coupled with continuing restrictions on bank mergers and branching, these measures constrained the growth of commercial banks, which remained fragmented and were unable to meet the long-term financing requirements of American business. Instead, these were largely met by the securities markets.

Other countries (including Canada, France, and Italy) also separated investment from commercial banking and imposed maturity controls on the lending and deposits of commercial banks. In contrast, neither Germany nor Japan (prior to World War II) prohibited universal banking, and in Britain such measures were irrelevant because the big commercial banks had specialized in deposit banking of their own accord. Germany did enact detailed prudential controls, but universal banking

continued. The big commercial banks substantially increased their involvement in industry during the 1920s and 1930s, when widespread company failures caused many debt claims to be converted into equity.

The American banking crisis of the 1930s and its impact on the Great Depression have been much debated. Some have argued that the crisis and its economic repercussions were exacerbated by the failure of the Federal Reserve System to provide adequate liquidity to stem the collapse of small banks. Others have stressed the banks' weak loan portfolios, which were concentrated in agriculture and real estate. The pattern of recent bank failures in the United States, which is quite similar to that of the 1930s, underlines the threat posed by poor loan diversification and excessive speculative financing of real estate—both of which can be attributed to restrictions on interstate banking and inadequate supervision of the banks. Recent studies have also shown that security underwriting and investment banking had little to do with the bank failures of the 1930s. The present worldwide trend toward universal banking argues for the abolition of the legal separation of commercial and investment banking. At the same time there is a growing recognition that effective prudential regulation and supervision are essential.

### **Financial systems in developing countries**

The evolution of financial systems in developing countries reflected their diverse political and economic histories. Latin American and Mediterranean countries, politically independent since at least the first quarter of the nineteenth century, suffered frequent bouts of financial instability. These prevented the emergence of mature financial systems. In contrast, developing countries in Africa and Asia, under colonial rule until the end of World War II, enjoyed relative financial stability—but their financial systems suffered from colonial neglect and stagnation.

The financial systems of most developing countries were heavily oriented toward agricultural exports, other primary production, and foreign trade. In Africa and Asia, financial systems catered principally to expatriate communities. Financial services for the indigenous populations were limited. Foreign banks confined their operations to port towns and other centers of commerce where the expatriate communities were gathered. The domestic population, especially in Asia, hoarded precious metals and jewelry. Hoarding was insur-

ance against financial emergencies caused by war, crop failure, natural disaster, and personal mishap—but it was saving denied to productive investment.

Sound banking promoted financial stability in Africa and Asia. Currency boards regulated the money supply and maintained reserves that were invested in London and Paris. The financial systems of most African countries, however, were underdeveloped until independence. They comprised a few foreign colonial banks, post office savings banks, cooperative societies, and moneylenders. Nigeria was the only African country with indigenous commercial banks before the late 1940s (see Box 3.4).

Financial development was more advanced in Asia. As in Africa, foreign banks confined their operations largely to the financing of foreign trade, but they also helped to finance internal trade. Most Asian countries also had a fairly well-developed indigenous banking system, with commercial banks, cooperative credit societies, and informal bankers and moneylenders. India, in particular, had a sophisticated indigenous banking structure. It had evolved over several centuries, developing the use of commercial bills known as *hundi* for financing nonlocal trade and relying on an elaborate system of personal relations to finance local, mostly small-scale activities (see Box 3.5).

Foreign banks operated in pre-1949 China, mostly in treaty ports, and some indigenous banks (*shansi*) remitted funds across regions and financed local trade. Foreign banks promoted foreign direct investment in railroad construction, mining, and manufacturing. They also made massive loans to the Chinese government and in the process gained control of its customs and salt revenues. Modern Chinese banks came into being in the 1930s. They had close links with the government and the ruling families and were able to seize the initiative from foreign banks and emerge as the dominant group. After 1949 China built a monobanking system typical of centrally planned economies.

Indigenous bankers and moneylenders were able to meet the borrowing needs of local traders and farmers by maintaining close personal contact with them and acquiring intimate knowledge of their operations. Their services were accessible but expensive. Informal financial institutions, such as rotating savings and credit associations (ROSCAs), also emerged in most countries (see Chapter 8). Indigenous bankers and informal financial institutions, however, could not mobilize the resources required for industrialization.

### Box 3.4 Financial underdevelopment in Nigeria

In the late 1940s, Nigeria had a population of 30 million and no more than twenty-nine bank branches. Seventeen of these belonged to the Bank of British West Africa and eight to Barclays Bank (D.C.O.). The other four were branches of indigenous banks. In addition, Nigeria had a post office savings bank, a network of credit cooperatives, and later on some development corporations. Moneylenders operated in the informal market alongside other informal institutions known as *isusu*.

Nigeria was the only country in Africa to develop indigenous commercial banks (that is, banks incorporated within the territory and owned and managed by Africans) before the late 1940s. Three indigenous banks were created in the 1930s to serve the African population, but of these only the National Bank of Nigeria survived. In the early 1950s the number of indigenous banks increased, although most of them soon failed. Then in the years before and after independence, both

colonial and local banks greatly expanded the number of branches so that by 1962 there were more than 200 commercial bank branches.

African traders believed that the colonial banks were mostly concerned with maintaining the dominance of expatriate trading houses. Understandably, colonial banks feared that loans to local traders and farmers could be risky, but their failure to mobilize savings deposits is harder to justify. Indigenous banks attracted funds from the public by offering attractive interest rates, advertising (with an appeal to nationalist sentiment), and opening branches. The expansion of banking facilities by both colonial and local banks and their success in mobilizing deposits before and after independence indicated the potential for changing the savings and financial habits of the local population—a potential that went untapped because of the colonial banks' orientation toward the expatriate communities.

### Box 3.5 Indigenous banking in India

At independence, India had an indigenous banking system with a centuries-old tradition. This system had developed the *hundi*, a financial instrument still in use that is similar to the commercial bills of Western Europe. Hundis were used to finance local trade as well as trade between port towns and inland centers of production. They were often discounted by banks, especially if they were endorsed by indigenous bankers.

Indigenous bankers combined banking with other activities, much as the goldsmiths, merchants, and shippers of eighteenth- and nineteenth-century Europe had done. They usually belonged to certain castes or communities, such as the Multanis, Marwaris, and Chettiars, and they differed in the extent to which they relied on their own resources, rather than deposits and other funds, for their lending. Indigenous bankers often endorsed hundis issued by traders and sometimes provided personal guarantees for loans from commer-

cial banks. Such bankers were collectively known as Shroffs, a term that probably originally referred to money changers but over time came to refer to the more sophisticated and influential indigenous bankers. The main moneylenders were the Sowkars (who lent to farmers from their own resources or funds borrowed from the Chettiars and other indigenous bankers) and the Pathans (who lent mainly to poor people and often resorted to intimidation to ensure repayment).

Indigenous banking was based on an elaborate and extensive network of personal relations that overcame the problems of dealing with large numbers of customers. Brokers were used for making introductions and vouching for the creditworthiness of individual borrowers but did not offer personal guarantees. Some brokers specialized in introducing indigenous bankers to commercial banks, while others brought together traders and indigenous bankers.

Throughout the nineteenth century, Latin American countries relied too much on foreign capital. Argentina and a few other countries developed active mortgage-bond markets and stock exchanges alongside thriving but fragile banking sectors. Unfortunately, however, recurring financial crises undermined attempts to develop the system adequately. Finance lagged behind the region's achievements in infrastructure, agriculture, and mining. Instability resulted from too much foreign

borrowing; the overissue of currency; imprudent domestic banking; speculation in commodity, securities, and foreign exchange markets; excess capacity in industry and commerce; regional wars; and internal political unrest. Many of these were to figure in the debt crisis of the 1980s.

Latin American economies ran for long periods with inconvertible paper money, high inflation, and depreciating exchange rates. Producers and exporters of primary commodities welcomed this;

they stood to benefit and had a strong hold on government policies. Latin American countries occasionally suspended the servicing of their external debt. Foreign lenders, however, were usually lenient, probably because the region had immense potential for profitable investment. Major international houses arranged so-called funding loans, such as the Brazilian loan of 1898, which had many features in common with the multiyear rescheduling agreements of recent years. In contrast, foreign lenders imposed strict controls on the finances of many other countries, such as China, Egypt, Greece, and Turkey. Their governments were forced to cede revenues from stamp and customs duties and from state monopolies (on salt, matches, and tobacco) until the debts were fully repaid.

International banking crises seriously affected the financial markets of Latin America and the Mediterranean countries. At the first signs of trouble, foreign banks withdrew capital by calling their loans, reducing their advances, and pressing for remittances. The financial systems of Africa and Asia were better insulated, but their economies were hit just as hard by the effect of financial turmoil on international trade.

World War I and the depression of the 1930s played havoc with the world economy. Latin American countries were particularly affected by the development of man-made raw materials and the transformation of the British Commonwealth into a protectionist bloc. Most of them defaulted on their foreign debts, but the central and other state banks that had been created in the 1920s averted the panics of earlier periods.

Before World War II, developing country governments had a poor record on financial development. In Latin America and the Mediterranean countries, they failed to create sound legal and regulatory systems and to maintain macroeconomic stability. Borrowers relied excessively on foreign capital, and financial systems were undermined by imprudence. In Africa and Asia the restricted use of bank credit, the limited spread of the banking habit, and the persistence of the hoarding habit were all legacies of colonial banking systems that had failed to reach the indigenous population.

### **Financial regulation after World War II**

After World War II, governments began to take a greater interest in the financing of high priority sectors such as industrial investment, exports, and housing. They created, or helped to create, credit

institutions that specialized in long-term finance. National investment banks or institutions, such as *Crédit National* in France and the Industrial Bank of Japan, promoted industrial development through medium- and long-term lending and equity participations. They also encouraged the use of modern techniques of lending and credit appraisal.

Direct government intervention in the financial systems of several industrial countries increased with the nationalization of large commercial banks (for example, in France and Italy) in the aftermath of the crisis of the 1930s and World War II. Public sector banks—postal savings banks, postal giro, and savings banks linked with regional and local government, as in Germany and Switzerland—also extended their reach. Special export credit institutions, such as the U.S. Export-Import Bank, supplied export finance.

Domestic and international financial activities expanded, new institutions such as leasing and factoring companies came into being, and the contractual savings institutions continued to grow. Noncommercial financial institutions, such as mutual and municipal savings banks, urban and agricultural credit cooperatives, building societies and savings and loan associations, came to play a prominent part in financing small and medium-size enterprises, agriculture, and housing. Despite mergers, competition intensified because the demarcation lines between different types of institutions were eroding and because domestic markets were opening up to foreigners. In most countries the trend toward universal banking continued: the big commercial banks moved into a variety of ancillary services, such as insurance brokering, fund management, and securities transactions (see Box 3.6).

Regulation, taxation, and the organization of social security played a significant role in shaping the structure of different financial systems. In the United States, commercial banks continued to be prevented from becoming nationwide, universal banks—although the development of bank holding companies made the restrictions less binding. At the same time, the growth of funded occupational pension schemes increased the supply of long-term funds to the securities markets. Australia, Britain, and Canada saw similar developments, although none placed restrictions on nationwide banking.

In Germany and other continental European countries, securities markets played a much smaller role in the financial system. This was be-

### Box 3.6 Universal banking

One of the most important trends in financial markets in recent years has been the spread of “universal banking.” This term has different meanings but usually refers to the combination of commercial banking (collecting deposits and making loans) and investment banking (issuing, underwriting, placing, and trading company securities). It also involves close links and extensive consultations between banks and industry. Universal banking has been criticized for threatening to concentrate excessive power among a few banks and for introducing potential conflicts of interest. Adequate regulation and supervision ought to overcome these difficulties, especially if securities markets and other financial institutions are able to compete effectively.

Universal banking began in Belgium with the *Société Générale de Belgique* in 1822. Its initial impact was rather small, but it attracted considerable attention following the creation of *Crédit Mobilier* in France in 1852. By the 1860s similar institutions had been formed in Italy and Spain, but most of these ran into trouble. Universal banking was put on a more solid basis in Germany when *Deutsche Bank* and *Commerzbank* were set up in 1870 to finance foreign trade. They were largely unaffected by the company failures in Germany before the international crisis of 1873, and after 1876 they gradually became universal banks with an extensive deposit business and close links to German industry.

The German universal banks helped to establish many large industrial companies and presided over the gradual concentration of industry in Germany. Their expanding role in industrial finance coincided with technological advances that greatly increased their clients’ capital requirements. With seats on supervisory boards and proxy voting rights on behalf of individual shareholders (who deposited their shares with the banks), they began to exercise tremendous influence.

Universal banking in Japan dates from the 1870s, when traditional trading houses such as *Mitsui* were allowed to establish joint-stock banks. It increased in importance after the emergence of the *zaibatsu* conglomerates, which had extensive interests in industry, commerce, banking, and finance. The *zaibatsu* banks became more prominent after the 1920s—although some of the most important banks of that period, such as *Yasuda* (now *Fuji*) and *Dai-Ichi*, had close links with various *zaibatus* without being formally incorporated with them.

In the United States, state-chartered commercial banks operated as universal institutions along the lines of German banks, underwriting and distributing corporate securities until the Great Depression. National banks were prevented from engaging in investment banking (although in 1927 they were allowed to underwrite corporate securities on the same basis as state-chartered banks). But by the turn of the century, the big New York banks had combined with private bank-

ers and trust and insurance companies to create large industrial trusts. Britain and France, after the failures of the 1860s, were perhaps the only countries in which the leading commercial banks specialized in deposit banking and short-term, self-liquidating lending. After the Great Depression, commercial and investment banking were legally separated in the United States, Canada, and several European countries—but not in Germany, Japan, and Britain (where functional specialization continued to be based on tradition).

Universal banking began to spread again after the mid-1960s. In Germany the large commercial banks are actively involved in investment banking and in the German stock exchanges. They provide both short- and long-term debt finance to industry, hold equity in industry (although their equity holdings are concentrated in a few large companies), and exert a strong influence on corporate affairs. Swiss and Dutch banks are similar, except that they do not hold direct equity stakes in industrial companies. In Sweden, commercial banks are authorized to act as stockbrokers, but they are not allowed to hold equity except through holding companies. In Belgium, holding companies such as the *Société Générale de Belgique* have large equity stakes in both banks and industrial companies. Many industrial countries (for example, Belgium, Britain, Canada, France, and Greece) have reformed the membership regulations of their stock exchanges to allow banks and other financial institutions to act as stockbrokers. In recent years, universal banking practices have been adopted by the large commercial banks in Britain and France, which also have considerable interests in insurance business.

In Japan, the *zaibatsu* groups were dismantled after World War II, and commercial and investment banking were legally separated. Banks exert their influence through the new industrial groups, and relations between banks and industry are close. Equity holdings are limited, but Japanese financial practice gives debt an equity-like role.

The success of universal banking seems to reflect not only the economies of scale and scope enjoyed by large and diversified financial institutions but also the importance of universal banks in monitoring corporate performance and controlling the behavior of corporate managers. With the convergence of the world’s financial systems, securities markets and institutional investors have a bigger role in Germany and Japan, and commercial banks are becoming more involved in investment banking in Britain, Canada, Japan, and the United States. Concerns about the concentration of power and conflicts of interest can be met by regulation and supervision—for example, by requiring that a separate subsidiary handle securities trading—and by the development of securities markets and other intermediaries.

cause savers sought safety and liquidity; generous social security systems organized on a pay-as-you-go basis worked to the same end. Universal banking forged closer relations between banks and industry. There were differences within Europe (in attitudes toward universal banking, for example, and in the extent of government intervention), but the common features were the secondary importance of securities markets and institutional investors and the greater influence of banks in corporate finance.

In Japan, the zaibatsu conglomerates were dismantled after World War II at the behest of the American authorities. Investment banking was separated from commercial banking, and the growth of securities markets was encouraged. However, industrial groups, although less significant than the earlier zaibatsus, grew up around the major banks and large general trading companies. They came to play a central role in the industrial reconstruction of postwar Japan and promoted close relations between industry and finance. The regulatory framework favored the provision of bank loans for industrial investment. As in Europe, the securities markets and institutional investors played relatively minor roles in the financial system.

Most developed countries used direct controls to regulate the overall expansion of credit and to influence the sectoral allocation of financial resources. Several countries put interest rate ceilings on deposits and loans and restricted the banks' branch networks. But the mix of controls and regulations varied widely. The authorities in the United States and Germany did not set credit ceilings, although they conducted selective credit policies through special institutions. Britain set credit ceilings for purposes of monetary control and used some selective credit devices, but for the most part it did not use interest rate controls or branching restrictions. France, Italy, Sweden, and other European countries all used detailed and comprehensive controls. France adopted medium-term refinancing schemes, levied special taxes on interest paid and received, and put caps on lending margins. Similar controls have been widely applied in the Francophone countries of North and Sub-Saharan Africa. Japan used interest rate and branching controls and influenced the allocation of credit to high priority sectors through the so-called "overloan" position of large commercial banks.

Many countries provided a fiscal bias in favor of long-term saving through life insurance policies and occupational pension schemes. Home ownership and housing finance benefited from generous

fiscal incentives, and specialized housing finance institutions enjoyed considerable fiscal and regulatory advantages. Since bank deposits and credits often faced ceilings or other controls, housing finance and contractual savings assumed great importance in most industrial countries.

### **Financial innovation since the 1970s**

In the late 1960s and early 1970s, high inflation and changes in financial markets undermined many of the credit and banking controls then in use. Several countries, including Britain, Canada, France, the Netherlands, and Sweden, enacted a series of wide-ranging banking reforms. These abolished the distinctions among different types of institution, relaxed both global and selective credit controls, removed branching restrictions, and liberalized interest rates on lending and wholesale deposits.

Financial deregulation was interrupted by the macroeconomic turmoil that followed the rise in oil prices in 1973. Many countries reimposed credit controls, hoping to contain monetary expansion without raising interest rates. But deregulation resumed in the late 1970s. It ranged from the elimination or relaxation of controls on credit, interest rates, and foreign exchange to the removal of restrictions on the activities of institutions and on new financial instruments. In most countries the changes were cautious and gradual. This contrasted sharply with the experience of some Latin American countries.

Deregulation was prompted by the growing realization that direct controls had become less effective over time. The growth of the Euromarkets, the development of new financial instruments, and the advent of electronic technology all made it easier to bypass the restrictions. Governments also recognized that the prolonged use of directed and subsidized credit programs would lead to the inefficient use of resources and hinder the development of better systems.

The Eurocurrency markets are markets in which assets and liabilities denominated in a particular currency are held outside the country of that currency (dollar-denominated assets held outside the United States, for example). These markets first appeared in the 1960s and have greatly contributed to the financial innovations of the past twenty years. They have regulatory and fiscal advantages—transactions are anonymous, exempt from reserve requirements, and exempt from the interest equalization tax that was imposed on foreign borrowings in the New York markets in the mid-

1960s. They speeded the international transfer of financial technology. However, one result of their growth was an excessive emphasis on the expansion of bank lending, which led in the end to the developing country debt crisis of the 1980s.

In the 1960s the main innovations of the Eurocurrency markets were revolving medium-term floating rate credit facilities and the syndication of large Eurocredits among several participating banks. Later innovations included changes in maturity patterns (very short-term Euronotes and Eurocommercial paper, and perpetual debt instruments), in pricing (floating rate notes and zero-coupon bonds), and in funding options (complex convertible bonds and bonds issued with warrants). These innovations blurred the traditional distinctions between equity and debt, short-term and long-term debt, and bank debt and marketable securities. The development of swaps brought about greater integration of markets through the international diffusion of new instruments and the opening up of national markets previously closed to Euromarket activity.

Most industrial countries have encouraged the development of government bond markets, so that they can finance their public sector deficits in a noninflationary way, and have established or revived their money markets, so that monetary and credit control can be achieved through open market operations. All this marks a considerable shift in the balance of power from governments to financial markets. In addition, equity markets have been reformed to allow commercial banks to play an active part as market makers and securities houses, and new markets with less demanding listing requirements have been created for smaller companies. Governments have used fiscal incentives to stimulate venture capital and personal investments in mutual funds and equities. Financial futures and traded options markets have been established to allow hedging against the greater volatility in exchange rates, interest rates, and equity prices that followed the move to floating exchange rates and the use of indirect methods to control money and credit.

Recent years have also witnessed a major expansion in international transactions fueled by the accumulation of insurance and pension reserves and the liberalization and modernization of stock exchanges. As in the nineteenth century, however, this expansion of capital flows has exerted a destabilizing influence on markets, because foreign investors tend to repatriate their funds in troubled times.

Effective competition in banking, especially for corporate business, has increased with the opening of domestic markets and the creation of specialized nonbank financial intermediaries. But retail banking has also become more competitive, because commercial banks are turning toward the household sector and offering new credit, deposit, and payment instruments.

Deregulation has eliminated many of the man-made barriers to global finance, and technology has lowered the barriers imposed by nature. Advances in computing, information processing, and telecommunications have boosted the volume of business by reducing transaction costs, expanding the scope of trading, and creating information systems that enable institutions to control their risk more efficiently.

Deregulation, technology, and other common trends have caused a growing convergence of national financial systems. Universal banks and specialized institutions as well as institutional investors and securities markets all now play important parts in the financial systems of most high-income countries. Nowhere is this convergence more evident than in Japan, which has successfully expanded the nonbanking segments of its financial system to the point that it now has the largest securities houses and stock market in the world, as well as the largest commercial banks, postal savings bank, and housing finance institution.

The trend of convergence has been reinforced by the vast accumulation of financial assets by both households and corporations in most high-income countries (Figure 3.1). This underscores the growing importance of the financial sector as a service industry and its shift from the mobilization and allocation of new financial savings to the management and reallocation of existing resources.

### **Current policy concerns in industrial countries**

Since the late 1970s the focus of financial regulation has also shifted. There is now less emphasis on product and price controls and more on prudential regulation and supervision. Another goal has been to promote competition. Financial systems are undoubtedly more efficient as a result. But some of the changes have caused concern in developed countries. Financial institutions are exposed to greater risks, the potential for conflicts of interest between institutions and their customers has increased, and the implications for the long-term performance of industrial and commercial corporations are unclear. The widespread distress

of deposit institutions in the United States and Norway in the 1980s underlines the growing risk exposure of financial institutions in a deregulated but inadequately supervised system (see Box 5.4 in Chapter 5).

International efforts to regulate the risk exposure of financial institutions yielded the recent agreement, under the aegis of the Bank for International Settlements, on new capital requirements for commercial banks, based on risk weights for different types of assets. In the Eurobond and Eurocredit markets, concern centers on the risks taken by banks in the pursuit of new business and on poor profitability due to fierce price competition.

Developments in the equity markets have raised different issues: insider trading, the growing number of hostile takeovers, and the methods used by corporate raiders and incumbent managements to take or retain control. Hostile takeovers may promote efficiency, but they also cause an accumulation of corporate debt and may worsen the conflicts of interest between managers, shareholders, and bondholders. There is also concern that institutional investors and corporate managers stress short-term performance at the expense of long-term efficiency. So far, however, the evidence has been inconclusive.

The next chapter will review the systems of finance in place in developing countries and assess the interventionist role played by government in the pricing and allocation of credit. Perhaps the most important lesson to be learned from the experience of the high-income countries is that the fi-

ancial decisions of private agents are also imperfect—witness the savings and loan debacle in the United States and the excessive lending of commercial banks to developing countries in the 1970s. The future is uncertain. Under any system of finance mistakes will be made. Market-based financial systems, like public ones, are subject to fraud and instability. The goal is not perfection but a system which mobilizes resources efficiently, minimizes allocative mistakes, curbs fraud, and stops instability from turning into crisis.

Governments must certainly play their part. In most high-income countries, they continue to influence the pricing and allocation of credit, but only to a modest extent. Their main concern is to regulate and supervise financial institutions and markets while maintaining a stable macroeconomic environment. The need for prudential regulation increases as financial systems become deeper and more complex. From the development of the lender-of-last-resort facility during the nineteenth century and the introduction of deposit insurance after the Great Depression to the recent emphasis on risk-weighted capital requirements and the growing adoption of regulation by function rather than by institution, a main concern of financial regulation has been the achievement of stability without undermining efficiency. But finance remains a dynamic field, changing far too rapidly to achieve a perfect balance between the freedom needed to stimulate competition and growth and the control needed to prevent fraud and instability.