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Financial History

Lessons of the Past for Reformers of the Present

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The environment in which financial institutions operate has changed greatly, but the history of financial development offers important lessons for today.

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Summary findings

Among the lessons financial history offers:

• Macroeconomic stability — low inflation and sound public finance — is important for creating the right incentives for banks and for facilitating the development of securities markets. High inflation and large fiscal deficits distort economic behavior in favor of short-term speculative projects and discourage the long-term investment projects conducive to sustainable economic development. Central bank independence may contribute to economic stability. One way to increase it is by lengthening the term of central bank governors.

• There must be incentives for bank owners to behave prudently — a requirement that they have capital commensurate with the risks they assume, for example. Unlimited liability and double liability limits may be less feasible now than in the past, but banks in developing countries that face higher risks should maintain higher capital ratios than banks in the more advanced OECD countries. Effective supervision is also essential.

• Banks run into solvency problems because they fail to diversify — often because of regulatory (especially geographic) restrictions, but also because of excessive connected lending or genuine mistakes. Regulators must ensure that banks diversify their risks, which means ending geographic or sectoral restrictions (including prohibitions against holding foreign assets) and restricting connected lending.

• Developing effective supervision (to ensure meaningful and effective compliance with prudential rules) is difficult and time-consuming but essential.

• The difficulty of supervising universal banks and financial conglomerates is an argument used against them in developing countries. But universal banks may generate efficiency gains as they overcome the problems of inadequate reliable public information on industrial and commercial companies. Holding small equity stakes and being involved in corporate governance may be productive. The risk of overlending to related firms is likely to be small when banks hold small stakes in industrial firms; it is high when firms control banks.

• Pension funds and other institutional investors have grown in importance in many countries over the past thirty years or so, because of longer life spans and longer retirement. These funds started as labor market institutions and personnel management tools, but have become important financial intermediaries. Pension funds offer developing countries an alternative both for restructuring their public finances and for promoting their capital markets.

Pension funds can play the role that thrift deposit institutions — such as savings banks, credit cooperatives, and building societies — played in developed countries in the nineteenth century. But thrift institutions can still contribute to financial and economic development by promoting thrift and facilitating credit in rural areas and among low-income groups. They will contribute more if they involve a three tier structure that combines the benefits of local involvement and monitoring with centralized auditing and supervision.

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. (26 pages)

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Financial History: Lessons of the Past for Reformers of the Present

by

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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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Financial systems in many developing and transitional economies are in a state of flux, in many instances emerging from periods of significant repression and more recent episodes of financial reforms, with little to show for the changes. Indeed, financial crises or more silent forms of financial distress appear to be widespread, from Argentina, Mexico and Venezuela, to many countries in Eastern Europe and the former Soviet Union, to those in Africa and parts of Asia. For a variety of reasons, financial reforms are difficult to manage, as they involve changing incentive systems and institutions. Also, finance, in particular banking, the heart of developing and transitional economies financial systems, is different from other sectors or industries, in that failures can spread in a contagious fashion from one institution to another, with deleterious effects on the rest of the economy. And, in part as an effort to cope with contagion, some or all liabilities offered by banks often carry an implicit or explicit government guarantee, creating a moral hazard problem.

In addition, a major difficulty with attempts to reform finance, whatever the initial conditions, is that the reformers virtually always take as given the goal, namely to move their financial systems towards the general model that has been adopted in most OECD countries today. This model, to the extent that one can generalize, is based on a safety net, in the form of government "insurance" for deposits, a prescribed minimum capital adequacy ratio, and government supplied supervision. Not only do these latter financial systems have unresolved problems of their own -- for example, significant banking problems in France, Japan, Scandinavia, and the United States -- but they require a rich institutional environment that cannot be transplanted overnight, or even in a few years, if

at all. In particular, the upgrading of supervisory systems to "world class" standards, without which government guarantees are dangerous, appears to be difficult and time consuming. It is also noteworthy that the prescribed capital ratios are low (8%) compared with that found in OECD countries during their industrializing period.[1]

Fortunately, the present OECD country experience is not the only one available to emerging markets today; modern banking has been in existence since the fourteenth century, and the late eighteenth century and especially the period of the nineteenth century through the 1920s are rich with experience of financial systems without much supervision or government safety net, both of which began during and following the depression of the 1930s. This period is also relevant to developing and transitional countries today, as it is the era when OECD countries were moving from a reliance on agriculture and various commodities to industrial development. Given the relevance of these earlier periods, the conference from which this paper takes its title was organized to investigate various aspects of the evolution of financial systems and to draw out lessons for emerging economies today. This paper summarizes the key lessons, including the rise of central banks, debates on how to make banking safe and sound, the relative efficiency of universal banking (compared with the Anglo-American commercial banking model), and the role of savings banks, nonbanks, and securities markets in development. The next section concentrates on the lessons that have been deduced from a review of the rise of central and commercial banking, while Section II looks at issues related to savings banks and nonbank finance.

It should be noted that this paper does not present magic cures which, if taken, alone suffice to ensure a dynamic and efficient financial system in which all deposits are safe and all loans performing. If there had been such a successful model for finance, it

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[1] For example, in the United States capital-asset ratios routinely ranged from 15% to 35% in the latter part of the nineteenth century through the 1920s (Saunders and Wilson in this volume). According to Tilly (1966) even higher ratios -- 25% to 50% -- were recorded for German banks in the period 1830 to 1900.

would be clear from country experience -- and although some observers had been quick to claim such merits for the Japanese financial system in the 1980s, the number and vociferousness of their claims have plummeted with the growing estimates of losses in that banking system. Careful examination of cross country and historical evidence can instead only lead one to conclude that recommendations for any country s financial system need to be "tuned" to the institutions and culture of the country.

That caveat notwithstanding, there are some lessons to be drawn. Perhaps the two most important factors that authorities should keep foremost in their minds in reforming their financial system are diversification and incentives. Regulators need constantly to verify that banks can and do diversify their risks, and that bank owners face incentives that will induce them to behave prudently. Although the latter is of prime importance, there are different ways of accomplishing this goal, which in turn provides the basis for some of the differences observed over time in financial systems. Many of the lessons provided below put some flesh on these quite general recommendations and elaborate their consequences.

I. On the Role of Central and Commercial Banks.

For several hundred years after the rise of banking during the Renaissance, banking systems functioned without a central bank, and these systems experienced serious inflationary and deflationary shocks associated with reserve flows, among other factors. Central banks emerged, as Forrest Capie explains in Chapter 2, to fulfill both the macro function of inflation control as well as the micro role of ensuring banking system stability. Early central banks originated as national banks that were induced to assume more of a role as a lender of last resort, and it is this function which Capie notes was an important factor leading to their divestiture of commercial banking to avoid any conflict of interest. Also, it might be noted, it is difficult enough to excel at central banking

functions, so one might suspect that central banks would perform better with fewer distractions.[2] Interestingly, transitional economies appeared to have relatively quickly separated commercial and central banking functions. However, the appearance of a move to a two-tier banking system is somewhat deceptive in economies where the central bank refinances a significant amount of credit by state owned banks, a phenomena that has been occurring in some transitional economies.

Central bank independence is much discussed currently, and Capie notes that early central banks in effect had a special source for their independence, due to the absence of the notion, which did not become popularized until the Depression and the early post-World War II era, that fiscal policy could be used to influence macroeconomic aggregates such as employment and output. Without this presumption, and with a gold standard system, the few central banks in existence -- the Bank of England and a dozen other institutions -- were able to maintain a high degree of independence.[3] Although many economists have long since concluded that changes in budget deficits will not have permanent real effects, the fact that politicians live in the short run, along with more widespread beliefs in the role of the state in providing an array of services and safety nets, has led to more regular attempts to use fiscal policy to influence macroeconomic aggregates. If authorities wish to increase the likelihood that the central bank will be able to resist pressures to accommodate future fiscal demands, then measures such as significantly lengthening the terms of central bank governors, making it difficult to remove them, etc., would all tend to give monetary policy officials the longer term view that, in effect, formerly tended to induced by the gold standard.[4]

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[2] Hammond (1956) describes how the Second Bank of the United States -- which, like the Bank of England, was a private institution -- coped with this conflict of interest during the 1812-1932 period. As is easily imaginable, it is difficult to construct an incentive system for an institution with both commercial activities and central banking functions.

[3] Of course, with a textbook gold standard, one might say that central bankers had little to do in terms of worrying about the growth of monetary aggregates. However, the gold standard was not quite an automatic text book system, as suggested by Triffin (1964).

[4] Alcazar (1995) suggests that longer terms are more effective than other methods at increasing central bank independence.

A second lesson on central banking that is of key importance to policy makers is that reforms take time. While it is fashionable to try to introduce market determined interest rates and open market operations, Capie recounted in the discussion period that the Bank of England took about 50 years to move from direct to indirect implementation of monetary policy. To be sure, as the first central bank, and the first one to make this shift, it is understandable that changes proceeded slowly. However, although this previous experience can help accelerate change in developing countries today, organizations and institutions still take time to change and acquire needed skills, such as the management of interest rate risk, and officials in particular need time to feel comfortable without direct controls. Since it is important that organizations competing in markets for funds be solvent, assuring that the participants are and likely will remain solvent will also take some time. Thus moving from direct to indirect implementation of monetary policy should be seen as a problem of financial development that will have to stretch over many years -- say a decade -- rather than a short interval -- and the lower the initial income level, the longer the expected time for this transition.

Whenever central banks are criticized for their performance, or seem incapable of improving economic outcomes and possibly worsening them, inevitably there are calls to do away with these institutions and instead adopt "free banking." This term can have many meanings. In the narrow sense, free banking means both free entry into banking and the ability of banks to issue their own paper, or notes. So conceived, free banking eliminates, or appears to deny, the need for a central bank, which is usually given a monopoly power on note issue and the ability to serve as a "gatekeeper" regarding entry into the system. The Scottish example (in the 150 years up to the Peel Act of 1844) comes the closest to satisfying the criteria for free banking, and it appears to be a successful case. Scotland during that period was a rapidly industrializing country, starting from a low level and actually overtaking England. One of the fears of removing

entry barriers in banking is that it might attract unsavory elements, or more kindly, those who are willing to engage in excessive risk-taking. Kroszner makes clear in his contribution to this volume that one important ingredient in the Scottish case was the unlimited liability of the owner of "free" banks. This feature likely led to high levels of capital to protect the personal fortunes of bank owners. True, as with any regulatory requirement, its spirit can be evaded by having a part owner who is hard to find, but if laws are in place so that this is the duty of the other owners, and that the penalty for evading the law is high, it likely would be effective in motivating owners to ensure that their bank is prudently managed.

If unlimited liability is more effective in inducing safe and sound banking, then one might expect to find lower losses and less evidence of contagion, and this is suggested by Kroszner and by Saunders and Wilson as well. Kroszner notes that the Scottish experience was not entirely without a lender of last resort (LOLR), as there were three large banks with limited liability, as well as the Bank of England (BOE) to call on in times of crisis. So although it is possible to argue that unlimited liability reduced the threat of bank contagion, the presence of these other institutions might also have been a factor. The case for unlimited liability is strengthened, however, by the fact that bank runs were more prevalent among English banks at the time, which of course had the same BOE on which they could depend as well. To be sure, adopting free banking is not an all-or-none proposition: one could still have a central bank in charge of note issuance and yet have higher liability limits and easy entry for bank owners to reap the incentive benefits.

Saunders and Wilson also reviewed higher liability limits, in the form of the double liability limits in some states in the U.S., a practice that came into existence at least in part following the experience, beginning in 1837, of free banking with limited liability (and the popular stories of "wildcat" banking). According to the double liability system, each owner was liable for a post-closure assessment of an amount equal to their

capital, which would have already been drawn on to cover losses. As Saunders and Wilson indicate, this practice led to fewer involuntary closures and more voluntary mergers, and appeared to have played an important role in insulating depositors against loss. Thus some form of higher liability limits on bank owners appears to be worth consideration in emerging markets as a way of increasing owners incentives to monitor their managers. As noted by Caprio (1995)[5], developing and transitional economies are risky environments, not just due to policy changes but even more so due to their small size. Hence, applying the same capital requirement -- in the form of the Basle guidelines, which were devised for relatively large and diversified economies -- to smaller and undiversified countries could be dangerous. Raising liability limits induces the market to set capital ratios, rather than officials, which may be convenient as it is difficult to know how high capital ratios should be raised in different economies.

It is possible that raising liability limits too high might lead to a sub-optimal supply of financial services. However, in neither the Scottish nor the U.S. case does this appear to have been a problem: both economies were the "miracle" economies of their era and as Kroszner illustrates, even with unlimited liability there was notable innovation by the Scottish free banks, including a form of option contracts.[6] Thus this drawback does not appear to be too severe, though it would be reassuring if there were more cases of higher liability limits on which a conclusion could be based. But for officials beset by financial instability and underdeveloped supervisory capacity, higher liability limits

[5] That paper also notes other methods to improve incentives facing bank owners, such as arbitrarily raising capital requirements, limiting entry to build up franchise value, free banking, and narrow banking. It should be recognized that all of these assume private owners. Joint liability, such as through participation in a clearinghouse association, would also improve private incentives. For state-owned banks, there is no clear evidence that any of these options would have an effect, as they assume owners motivated by profits.

[6] Interestingly, these option clauses represented a market solution to bank runs, in that they gave the issuing bank the right to defer payment on bank notes, so that holders would get either what they were due when they presented the note, or alternatively that sum plus interest in six months. As Kroszner notes, these options were quite popular until banned, largely at the behest of the large, limited liability banks, who were losing business, as the options made small banks notes more attractive.

appear to be a potential solution to ensuring safe and sound banking.[7] Completely free banking -- including removing monopoly of note issuance -- need not be adopted as part of the same reforms, though as more countries are willing to consider currency board arrangements, they might even consider this radical step. For now, a system of freely competing currencies appears to be an idea whose time has not yet come.

Officials intent on reforming their financial systems should keep in mind that most banks -- and banking systems --- encounter solvency problems (or bank crises) because they fail to diversify. To be sure, there are myriad reasons for such a failure, but these are usually due to regulatory restrictions, an inability on the part of bank management to plan, and connected lending. Regulatory restrictions are the easiest conceptually for authorities to correct in principle. In the United States, the battle to keep as many powers at the state level, coupled with a fear of concentrations of wealth and political power, led to the imposition of a prohibition on interstate branching, and in many states there were further restrictions limiting banks to a single branch. Calomiris (1993) has shown that branching states enjoyed more stable banks and lower losses per dollar of deposit than did unit banking states. Michael Bordo in this volume shows quite convincingly how branching restrictions led to a much larger failure rate in the U.S. than in Canada during the 1870-1980 period. Canada experienced the same shocks and was a smaller economy, yet had a much lower bank failure rate due to nationwide branching, which led to far fewer banks. Indeed, he notes that during the international business cycle contraction -- most severe in the 1870s and 1890s -- the contagion effect led to bank runs and a further contraction of output in the United States, but Canada, which was not spared the effects of international forces, did not suffer further contractionary effects due to its better insulated banking system. Having a small number of banks also facilitates the merger process when one gets into trouble, as the remaining banks can clearly see the problems

[7] The authors recognize that this suggestion may not be viewed as practical, given the trend in industrial countries away from partnerships and unlimited liability. Still, the greater risks and volatility in developing and emerging country markets may require different solutions than in the OECD economies.

they might encounter if depositors at the insolvent bank suffer losses. Thus, with fewer banks there may be a form of implicit joint liability, and Calomiris (1992, 1993) has substantiated these benefits in the case of U.S. clearinghouses, for which the joint liability feature was important.

It is likely that with the benefits of greater stability, there may be costs due to less competition. However, Canadian authorities appear to have lessened these effects by keeping their economy open. Hence, this case might be useful for small emerging markets: for many countries the small size of their economies means that even with branching, their banks will still be concentrated, but then there is little choice, if stability is desired, but to permit these banks to hold assets overseas (and to permit foreign banks to enter the domestic market). Although many observers have noted that banks tend to make losses if they stray far from their base, holding assets abroad need not mean lending there. Instead, banks in small developing countries could hold securities -- such as shares in internationally diversified mutual funds -- which would greatly limit their risk.[8] For example, Mexican banks were seriously weakened by the collapse of the peso in late 1994 and early 1995 and it is argued that the expected recession will be worse due to their weak condition. If Mexican banks had held, say, 50% of their portfolio in the form of internationally diversified mutual funds, they would be in much better condition today and would be better able to lend and thereby support a recovery. Similarly, if Japanese banks had done the same in the 1980s, they would be in commensurately better shape at present.

[8] As should always be the case, attention should be paid to asset-liability management issues. Thus banks with mostly short term deposits would need to invest in money market mutual funds holding short term, high quality treasury and commercial bills, while those with longer term liabilities could hold some medium and long term bond funds.

As noted above, banks might be undiversified due to an inability to plan, such as an unawareness of the risk covariance in their portfolio or simpleminded forecasting.[9] When asset prices or commodity prices rise, many banks have stumbled or failed because they assumed that the price rises would continue, and therefore augmented their concentration in that part of their portfolio. Or, less knowingly, they failed to understand the extent to which various parts of their loan book -- oil, land, and construction in the case of Texas banks -- were correlated. This inability to plan might be understood more as a consequence of poor incentives. If bank owners will reap a large reward from prudent bank practices, then that is the activity in which they will tend to engage. Thus Caprio and Summers (1994) argue that as banks franchise value declines, owners will invest less effort in ensuring safety and soundness, and Keeley (1990) linked the declining franchise value of U.S. banks to lower capital ratios. Again, then, there appears to be a case for making sure that banking is profitable, and in emerging markets this usually means reducing the often excessive reliance on financial intermediaries as a source of tax revenue, as well perhaps as imitating the Canadian experience.

Insufficient diversification might also be due to connected lending, in which banks lend to related businesses -- those that they own, or are owned by -- or to businesses owned by friends, family, or by those willing to pay a bribe for a loan. Even with proper regulations, history suggests that banks demand alert supervision to prevent these abuses, coupled with severe penalties in the case of transgressions. Regarding ownership links, it should be noted that banks often arose in connection with nonfinancial enterprises, such as in the case of Japan in the last third of the 19th century. However, as Packer reminds us below, as soon as these banks acquired some size, they went from cost centers to specialize on short-term trade finance and became highly profitable. They later were split off from the commercial firms and -- presumably because prudent banking was sufficiently profitable -- functioned as independent banks, some of which failed in the

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[9] One could also classify interest and exchange rate mismatches as due to an inability to plan. De Juan (1987) describes this process by which bankers descend along the path from being good bankers to bad in greater detail.

1920s but others remained quite successful. The Japanese also adopted a "hard bankruptcy" policy that suspended transactions of firms that were unable to pay their notes. Thus clear incentives matter. Also, when banks control firms -- as in Japan later in time and in Germany -- excessive lending to related firms appears to be less of a problem than when firms control the banks, as in the case of Chile during the 1970s and early 1980s[10].

Should ownership links be severed, and should banks be constrained to commercial banking narrowly defined, or is universal banking the superior model? Research has not been able to answer this thorny, long-standing debate. Kennedy (1987) argues that in response to banking crises of the mid-nineteenth century, U.K. banks retreated to develop the most efficient short term markets in the world but cut back on lending to industrial firms, whereas German universal banks continued this lending in part due to superior information and control over corporate clients, related to the banks ability to buy and underwrite securities including equity. Calomiris in this volume also shows convincingly that the German system permitted cheaper issuance of new shares than in the United States. This is an important comparison: Sylla argues below that inefficient regulation of U.S. banks -- in particular the balkanization of this industry due to limits on branching -- contributed directly to the development of U.S. securities markets, which he argues were deeper than those in the U.K. except for the period 1937-50. Yet the fact that equity issuance was cheaper in Germany gave firms in that economy an ability to expand quickly and to benefit from economies of scale, making the universal banking model attractive for newly industrializing countries.

The major drawbacks to universal banking are first, that these institutions are more complex to supervise than narrow commercial banks, and second that they permit more transactions to take place outside of open markets. The first concern is genuine, but

[10] See de la Cuadra and Valdes-Prieto (1992) on the role of conglomerate groups in the Chilean crisis.

goes to the issue of how much reliance is placed on supervision vs. incentives in trying to assure safe and sound banking. If greater primacy is placed on incentives, then the supervisory concern might be lessened. Moreover, the efficiency gains noted by Calomiris might be sufficient to outweigh these concerns. However, the second objection is more one of culture and institutions. Some societies -- often when they are relatively homogenous, or are dominated by a relatively homogenous group -- are less concerned about the potential for a build up of wealth and influence. Others, being less homogenous, are more concerned about level playing fields and avoiding undue concentrations of power. Thus these "tastes" might figure prominently in determining whether or not to adopt the universal banking route. The evidence here suggests that, if this model can be accommodated to other institutions in a country, there are some potential efficiency gains. Lastly, for developing and transitional economies in which volatility is large, allowing banks some equity ownership may contribute to faster growth, since if banks can only engage in debt finance in a high risk environment, they may retreat and do less lending than otherwise. An equity stake in their clients can (but does not necessarily) make them inside investors, with the hope that better information will offset higher volatility.[11]

To summarize, then, banking systems can be made more safe and sound by focusing on incentives facing bank owners as well as by ensuring that banks are adequately diversified. History has had some useful lessons on both counts. More radical reforms, such as free banking and higher liability limits, may be viewed as impractical in many countries, though as experience with systemic banking problems spreads and grows in importance, as it has in the 1980s and 1990s in industrial and developing economies, officials may become more disposed to return to these experiments from the past. The reform that appears somewhat more practical is to ensure

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[11] German banks own relatively little equity but have influence by being able to exercise the proxy for many shareholders for whom they (the banks) were the underwriter.

the ability of banks to diversify, and even to force this process in countries that are relatively small. Although diversification, especially when it entails sending resources abroad, can be perceived as reducing the supply of funds for local investment, the improvement in the viability of domestic financial institutions may increase the volume of savings intermediated by the formal financial system and reduce the fiscal cost of covering losses associated with bank insolvency.

Even though incentives are important for motivating bank owners and managers, banking licenses will naturally be attractive to a variety of unsavory elements, as well as to investors who will attempt to maximize short run profits notwithstanding increased risk. For this reason, improving supervision in most emerging market economies is important, especially where the existing system is geared more to a repressed regime and not a market-oriented one. Supervisory powers could be augmented by either imposing or vesting them with the ability to impose limits on bank growth, as rapidly expanding lending routinely precedes bank failure. Indeed, one could envisage a range of choices for banks: highly capitalized banks could be allowed more powers and faster growth, while banks with lower capital ratios could be constrained to slower growth and more conservative investments[12]. Authorities in very risky economies could opt for 100% reserve banking -- the so-called narrow banking model which represents the ultimate in portfolio limits -- though it may take several significant banking crises before authorities are willing to opt for this solution.

Financial systems can be made more stable also by developing savings and nonbank financial intermediaries, and it is now to the lessons from the history of these institutions that we turn.

II. Savings and Nonbank Finance

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[12] See Vittas (1992) for a discussion of growth and portfolio limits on banks.

Financial policy in developing countries, and in most developed countries until recently, has long been concerned with real or perceived gaps in national financial systems. An early and persistent manifestation of this concern related to the shortage of term finance and long-term financial markets that characterized most developing countries. Commercial banks were widely criticized for focusing on trade and working capital finance and neglecting the long-term needs of large industrial firms. In many countries, commercial banks were nationalized in an attempt to control their lending decisions, while development banks were created to channel (long-term) finance to industry.

Development banking and state ownership were institutional innovations of the twentieth century. With few exceptions, their performance was dismal as lending decisions were often based on political considerations rather than on economic criteria, loan supervision and recovery were very weak, and they also suffered from high levels of overstaffing and large overheads[13]. Moreover, their main customers were often themselves state-owned enterprises, suffering from overmanning, high labor costs, and large losses. State-owned commercial and development banks were faced with the wrong incentives and their failure to develop profitable and efficient operations resulted in a heavy tax burden on the rest of the financial system and the economy at large. In many developing countries and especially in transitional economies, tackling the financial problems of state-owned enterprises and state-owned banks seems to be a sine qua non for effective restructuring of each country's financial system.

Commercial banks were also widely criticized for neglecting the financial needs of farmers, artisans and small traders as well as low and middle income people, especially with regard to their needs for mortgage loans to finance the acquisition of houses.

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[13] World Bank (1989) contains an extensive discussion of the failure of state-owned commercial and development banks in developing countries.

Specialized thrift deposit institutions, ranging from various types of savings banks to credit cooperatives and credit unions to housing finance institutions were created, or emerged spontaneously, to fill these gaps in the financial system in the late eighteenth and throughout the nineteenth centuries in many European countries as well as in the United States and Canada.

The creation of thrift deposit institutions was often promoted by individuals of substance and high integrity who were eager to transplant ideas and institutions that appeared to work well from one country to another. Thrift deposit institutions took many different forms. Some were state-owned, e.g. the postal savings banks. Others, e.g the savings banks in Germany, Switzerland and other European countries, were set up by municipal authorities and benefitted from their tutelage and guarantee. Most were set up as mutual institutions, "owned" by their members but with limited liability. And some, e.g. the rural credit cooperatives, were established with unlimited liability among their members, a feature that endured only in communities with a more equal distribution of wealth. The types of thrift deposit institutions that prospered in different countries reflected the structure of market gaps in the respective financial systems.

Thrift deposit institutions were stronger in countries where they developed a three-tier structure that combined the local character and autonomy of individual entities with the geographic diversification, liquidity management, and auditing and control services of central regional and national institutions. In general, those that emerged spontaneously by local interests performed better than those that were created by government initiatives.

Thrift deposit institutions were an institutional innovation of the 18th and 19th centuries. Their record was in general more favorable than that of state-owned commercial and development banks. They experienced considerable growth in many

countries and came to represent a substantial share, ranging from 20 to 40 percent, of total financial assets by the mid-1970s.

The success of thrift deposit institutions can be attributed to their generally low transaction and information costs. Postal savings banks provided a convenient place for saving for the poor. Credit cooperatives and credit unions offered credit facilities to their members that avoided the high spreads charged by money lenders. Housing finance institutions developed long-term mortgage instruments that facilitated the spread of home ownership. Thrift deposit institutions relied on the simplicity and convenience of their savings facilities for attracting funds from low and middle income households, while their credit facilities benefitted from the local nature of their operations and from the peer monitoring and pressure for loan repayment that were enco''raged by the common links among their members. Savings banks played a limited part in financing industry, especially large-scale manufacturing, except for the mutual savings banks in New England, and the municipally-owned savings banks in Germany and other central European countries. Their record was mixed. Early success was followed by failure as a result of connected lending and excessive risk exposure to cyclical industrial downturns[14].

The financial fortunes of all types of thrift institutions were affected by the same gyrations as those of commercial banks. Like commercial banks, they suffered when they were faced with distorted incentives (e.g. the Savings and Loan debacle of the 1980s in the United States) and they also had their share of fraud and mismanagement throughout the nineteenth and twentieth centuries. However, they were able to prosper in

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[14] In Germany, saving banks survived to the modern era, despite their interest rate mismatch and bouts of hyperinflation, because they were supported by their municipal authorities. Despite being state-owned, they avoided a heavy politicization of their operations.

the longer run, supported by financial and political stability, and by efficient financial and legal infrastructures.

As argued by Vittas in this volume, the heyday of thrift deposit institutions in OECD countries was probably the mid-1970s. Since then they have come under increasing pressure from four main sources: changes in the size and distribution of financial wealth that imply a growing demand for pension and mutual funds, which can then meet the financial needs of housing and other markets through the use of securitized instruments; greater competition from commercial banks, which have been forced to re-orient their operations toward retail financial services; changes in transaction and information technology that have undermined the past comparative advantage of thrift deposit institutions; and changes in financial regulation that have removed the barriers between different types of financial institutions. These changes have motivated the recent trend of diversification of financial services and despecialization and the concomitant trend of "demutualization", i.e. conversion of mutual institutions into joint stock ownership.

Thrift deposit institutions were also created in many developing countries, but their record suffered from the problems caused by high inflation, negative real rates of interest, weak monitoring and enforcement mechanisms, and government interference. These factors helped to weaken and distort the incentives facing their managers, owners and customers. Loan arrears undermined their soundness and caused large failures, government bailouts, or stagnation. This sorry experience helps to underscore the importance of financial stability and sound financial infrastructure.

Could thrift deposit institutions play a big role in the future in the financial systems of developing countries? The recent changes in the technological and institutional environment facing thrift deposit institutions in developed countries suggest

that their prospects and future role in developing and transitional countries would be rather limited. In particular, their role in financing large scale industry and in providing a specialized circuit for housing finance would likely be circumscribed by the development of more efficient networks based on securities markets and institutional investors.

Nevertheless, they could still play a role in rural and retail finance, as they did in the nineteenth and early twentieth century in industrial economies. Thus, provided inflation is kept under control, postal savings banks could mobilize deposits from poorer areas where there may be few commercial bank branches. Credit unions and credit cooperatives could encourage thrift among poorer households and among farmers, artisans and small traders and they could distribute credits to these groups in countries where commercial banks have small branch networks and are unlikely to be successful in accessing these markets. But an important lesson from the experience of developed countries is the creation of three-tiered structures, consisting of local, regional and national institutions: local units operating in a small geographic area and having small membership (and thus able to monitor the performance of local borrowers and exert peer pressure for loan repayment), regional units providing liquidity, auditing and monitoring services to the local units and national entities linking these institutions with the money and capital markets and also representing their interests at the national level.

Low inflation and sound public finances are also an essential precondition for the development of securities markets. As explained by Sylla in this volume, the securities markets in the United States prospered after the restoration of sound public finances in the aftermath of the American revolution. A major funding and restructuring of US government debt, which also included the generation of secure state revenues to service this debt, caused a very large increase in its market value within the spate of a few years. The sound public finances attracted foreign capital and established the foundations for a thriving government bond market. Other securities markets followed and they were helped by the absence of restrictive regulations on the formation of corporations.

A second essential precondition for the growth of securities markets is the generation and dissemination of standardized information. The development of American securities markets lagged behind those of Britain between 1870 and 1920. Sylla attributes this to the earlier development of stock market regulation in Britain, requiring corporations to issue prospectuses and publish audited reports. During this period, American securities markets suffered from a scarcity of reliable public information and from endemic insider trading. However, during the 1930s and 1940s, the market regulation developed by the Securities and Exchange Commission and the mandated disclosure of standardized information surpassed the financial regulation imposed in Britain and contributed to the further development of American stock and bond markets.

Many developing countries try to develop their securities markets by providing tax incentives to firms to list on the stock markets, by offering tax incentives to savers to invest in long-term instruments, or by requiring banks and other financial institutions to invest in government and mortgage bonds. The experience of the United States (and other developed countries) suggests that these measures may not be necessary. Once governments set their public finances in order, establish effective regulation for information disclosure and remove tax and other obstacles to the development of markets, all they have to do is get out of the way and let the markets develop on their own.

But a major problem facing developing countries today is that it is much more difficult to set public finances in order as governments are more heavily involved in all types of expenditure programs and have large amounts of explicit and implicit liabilities that may not be as easy to restructure and downsize as was perhaps the case in the United States at the end of the eighteenth century. As already noted, governments in developing and transitional countries must tackle the problems of state-owned enterprises, including

state-owned banks and insurance companies, and must restructure their tax systems and improve the administrative efficiency of tax collection. But they must also reform their social security systems, which evolved over many years of government involvement in the provision of social pensions and are placing a heavy burden on public finances. Restructuring pension systems by downsizing the public pensions paid by social security institutions and encouraging the development of private pension funds is likely to be a major financial and political challenge, but it could have significant beneficial long-term effects on public finances and on the structure of capital markets[15].

Pension funds as financial intermediaries were not important in the nineteenth century because coverage was limited and few people lived for any significant time after retirement. Historically, pension funds initially emerged as labor market institutions, essentially as personnel management tools, at the turn of the century as large corporations needed to attract skilled workers, reward loyalty and facilitate the retirement of older workers. As discussed by Williamson in this volume, pension schemes in the United States grew to replace more traditional forms of life saving, especially "tontine" insurance, which was banned in 1906. Early pension schemes were non-contributory and unfunded, and offered no vesting and portability rights. Their actuarial cost was low because the labor force was young and firms expected to provide pensions to a small minority of loyal workers who stayed with the same firm until they reached the mandatory retirement age[16].

Over time the structure of pension funds experienced several changes. Some pension funds became contributory and this increased pressures for better vesting and portability rights. There was a also a growing need for funding by investing in

[15] The feasibility of pension reform and its beneficial effects for the capital markets has been demonstrated by Chile, which implemented such a reform in 1981. See Diamond and Valdes-Prieto (1994) and Vittas and Iglesias (1992) on the early success of the Chilean pension reform.

[16] This pattern of development was also experienced in Britain (Hannah 1986).

marketable securities, a trend that was encouraged by tax incentives, and by fiduciary standards. Coverage expanded over time, although it has never reached a universal level, as small employers have refrained from introducing pension schemes and the basic retirement needs of low income workers have been met by the development of social security pensions. A recent trend, that is fueled by basic changes in industrial structure and employment patterns, is the relative growth of defined contribution funds, that are based on individual capitalization accounts and are fully funded, fully vested and fully portable.

Pension funds are now a major force in the capital markets of many developed countries as well as a small number of developing countries that have reformed their social security systems (e.g. Chile) or avoided the creation of pay-as-you social schemes (e.g. Singapore and Malaysia). Their role as financial intermediaries has grown because their coverage has expanded, life expectancy has increased, and funding has become more widespread. However, their role in the capital markets and in corporate governance is still in its early stages of evolution. The progressive aging of the population of most developed countries suggests a bigger role for pension funds as institutional investors in the future.

Developing and transitional countries need to undertake a fundamental reform of their social security systems, to lessen the fiscal burden of unsustainable and unfunded liabilities, and to create the regulatory and financial conditions for the creation and growth of supplementary funded schemes, preferably based on full funding, vesting and portability. There is some hope based on the Chilean experience that a move in this direction will also have a favorable effect on the level of savings, in addition to increasing the supply of funds available for longer term investments.

III. Concluding Remarks

To recap, there are clearly some important lessons from the earlier history of financial development, even though the environment within which financial institutions operate is much different now.

The first lesson is the importance of macroeconomic stability, implying low inflation and sound public finances. This is important not only for creating the right incentives for banks but also for facilitating the development of securities markets. High inflation and large fiscal deficits distort economic behavior in favor of short-term speculative projects and discourage long-term investment projects that are conducive to sustainable economic development. Central bank independence may contribute to macroeconomic stability. One way to increase central bank independence is by lengthening the term of central bank governors.

The second lesson is to ensure that bank owners face incentives that induce them to behave prudently. This implies that bank owners have capital that is commensurate with the risks they assume. Although unlimited liability and double liability limits may be less feasible now than in the past, the implication is clear: banks in developing countries that face higher risks should maintain higher capital ratios than banks in the more advanced OECD countries.[17]

A third lesson relates to the need for risk diversification. Historical experience shows clearly that banks face solvency problems because they fail to diversify. Often,

[17] Caprio and Summers (1995) and Hellmann, Murdoch, and Stiglitz (1994) argue that if capital is scarce, bankers incentives can be improved by limiting entry and creating greater charter value, in the form of higher expected future profits.

this failure is due to regulatory restrictions, especially geographic restrictions. But it may also be caused by excessive connected lending or by genuine mistakes. Regulators must ensure that banks diversify their risks. This requires removal of geographic and sectoral restrictions, including removal of any prohibition to hold foreign assets. But it also requires restrictions on connected lending.

Restrictions on connected lending as well as higher capital requirements imply an important role for regulators and supervisors to ensure meaningful and effective compliance with such rules. Developing effective supervision is difficult and time consuming but is essential if prudential rules are to be enforced.

The difficulty of supervising universal banks and financial conglomerates more generally is an argument used against them in developing countries. But universal banks may generate efficiency gains as they can overcome the problems caused by the absence of reliable public information on industrial and commercial companies. Holding small equity stakes and being involved in corporate governance may produce beneficial effects. The risk of excessive lending to related firms is likely to be small when banks hold small stakes in industrial firms. In contrast, it is very high when firms control banks.

Effective supervision is also important for the development of securities markets. Apart from low inflation and sound public finances, the other major factor that explains the growth of securities markets seems to be timely and reliable public disclosure of financial information and protection of small investors and minority shareholders.

Pension funds and other institutional investors have grown in importance in many countries over the past thirty years or so, directly as a result of longer life spans and longer retirement. Although these funds started as labor market institutions and personnel management tools, they have become very important financial intermediaries.

For developing countries, pension funds offer an alternative both for restructuring their public finances and for promoting their capital markets.

Pension funds can in fact play the role that thrift deposit institutions, such as savings banks, credit cooperatives and building societies played in developed countries in the nineteenth century. But despite the changes that have taken place in the technological and institutional environment, thrift institutions can still make a positive contribution to financial and economic development by promoting thrift and facilitating credit in rural areas and among low income groups. Their contribution will be stronger if they involve a three-tier structure that combines the benefits of local involvement and monitoring with centralized auditing and supervision.

Financial reformers in developing and transitional economies can also draw lessons from the recent experience of financial systems, especially the adverse effects of the heavy politicization of the financial system that has characterized many countries in recent decades. State-ownership of banks and other financial institutions is an extreme form of politicization. This has potentially seriously adverse effects when large sections of industry are also under state ownership. In these circumstances, banks are pressured to lend to unprofitable and overbloated state companies. Restructuring and privatization of state-owned banks and industrial companies should therefore be a high priority in reforming countries. But privatization by itself is not sufficient, as suggested by the Mexican crisis of 1994-95. Developing effective and independent regulators is necessary to prevent private bankers from engaging in self-lending and excessively risky ventures and relying on government bailouts in the event of failure.

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