

POLICY RESEARCH WORKING PAPER

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The Evolution of General Banking

Forest Capie

What have we learned about central banks?

The principal factors affecting central bank autonomy in the past two centuries have been prevailing political conditions, a laissez faire environment, and the exchange rate regime (whether fixed or floating).

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Summary findings

Institutions we know as central banks emerged or were established as commercial banks or government banks. Their evolution into central banks came with their monopoly issuing notes and their role as lender of last resort, among other functions. Carrying out commercial business on a large scale created a conflict of interest, so this practice was abandoned. Depending on government also hindered maximum performance.

Establishing the right degree of dependence was difficult, and changed in times of crisis. Independence is important: it helps to establish reputation, which is everything in banking. Independence can't be established overnight and is liable to abrupt alteration. The Great Depression, widely attributed to inept Central Bank behavior, interrupted central bank independence, but poor price behavior brought about its return. In the nineteenth century, laissez faire and the gold standard encouraged and sometimes allowed for considerable independence. After the end of the "intermission of mercantilism," which arrived with World War I, preferences changed. Crisis provoked intervention. But wartime inflation and the return of peace allowed independence to return briefly. Greater changes came in the new dirigiste environment following the Great Depression and the rise of the managed economy. In the current climate — in which market solutions are

ascendant and intervention is falling out of favor — the pendulum has swung again.

Economies in transition confront high inflation and the problem of maintaining monetary stability just as newly independent developing countries did in the 1960s. How can inflation be controlled? Under fiat regimes, the money supply is controlled by the domestic monetary authority. But can they control monetary growth? Prior and current records are not encouraging. Even if authorities have good intentions, will they be believed? Credibility, so essential to success, does not come easily.

Options include maintaining a fixed exchange rate or reviving currency boards. Currency boards function like an independent central bank, holding reserves and tying domestic currency to strong foreign currency. Such arrangements have succeeded, but most operated when sterling was strong. And most countries with currency boards conducted most of their trade with Britain, at least in sterling.

There are drawbacks to currency boards, especially for countries in transition. They require a considerable sacrifice of sovereignty, and are unlikely to appeal to countries that are only beginning to recover lost sovereignty.

This paper — a joint product of the Finance and Private Sector Development Division, Policy Research Department, and the Financial Sector Development Department — was presented at a Bank seminar, "Financial History: Lessons of the Past for Reformers of the Present," and is a chapter in a forthcoming volume, *Reforming Finance: Some Lessons from History*, edited by Gerard Caprio, Jr. and Dimitri Vittas. Copies of this paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Daniele Evans, room N9-061, telephone 202-473-8526, fax 202-522-1955, Internet address pinfo@worldbank.org. November 1995. (15 pages)

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The Evolution of General Banking

by

Forest Capie

This paper was presented at a World Bank Seminar, "Financial History: Lessons of the Past for Reformers of the Present," and is a chapter in a forthcoming volume, Reforming Finance: Some Lessons from History, edited by Gerard Caprio, Jr. and Dimitri Vittas. The author wishes to thank the participants at that seminar and the editors for their comments.

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Discussion

Different types of economists have different opinions about establishing, reforming, and reshaping central banks. Mainstream economists would first think of questions of time consistency and the trade off between inflation and unemployment in the short and long run. More quantitative economists would first construct an index of independence—one of these exercises in specific accuracy that Morgenstern warned against about forty years ago. Economic journalists in Eastern Europe would be inclined to see the Maastricht treaty as the model for the kind of reform that should take place in the European community—or at least the source of discussion on the need for reform. Economists with a more political bent would talk about the need for central banks in a democracy if the banking system is to operate effectively. And some would emphasize the importance of leadership or stress the approach to change—dramatic or gradual—that should be taken to reflect the broad consensus of views. Economists with a historical bent would think immediately of longer-term factors and of the circumstances in which institutions might be or have been effective. All of these approaches are useful, but this paper emphasizes the importance of history.

Although we are guided by historical lessons and experience, lessons from history present problems. One distinguished British historian claimed that the only lesson to be learned from history is that history has no lessons. More useful, but still short of what is required today, is the view that history teaches us to act with skepticism or at least caution. But historians are always being asked for a more precise lesson. This request produces a tension among some historians. The historian within the economic historian is content to explain events in terms of the specific factors that caused them at a

particular time. But the economist within the economic historian is always pulled toward generalization, looking for patterns. This temptation is understandable temptation, and although it may be dangerous, it is being succumbed to here.¹

The major obstacle to the successful transition to a market economy is inflation. In periods of uncertainty and difficulty the likelihood of political interference in money growth arises, which could exacerbate inflation. And inflation must be prevented. In other words, reform must lead to central banking independence. At least that's where transition begins.

This paper first defines central banks, how they came into being, and how they functioned. It then comments on how central banks have operated historically and how they should operate today. After determining when they first appeared in their modern form, the questions of why they are needed and what they require in order to perform well are addressed. Consideration of their historical development reveals the kind of tensions that have arisen given the conflicting objectives that central banks have faced.

Inflation Control

For developing or transition economies the need to reform the monetary sector derives from the danger of inflation, particularly great if the expected upheaval from transition is large. An examination of the incidence of serious inflation (inflation in excess of 100 percent per year) prior to 1950 reveals some striking features. First, there were remarkably few episodes, and most took place in the twentieth century. Second, they were all a result of monetary expansion necessitated by budget deficits. In most

¹. The good economic historian combines an alertness for the contingent with an eye on the systematic. But there is also the dictum to bear in mind, that while good history may do a little good, bad history can do a lot of harm. Keeping this in mind, I will say something about the emergence and performance of central banks and suggest policies that might be advocated at the present time.

cases the principle cause was great economic stress: the potential for civil disorder was real because the government was weak, opposing forces stronger than itself. On occasion these forces were civil wars or revolutions. The explanation behind rapid inflation is straightforward. Serious social disorder provokes large-scale spending by the government in an attempt to placate or suppress the rebellious groups.

When this kind of tension exists, public revenue falls as the disaffected section withdraws its support. The need for extra support and the shrinking of the tax base forces the government to print money to cover the budget deficit—it relies on an inflation tax. As Keynes put it in 1923, inflation is the form of taxation that the public finds hardest to evade, and even the weakest government can enforce it when it can enforce nothing else.

This evidence would suggest that the proliferation of rapid inflation after 1950 would have a similar explanation. And indeed a casual examination of the worst cases of inflation between 1950 and 1990 confirm that this stress is a common experience. Recent episodes provide further confirmation, with the worst examples coming from some parts of the former Soviet Union and former Yugoslavia.

Inflation arises not simply because of monetary expansion but because of an unsustainable fiscal position. In fiat monetary regimes, which have characterized most countries for the last quarter century, the only backing for currency is the government's commitment to a sustainable fiscal position: the stream of income from taxation is sufficient to cover proposed expenditure. In countries in transition such a commitment is difficult to provide. Furthermore, in many of the countries that we examine here, price deregulation has meant that cash flow to the central government has been cut, especially from state-operated enterprises. With few, if any, alternate sources of tax revenue and a debt market in its infancy, budget deficits widen and the danger of monetization and inflation arises. Some countries, such as Czechoslovakia, Hungary, and Poland have been able to cope with this stress quite well, but others will not.

It is this danger of inflation appearing or worsening that produces the need for monetary reform. In many of the countries that we discuss, these kinds of tensions reign, which are undoubtedly going to produce a threat of serious inflation.

A properly functioning market economy needs a stable national currency. Regardless of how the currency was stabilized, it was in place before economic growth occurred in all modern industrial countries. Reforming countries, particularly those with command economies, must establish a proper legal framework that includes a comprehensive commercial code covering the operation of the monetary sector. In particular, the code must specify the provision of the currency and therefore involve the central bank. But although the case for independence is powerful, it could have some weaknesses. It seems to me that this is a lesson that historians learn: when everybody joins the bandwagon, it may be time to reassess the logic of the bandwagon.

The Development of Central Banks

The starting point for a central bank is a banking system that is already in place—the banking system necessitates the central bank. I argue that the central bank, with very few exceptions, most notably the Bank of England, is essentially a twentieth century phenomenon and emerged in order to deal with actual or potential problems in the banking system. The Bank of England was established in 1694, but at that time there was no concept of central banking. Something close to that conception had emerged by the end of the century, and Henry Thornton probably regarded the Bank of England as a nascent central bank in the modern sense, albeit recognizing many of its deficiencies.

But some prefer to date its beginning from the time that monopoly rights of issue were established. Still others require that it have the role as the lender of last resort (and be divested of commercial interests). If we accept that all of these conditions are needed then most European central

banks of the nineteenth century were not central banks. They became central banks only in the twentieth century. By the beginning of the twentieth century there were eighteen central banks. Thereafter, the concept was so thoroughly accepted and the institutions so widely desired that many independent countries established their own central banks. By 1950 there were fifty-nine, 161 by 1990, and the number has risen subsequently.

Central Bank Operations

What is it that central banks do? Their operation can be reduced to their macroeconomic function and their microeconomic function. The macroeconomic function is to preserve the value of the currency, that is, maintain price stability. The microeconomic function is to maintain stability in the banking system. The maintenance of price stability has almost always been achieved with the same instrument: the central bank's discount rate. When the gold standard was used, the value of central bank notes was expressed in terms of their metal (usually gold) content, which the central banks attempted to maintain at stated levels over time.

The gradual replacement of the gold standard with pure fiat standards in the twentieth century recast the objective of central bank policy as maintaining price stability. Comparisons between the gold standard, classical gold standard theories, and subsequent monetary regimes showed that while none fully stabilized prices, the gold standard outperformed the others in this respect.

Central banks are also needed because of the unique nature of the banking business. Banks hold deposits that are redeemable for money on a first-come, first-serve basis. In a fractional reserve banking system there can never be a run on deposits, which could produce a collapse in the money stock. To prevent a run the bank assets should be marked to market. But it is impossible, because of the nature of

the assets, to mark them to market. Thus central banks, the provider of the ultimate means of settlement, are essential for maintaining the stability of the financial system.

Throughout the history of central banking there has been tension between their function of maintaining the value of the currency and their function as bankers to the government. Central banks have almost invariably been established by legislative charter and have been designated as bankers to the government. Governments have a natural preference for cheap finance from their own bank, particularly when there is a threat such as war. The government has both the power and the incentive to force the central bank to give priority to their immediate needs. Another tension arises in functioning as the lender of last resort, which may necessitate seeking agreement or help from the government.

Lender of Last Resort

The role of lender of last resort is at the core of the discussion of central banking. The issue is much discussed, but a lot of the discussion has either been at cross purposes or there is disagreement over how the role should be defined. Usually, the definition comes down to rescuing individual banks or providing liquidity for the market as a whole.

The difficulty in defining this role can be illustrated as follows. Any commercial bank may extend additional loans to clients who are temporarily illiquid or, possibly, insolvent. They may do so even when the expected return from the new loan is zero or negative, if the wider effects—for example, on their reputation for commitment to clients—or the "knock-on" effects of the failure of the first client on a customer justify this action. In the same way a nascent central bank may rescue some client or correspondent bank, just as a commercial bank supports its business customer. But we would not want to include such occasional, ad hoc exercises as duties of the lender of last resort. If we did, then we would have to date the Bank of England's activity to the early eighteenth century. On the other hand, a central

bank would not want to precommit to supporting a bank that was having liquidity problems. Given the development of efficient interbank and other short-term money markets, liquidity problems, if not caused by a technical problem, likely reveal a deeper problem with the bank's solvency. Consequently, an unqualified precommitment to provide assistance would generate the problem of moral hazard.

In my view the central bank fulfills the role of lender of last resort when it accepts responsibility for the stability of the banking system, which overrides any residual concern with private profitability. Thus it is the rationale for providing such support, rather than the acts themselves that determine whether the central bank has in fact become a lender of last resort.

Of course, shifts in perception are hard to date. The Bank of England's court remained divided over this issue at least until the publication of Bagehot's *Lombard Street* in 1873. And we have less insight into the transformation in other countries that have institutions founded at early dates. But we can say for sure that by about 1900 the role was widely accepted as a core function.

A similar problem arises when we turn to open market operations. The early, large commercial banks could extend or reduce their own loans and discounts and thus influence markets rates of interest or external gold flows. And they occasionally used their power to these ends. Nevertheless, this behavior did not necessarily show that bankers had a full understanding and command of open market operations. As the commercial banks in England increased in size relative to the size of the central bank, the central bank found that the market diverged from bank rates, and they worried about how to make bank rates effective.²

². Sayers (1936) shows how the Bank of England developed an understanding over a long period of how to use its open market operations.

Because at that time the central bank had a crucial interest in and indeed an overriding objective of ensuring financial stability, it would rescue the system as lender of last resort. Serving this function frequently leads to the cessation of commercial rivalry and the possibility of the need to supervise, monitor, and regulate the system. In order for a central bank to act with the necessary detachment and objectivity, it should not conduct commercial activity on a scale that would force it to compete with commercial banks. As Goodhart (1988) put it, the metamorphosis from their operation as one of many competitive profit maximizing banks to a noncompetitive, non-profit maximizing institution marked the true emergence of the central bank. Before 1900, most European central banks failed this test.

Regulation and supervision are the key microeconomic functions of central banks, acting as lenders of last resort. These regulations have almost always, perhaps always, arisen because of practice. They were frequently in place before the last resort function and are seen by some as the cause of some crises. Furthermore, because of crises, regulations are usually devised in a hurry, and are thus worse than they might have been if they had been more carefully considered.

An Independent Institution

How can these institutions meet their goals? Central bank independence is an advantage. What is independence? I define it as the right to change the operating variable without a challenge from or a consultation with government. With this definition, or any other, it is still difficult to judge the degree of independence from central bank statutes. In any event these statutes were modified frequently. Hence skepticism regarding estimated dates of independence is warranted. When the Bank of England was a private institution in the nineteenth century, it was entirely independent by any formal criteria. But Fetter shows that this independence was a fiction because the connections between the government and the bank were very strong.

Also, the question of the operating variable is seldom dealt with in the statutes. And even if such a policy was stated explicitly, it may not necessarily prevail. Thus the characterization of banks requires a fairly intimate knowledge of their structure, organization, and working practices as well as the personalities in both the bank and government.

Several studies have examined the relationship between central bank independence and inflation. Using data from 1973 to the present—a period of floating exchange rates—they found a close correspondence between independence and good price performance. A colleague and I ran the test for 1890 to 1990, during which there were several periods of floating rates and therefore much more monetary independence. Our findings confirmed the earlier results.

The Nature of Central Bank Independence.

Institutions that were founded before the nineteenth century, but were not yet central banks, were acquiring central bank functions in the nineteenth century and beginning to behave like modern central banks. Chief among these functions was the responsibility for maintaining currency convertibility under the gold standard.

In the nineteenth century the philosophy of laissez faire dominated, and central banks enjoyed greater latitude compared with earlier (and later) times. World War I brought that freedom to an abrupt end. After the war there was a desire to return to prewar status, but movement toward this end was precluded by the Great Depression, World War II, and then permanently by the rise of the managed economy. Only in recent years has the trend begun to reverse.

By around 1800 the Bank of England dominated the monetary system and held the reserves of the system. Also, there are examples of the Bank rescuing the market and individual banks. Freed from the obligation of converting its notes after 1797, the Bank was accused of being responsible for the

falling exchange rate. It rejected the idea that it had the power to influence the price level or that it had public responsibility. But the bank was clearly beginning to develop into something other than a private institution. It had many characteristics of a modern central bank and its behavior was encouraged by people like Henry Thornton. But even in nineteenth century England the situation was far from straightforward. The 1844 act may have helped, but the exact nature of the relationship between the Bank and government continued to be debated. In the financial crises of 1847, 1857, and 1866 the Bank turned to the government to intervene, in effect to allow it to break the law and suspend convertibility.

Independence was not widespread in this age of economic liberalism. For example, even the Bank of France, which claimed to have a considerable degree of autonomy, was subject to many controls from the early 1800s until the mid-1800s. The Ministry of Finance exercised considerable power. Nevertheless, there was a large degree of independence in the operation of monetary policy in France and in some other countries in the middle of the nineteenth century.

Central European experience was somewhat different because the age of economic liberalism arrived much later and didn't have a great deal of time to flourish before the end of the nineteenth century. Intervention had always been more popular in Central Europe. The story that has always been told about continental Europe derives in part from the work of Gershenkron (1965). He held that because Central European countries had industrialized relatively late and in varying degrees relative to Britain, they were forced to take actions that were not needed in Britain, which gave rise to the universal bank and the greater role of the state: the less developed the country, the greater was the need for intervention. This thesis has been challenged in recent years, particularly with respect to the contribution that universal banks have made. But it is still a useful explanation for the extended intervention. Thus these central banks, or the institutions that became central banks, had a considerable degree of independence when they were established and throughout the nineteenth century.

But when the gold standard was abandoned at the outbreak World War I, the government sought greater control of resources, and prices soared almost everywhere. The relationship between the state and central banks was then sharply defined: at times of intense crisis the state enforced its authority. World War I was a stern test of bank independence. But the war proved too stressful, and independence was abandoned. The Federal Reserve, established just before the war as an independent institution, lost its independence immediately after the United States joined the war.

After the war there was a widespread desire to return the central bank to its prewar role. Furthermore, the high inflation experienced after the war generated widespread acceptance of the dangers inherent in political interference and an equally widespread desire to make central banks independent. At the Brussels conference in 1920 a resolution was passed stating that banks, especially banks of issue, should be free from political pressure and should be run solely on the basis of prudent finance. The years leading to the Great Depression were in fact characterized by a pursuit of independence.

Independence was a powerful feature of the reconstruction scheme of the League of Nations and was also found in Latin America. The Bank of England recaptured its independent status after World War I, but after the Depression the government had a greater desire to influence interest rates. It is still difficult to disentangle the issue for the Bank of England, as it is for other central banks.

At the end of the interwar period Plumbtree wrote "one of the primary tenets of accepted central banking thought has been the importance of keeping central banks politically independent." But that view began to weaken. Many countries regarded the Great Depression (1929-33) as a consequence of central and commercial bank failure. Reform was thought to be urgently needed, an important aspect being the removal of independence. Plumbtree's view became obsolete by the middle of the 1930s, as confidence in liberal capitalism weakened.

Three factors were responsible for the loss of confidence: the worldwide drift toward socialism and intervention, the rise of Keynesian economics and economic management, and World War II and its aftermath. Governments were encouraged to again adopt interventionist policies. Many central banks were nationalized. Further, the extension of national political independence and the birth of new states in the 1940s, 1950s, and 1960s resulted in the emergence of governments that sought control over their own affairs.

Governments established central banks or took over or converted existing institutions such as currency boards. Thus from just prior to World War II until around 1970 central banking grew widely, and the relationship between government and central banks was one of relative closeness and dependence, unlike the interwar years and most of the nineteenth century.

The inflationary experience of the late 1960s to the late 1980s—during which the world, for the first time, experienced a generally peaceful period—caused by a flat money regime, again made clear the relationship between expansionary monetary policy and inflation. The view developed that if central banks were less susceptible to government pressure, they would maintain lower inflation. The desire for more independence reemerged, and now that desire is being put into practice.

Concluding Thoughts

What have we learned about central banks? The principle factors influencing autonomy in the past two centuries have been prevailing political conditions, *laissez faire*, and the exchange rate regime (fixed or floating). In the nineteenth century *laissez faire* and the gold standard encouraged and sometimes allowed for a considerable amount of independence. After what Jacob Viner called the end of the intermission of mercantilism, which arrived with World War I, preferences changed. Crisis provoked government intervention. But the wartime inflation and the return to peace allowed independence to

make a brief return. Greater changes came in the new dirigiste environment following the Great Depression and the rise of the managed economy. In the current climate, in which market solutions are ascendant and intervention is falling out of favor, the pendulum has swung again.

Where does this history lead us in terms of advising economies in transition? These economies are confronted with high inflation and the problem of maintaining monetary stability just as newly independent developing countries were in the 1960s. How can inflation be controlled? Under fiat regimes the money supply is controlled by the domestic monetary authority. But can they control monetary growth? Prior and current records are not very encouraging. But even if the authorities have good intentions, will they be believed? An essential element to the process—credibility—cannot be achieved easily.

There are several possible solutions, such as maintaining a fixed exchange rate. A prominent suggestion is to revive currency boards. Currency boards act like an independent central bank. Domestic currency is tied to strong foreign currency and all reserves are held. Historically, these arrangements have been very successful, although the vast majority operated in a period when the sterling was strong. Further, most of the countries with currency boards conducted most of their trade with Britain, or at least in sterling. It may be the case that these particular features allowed for successful functioning.

Of course, there are drawbacks to currency boards, particularly for countries in transition. Currency boards require a considerable sacrifice of sovereignty. It is therefore unlikely to appeal to countries that are only beginning to recover lost sovereignty.

What have we learned from the historical experience of central banking? Institutions that we know as central banks emerged or were established as commercial banks or government banks. Their evolution into central banks came with their monopoly over note issue and their role as lender of last resort, among other functions. There was a conflict of interest as long as they carried out commercial

business on a large scale—this practice was thus abandoned. Dependence on government was also an obstacle to achieving best performance. But establishing the optimal degree of dependence was difficult, and it changed sharply in times of crisis.

Independence is important. Among other things it helps to establish reputation, which is everything in banking. And, by definition, it can't be established or acquired overnight. Historical experience shows that independence is liable to abrupt alteration. Invariably, it was a crisis that caused it to disappear—often the outbreak of a war. The Great Depression, widely attributed to inept central bank behavior, was another cause. On the other hand, poor price performance brought about its return. So, although I would like to think that we have discovered something about central banks and the benefits of autonomy, the circumstances guiding its adoption are, to say the least, open to discussion.

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