14.1 Introduction

This chapter examines the contributions of business historians to the analysis of comparative financial systems. Beginning with the responses of historical research to questions raised by economists, it then goes on to highlight new questions raised by the work of business historians themselves. After a short presentation of the debates among economists (Section 14.2), five topics will be discussed in an historical perspective: the role of firms' self-financing (Section 14.3), the role of external finance and the structure of its components (Section 14.4), the systemic character of cross-national variations (Section 14.5), the historical origins of national financial systems (Section 14.6), and the consequences of these differences for economic performances (Section 14.7). A short concluding section considers the problem of convergence.

14.2 Economists' Questions

Four main questions are debated among economists about banking and finance: does finance affect economic growth? Do financial systems differ from each other? What are the reasons for these differences? What are their consequences?
Concerning the first question, economists have recently reappraised their assessment. Whereas, following Joan Robinson’s views, most economists (Schumpeter excepted) have long considered financial structures as passive factors, they tend now to believe that financial development does in fact affect the development of the real economy. This shift was initiated by historians interested in the economic development of continental Europe and Japan (Cameron 1967; Gerschenkron 1962). But thereafter the paths followed by historians and economists diverged. Even though many recent historical works are sympathetic to the supply-side thesis that finance leads economic development (Sylla 1998), debates on the origins of the industrial revolution or on the decline of leading nations show that this question has not yet found a clear solution among historians. During the same period, the finance-led growth school has become increasingly influential in the economics literature.

Since the seminal work by Goldsmith (1969) first established a positive correlation between economic development and financial wealth or growth, important progress has been recorded in this field. Rigorous theoretical works have highlighted some of the channels through which the emergence of financial systems affects economic growth. The contribution of financial contracts, markets, and institutions to reducing transaction and financial costs has been broken down into a series of more basic functions (diversifying and pooling risk, producing information about possible investments and allocating resources, monitoring firms and exercising corporate control, mobilizing savings, facilitating the exchange of goods and services), each of whose influence on economic growth has been analyzed (Levine 1997). In addition, a growing body of empirical studies has investigated the problem of causality more deeply. Most of these works clearly demonstrate that efficient financial systems facilitate long-run economic growth (Rajan and Zingales 1996).

The existence or not of different kinds of financial systems is the second subject of debate. Corporate finance patterns and the structure of the financial sector vary across countries. The very nature of the financial intermediaries also differs: specialized banks are restricted either to deposit and lending activities (deposit or commercial banks) or to underwriting activities, securities trading, fund management, merger and take-over advice (investment banks); universal banks, by contrast, combine the business activities of commercial and investment banks. In addition some universal banks (ordinary universal banks) engage in commercial and investment banking but do not exercise control over non-banks while some others (privileged ones) add to these activities the exercise of non-default control over non-banks through a closer formalized relationship such as equity holding, proxy voting, and board representation. Are these differences systematic? For the period from 1950 to 1980, an abundant literature describes financial systems as either bank-based, universal, and relational or as market-based, specialized, and arm’s length. Germany and Japan head up the first group, while the United States and UK head up the second. Is this classification suitable for other countries? For a number of scholars, the answer is negative. Using net flow-of-funds data instead of balance-sheet data,

| Table 14.1 Financing patterns and financial systems around 1990 |
|----------------------|-----------------|------------------|-----------------|
| Country | Debt/equity (1980-1991) | Structure aggregate | Type of Bank |
| Switzerland | 1.75 | 1.58 | UB |
| USA | 1.78 | 1.34 | SB |
| UK | 1.48 | 1.24 | SB |
| Japan | 3.69 | 0.86 | SB |
| Canada | 1.6 | 0.82 | SB |
| Sweden | 5.5 | 0.8 | UB |
| Netherlands | 2.16 | 0.33 | UB |
| Germany | 2.7 | 0.17 | UB |
| Denmark | 0.17 | | UB |
| Belgium | 2.02 | -0.17 | UB |
| France | 3.6 | -0.17 | UB |
| Norway | 5.37 | -0.23 | SB |
| Spain | 2.75 | -0.31 | UB |
| Italy | 3.07 | -0.55 | UB |
| Greece | 0.66 | | UB |
| Finland | 4.9 | -0.76 | UB |
| Austria | 2.7 | -1.27 | UB |

Notes: Col. 1 gives the ratio of total debt/total equity (source: Demirguc-Kunt and Maksimovic 1996). Structure aggregate (col. 2) measures the size, activity, and efficiency of stock markets relative to banks (Levine 2002); the higher the ratio, the more market-oriented the financial system. UB and SB (col. 3) designate the predominance of universal banks and specialized banks during the 1990s (Fohlin 2000).

Colin Mayer, for instance, concludes that self-financing is dominant everywhere, that financing patterns do not differ very much between countries, and that those differences which can be observed are inconsistent with the classical distinction between bank-based and market-based systems (Mayer 1988).

In fact the most plausible hypothesis is that, even though the distinction between the two systems is overstylized and oversimplified, firms’ financing patterns do really differ and these differences are not unrelated to those observed in national financial systems. This is evident when the financing pattern is measured through gross financial flows or through debt-equity ratios of domestic corporations (Table 14.1). While according to the revisionist account, Germany, for instance, has the lowest leverage among the G-7 countries (along with the UK), on these measures, it clearly has a higher debt-equity ratio than the United States. Because of their dependence on bank finance, German firms figure among the most highly leveraged in the developed world; in spite of the role of bonds in their finance, US corporations, which rely more heavily on self-financing and equity issues, display the opposite pattern. More generally, where capital markets dominate the financial system, firms’ debt-equity ratio is low (as in the Anglo-Saxon countries); where bank lending prevails the debt-equity ratio is high (as
in Continental Europe). Thus, with the exception of Japan, we can conclude that the distinction between US-style market-based finance and the German-style bank-based pattern is not "inaccurate" (Hackethal and Schmidt 2004).

These differences are also consistent with the prevailing pattern of banking organization. Table 14.1 validates for 1990 the identification of universality with bank domination and specialization with market domination. The reason for this association may be that specialized banks and financial markets are unlikely to develop where universal banks prevail. Since the information acquired in the credit and deposit business is of significant value to the investment business and vice versa, universal banks enjoy important information economies of scope that lead to the crowding out of the other kinds of banks. Without the support of investment banks, financial markets are unable to develop. Financial markets will also be affected by the growing tendency for universal banks to concentrate their business on lending; not only is this activity more profitable than the provision of underwriting services, but it also generates a stream of information rents, while the information generated by underwriting business is often firm-specific and loses its value after each transaction (Dietl 1998).

In this schema, Japan is a special case since it benefits from both a well-developed financial market and a strong banking sector. The key explanatory factor is the very specific organization of its banking sector. For historical reasons, universal banks did not develop in Japan during the second half of the twentieth century. Although Japanese commercial and trust banks did not engage in investment banking activities, they did massively acquire minority equity stakes in non-banks. On the one hand, the separation of commercial and investment banking allowed the growth of an important investment banking sector and a well-developed equity market. On the other hand, banks' holding of company shares opened the door to profitable long-term investment and governance relationships with non-financial firms (Dietl 1998). Thus even though institutions and systems are often difficult to categorize crisply, strong connections can nonetheless be identified between firms' financing patterns, the predominance of financial markets versus bank lending, and the organization of the banking sector itself.

The explanation for these differences constitutes the third major area of debate. Many moncausal hypotheses have been suggested. Given the current obvious role of state policies, a number of scholars consider that the driving force behind them is the role of incumbent interest groups. Thus, for Mark Roe, it is the relative strength of political support for stakeholders that determines the respective importance of banks and markets. In Rajan and Zingales' account (2001) the incumbent interests (the landed gentry in the nineteenth century, industrialists and financiers in the mid-twentieth century) oppose financial development because it aids the entry of new classes or new firms. An increasingly influential stream of research contends that legal factors above all influence the present shape of financial systems. For La Porta et al. (1998), the legal rules governing protection of corporate shareholders and creditors explain the organization of financial systems. The basic idea is that securities are not only defined by their cash flows as in the traditional finance model of Modigliani–Miller, but are also defined by the rights they confer on their owners. Where the legal rules protecting investors and the quality of their enforcement are strong (i.e. in common law countries), financial markets are likely to develop; where the legal system is weak (i.e. in civil law countries), powerful financial institutions are needed to force firms to reveal information and to repay their debts. In a closely related approach, Holger Dietl (1998) distinguishes between the highly stylized poles of neoclassical (US) versus relational (Germany) regulation. Neoclassical regulation is based on the theoretical assumption that perfect markets efficiently allocate capital and is driven by the objective of eliminating market imperfections (such as ownership concentration, insider trading, market manipulations, etc.). Relational regulation focuses primarily on governance efficiency rather than allocative efficiency and is based on the idea that most neoclassical market imperfections far from being harmful should be considered as a means of economizing on governance costs. In this perspective, Japan is a "hybrid" model, with both relational elements (going back to the Meiji era), and neoclassical elements (introduced after World War II), which may account for both the size of its financial markets and the development of its banking system.

The relationship between financial structure and economic performance is the fourth area of debate among economists, which focuses mainly on the relative merits of bank-based versus market-based financial systems. Several competing theses have been advanced (Levine 2002). The bank-based view emphasizes the advantages of such systems in mobilizing savings, identifying good investment projects, and exerting corporate control. In contrast, the market-based view holds that such systems are better for promoting long-run economic growth because markets do a better job than banks at allocating capital and providing "key financial services that stimulate innovation." In addition, the former thesis stresses the shortcomings of market-oriented systems and the myopic investor climate generated by liquid markets, while the latter suggests that banks can inhibit innovation (by extracting internal informational rents and protecting established firms) and impede efficient corporate governance. National economic growth patterns around 1990 allow no clear conclusion, since the best economic performances can be associated with each financial system. A third thesis, which may be termed the financial services view, minimizes the relevance of the previous debate, by emphasizing the quality of services produced by the entire financial system. A fourth thesis contends that the relative merits of each financial system vary according to the context in which it operates. Since banks and markets do not always provide the same kind of services, the relative position of each type of financial institutions depends on its ability to adapt to the environment. For a number of scholars, banks outperform markets at low levels of economic development or when the financial sector is underdeveloped, while countries would benefit from finance
becoming more market-based at higher levels of wealth. According to Dietl (1998), “neoclassical capital markets are an efficient form of allocating scarce capital within immature industries” (those which need common and scattered knowledge), while relational financial systems based on universal banking would “efficiently allocate scarce capital within mature industries” (those which need common and insider knowledge).

What is the contribution of business history to these debates?

### 14.3 Self-Financing

Since the early observations by Gurley and Shaw (1955) and Goldsmith (1969), it is usual to consider that with economic development traditional sources of finance (self-financing, trade credit, credits from family, goldsmiths, scriveners, and attorneys) tend to give way first to bank-intermediated debt finance (by commercial banks, then by specialized financial institutions) and later to the emergence of equity markets as additional instruments for raising funds. In this perspective, self-financing has long been considered as a residual source (what firms can use when other sources of finance are lacking), which leads to a misallocation of capital. Self-financing is supposed to characterize situations with poorly functioning financial systems (the early stage of industrialization or periods of economic crisis) and it is expected to diminish once the development of efficient financial institutions and markets enables firms to finance their investments from external sources. New developments in microeconomic theory since the 1980s have modified this point of view. Given market imperfections (resulting in high transaction costs), self-financing is now seen as one among a series of alternative methods, the choice between which depends on a comparison of their total costs and benefits. This perspective invites us to consider self-financing as a permanent source of finance for firms, as well as to evaluate its relative efficiency (Hautcoeur 1999).

This point of view is supported by historical evidence. A diachronic approach shows that in all developed countries at any given time self-financing from retained earnings has been the main source of finance for firms. This was true for early industrializing countries during the initial stage of their development: in Britain, for instance, easy and relatively cheap entry to manufacturing production, coupled with its high profitability, allowed innovative entrepreneurs to finance the first steps of their growth from internal sources of capital. This remained the rule both in those countries that industrialized later without enduring acute conditions of economic backwardness (continental Europe and North America) and for the later stages of development in the early industrializers. A diachronic approach also shows that there were wide cyclical variations in self-financing. These variations reflect either shifts in business income (such as the contraction of gross profits in interwar Britain, aggravated by the rising level of taxation) or the intensity of the investment cycle and the ensuing gap between the level of investment and firms’ savings rate.

In the United States, for example, during the conglomerate movement of the 1960s and 1970s, financing shifted from cash to stock and then to debt. Firms’ saving rates themselves vary according to their productivity and according to the distribution of value-added between different stakeholders. If shareholders long tolerated high rates of self-financing, this has no longer been true in many developed countries since the last decade of the twentieth century. In the United States, for instance, the replacement of organizational by market control that occurred in the 1980s resulted in an increased level of payouts to shareholders of non-financial corporations (Lazonick and O’Sullivan 1997).

Whether the rate of self-financing is declining in the long run is more difficult to assess. High-quality, consistent quantitative data on self-financing are unavailable for the period before World War II. The availability of homogenous macroeconomic data does not allow us to give a correct account of its evolution. In France, for instance, the rate of self-financing declined from the early twentieth century, and in spite of a sharp revival in the 1930s and 1940s, it fell again from 1950 to 1980. Does this evolution reflect a sound tendency imputable to the diversification of financing sources, or is it rather the consequence of the shifting structure of the economy (such as the rise of sectors with massive external capital requirements) or of the changing social organization of the corporate sector (such as the development of state-owned firms with low levels of profitability and unlimited ability to borrow)? What is widely agreed is that during the last decades of the twentieth century internal financing remained the dominant source of finance in all developed countries (based mainly on depreciation and capital transfers rather than retained earnings) so that it is difficult to consider it as a residual factor.

But a synchronic approach shows that, even when we exclude the case of emerging countries where self-financing is less developed, a wide diversity of situations can be observed. During the period from 1960 to 1985, three groups of countries can be distinguished. In the first group, which includes countries with high rates of investment (United States) as well as some with lower rates (UK), self-financing is very high (equal to or higher than 100% as a percentage of fixed investment). The second group including Japan, Italy, and France is characterized by low rates of self-financing. In the third group positions are less stable. In Germany, for instance, the immediate postwar years were marked by exceptionally high rates of self-financing, compared to the pre-war era; in the succeeding period (mid-1950s–late 1960s), the strength of investment, coupled with a contraction of profits resulting from a sharp increase in wages, resulted in a decline of self-financing. Conversely, the years 1970–5 saw a revival of these rates which left German firms among the most self-financed in the world (Straus 1988).
14.4 External Finance and the Organization of Financial Intermediaries

External finance constitutes the symmetrical counterpart to self-financing. Its composition gives rise to multiple axes of differentiation among financial systems. The first is the respective share of financial markets and intermediaries. During the years 1930 to 1980 this axis matches up relatively well with the previous one: countries where firms resort more to financial markets than to intermediaries are those where rates of self-financing are high (United States, UK) while those which resort more to intermediation than to markets are those where the share of external finance is high (Japan, France, Italy). These parallels can be explained by the fact that the creation of banks active in the field of industrial finance, which is the answer to the lack of efficient financial markets, made firms less reluctant to link the level of their investment to that of their earnings.

Although these differences among countries were already visible at the beginning of the twentieth century, the two sources of external finance have evolved in parallel. Both markets and financial intermediaries expanded rapidly from 1850 to 1913–29. However this growth ended in the interwar period. During the "great reversal" of 1930–70 (Rajan and Zingales 2001) the ratio of financial activity to GDP decreased sharply in all developed countries. For financial intermediaries, it reached its trough around 1950 in most countries of Continental Europe and Japan, around 1980 in the United States, UK, and the Netherlands. In several countries of the first group (France, Japan) the ensuing jump recorded in the activity of financial intermediaries was driven by the development of an "overdraft economy" around the years 1950–80 (Aoki et al. 1994; Straus 1988). However, by 1999, in many countries (Austria, Germany, Switzerland, Anglo-Saxon countries) financial intermediaries exhibited lower levels of activity than in the interwar period. After the "great reversal", which they too experienced, financial markets recorded a slight recovery around 1960, but difficulties recurred so that it was not until the years 1980–2000 that these markets really boomed, exceeding the level of 1913–38 everywhere. Under the assumption that this evolution reflects the pattern of corporate financing, it is consistent with the general account of financial development as moving first to financial intermediaries and second to financial markets. But this evolution appears to be both recent and somewhat chaotic, not linear and ineluctable.

The internal composition of financial markets and financial intermediaries introduces further axes of differentiation. In spite of their early development in several countries (Netherlands, UK, France), financial markets long played no significant role in the financing pattern of firms. Until 1914, most securities quoted on the stock exchanges were bonds issued by states and railway companies; in 1913, bonds and stocks issued by urban utilities, mines, and industrial or commercial companies represented less than 20 percent of the securities traded on the London Stock Exchange (LSE), the largest and most international market (Michie 1999).

However the years 1880 to 1930 saw the take-off of several financial markets. The emergence of new industries, coupled with the transformation of family firms into public companies and the proliferation of mergers in developed countries, brought about a sharp increase in equity issues that reached its apogee in the 1920s. In addition, turn-of-the-century decades witnessed several financial innovations (lower denominated securities, issuance of preference shares and bonds) designed to spread the use of all kind of securities. No later than 1880–1914 these innovations allowed British manufacturing firms to diversify their sources of finance and to move away from reliance on equity to debenture capital, which increased their gearing ratio (Watson 1999), though preference capital also grew rapidly and equity remained the most important item in the capital structure of firms. The true role played by stock markets varied from one place to another: while the LSE was used to finance investments in new assets, the New York stock exchange was used mainly to transfer ownership of existing assets.

The "great reversal" stopped the switch from a market based largely on public securities to a more privately based market, but this shift recurred in the second half of the twentieth century. The stock market boom of the final decades of the century was supported by various changes among participants: in the UK, for instance, institutional investors started to participate in the market for corporate control from the late 1950s. The diffusion of stock ownership differed among countries: while in the United States the fragmentation of ownership among domestic households prevailed by 1990, in Germany and in Japan more concentrated ownership (dominated by non-financial enterprises in the first case, by financial institutions in the second) accounted for nearly one-third of total shareholdings. In spite of these developments, the role of new equity issues in firms' financing pattern should not be overestimated. Even in the United States, new equities represent only a small part of non-financial firms' financing (less than 10% of their gross finance between 1970 and 1990). The role of the stock market today is still less finance of corporate investment than liquidity creation; it is this liquidity that allows short-term savings to be transformed into long-term commitments and enables the capital market to play a significant role in corporate control.

The proportion of bonds in the financing pattern of firms also varies consistently among countries. From the 1950s onwards, bonds were important only in a small number of countries (as in the United States where their share in corporate finance exceeds that of stocks). This is not to say that bond markets are underdeveloped elsewhere; in developed countries the ratio of the nominal value of outstanding bonds to GDP usually exceeds that of market capitalization; but the bond markets either remain state-oriented as in Japan or are dominated by financial institutions as in Germany (where non-financial enterprises do not directly access primary debt
markets). Because the US bond market combines an intermediate level of state finance with a low level of finance by financial institutions, it is more oriented towards private non-financial enterprises (Dietl 1988).

The type of financial intermediary generates a number of axes of differentiation. The first is the distinction between public or semi-public banks and commercial banks.

In most countries, public banks coexist with commercial intermediaries but not in a similar proportion. Public banks include two kinds of institutions: special government banks such as mortgage institutions or industrial banks, designed to serve specific sectors; local non-profit institutions (saving and cooperative banks) designed to serve special classes of customers (small firms, craftsmen) and to collect savings neglected by commercial banks. The first group has played an important part in certain phases of financial history, especially during periods of financial distress: in Japan, for instance, the Industrial Bank of Japan (1902) was mobilized to support the stock exchanges of Tokyo and Osaka (1916), to provide assistance to a wide range of troubled industries, and to finance firms engaged in foreign investment (1918) and military production (1941) (Lazonick and O'Sullivan 1997). In France, the public institutions that channeled funds (Crédit Foncier de France, Crédit Agricole, Crédit National) have shaped the financial system in an original segmentation pattern where each institution was designed to provide privileged credits to a specific sector of the economy (Raabeau 2003).

Since the mid-nineteenth century, non-profit local financial institutions played a particularly important role in those continental European countries where

<table>
<thead>
<tr>
<th>Country</th>
<th>1913</th>
<th>1938</th>
<th>1963</th>
</tr>
</thead>
<tbody>
<tr>
<td>USA</td>
<td>81.34</td>
<td>18.66</td>
<td>81.94</td>
</tr>
<tr>
<td>UK</td>
<td>83.43</td>
<td>16.57</td>
<td>81.41</td>
</tr>
<tr>
<td>Germany</td>
<td>52.27</td>
<td>47.73</td>
<td>46.68</td>
</tr>
<tr>
<td>France</td>
<td>63.31</td>
<td>36.69</td>
<td>56.50</td>
</tr>
<tr>
<td>Italy</td>
<td>48.57</td>
<td>51.43</td>
<td>43.23</td>
</tr>
<tr>
<td>Belgium</td>
<td>64.00</td>
<td>36.00</td>
<td>64.03</td>
</tr>
<tr>
<td>Switzerland</td>
<td>90.05</td>
<td>9.95</td>
<td>91.68</td>
</tr>
<tr>
<td>Japan</td>
<td>74.79</td>
<td>25.21</td>
<td>87.63</td>
</tr>
</tbody>
</table>

Note: Thrift institutions include savings banks (private and public) and cooperative banks. In Switzerland, cantonal banks are included in the banking system. Data concerning private and public specialized credit institutions (such as mortgage banks, building societies, investment companies, insurance companies, and pension funds) are not included. Source: Goldsmith (1969).

intermediaries dominated the financial system (Germany, Italy) (see Table 14.2). In fact it is these banks, not the large private universal banks in these countries, that explain why the financial system is dominated by intermediaries. The reasons why non-profit institutions dominated the banking sector are various. In most continental Europe countries, savings banks had been launched before commercial banks so that they benefited from a first-mover advantage. In some other regions (like Catalonia), savings banks developed in response to the difficulties encountered by commercial banks (Sudria 2006). Everywhere the basic reasons were the support of the state and local authorities, the commitment of these banks to local economies, and in some cases (like Germany) the development of cooperative associations (Conti and Ferri 2004; Hardach 2004). The support of the state and local authorities was originally motivated by the goals of poverty relief (savings banks) and protection of artisans and small firms from unrestricted competition and proletarization (cooperative banks). Their effective role varied. If rural cooperatives for instance were an efficient answer to information asymmetry in the socio-economic environment of nineteenth-century Germany, they fared less well in different contexts like Ireland and southern Italy (Guinnane 1994). More generally Germany, where savings and cooperative banks operated more and more as universal banks, is a model of their good functioning. France is an opposite example since the savings collected by the savings banks have long been captured by the state for unproductive purposes, while cooperative banks after a long period of stagnation until the 1930s experienced a rapid development but to the exclusive advantage of the agricultural sector and at the expense of commercial banking (Gueslin and Lescure 1995).

Even limiting the scope of analysis to commercial banks, many axes of differentiation can be observed. The first opposes banks operating in domestic markets to those operating abroad. The development of multinational banking occurred in two historical waves (Jones 1993). The nineteenth-century wave was led by British banks, followed in steps by some other western banks (especially French, German, and Belgian). While in continental Europe foreign branches were founded by pre-existing domestic banks, British overseas banks (like the Hong Kong and Shanghai Banking Corporation) were launched first by merchant houses conducting no domestic banking; overseas banks were designed to facilitate the financing of the international business of their founders through foreign exchange and acceptance services. Except during the years 1850 to 1870, when a lot of Anglo-European banks came (ephemerally) into being, the large domestic clearing banks stood aside from overseas branching. It is not until 1911 that they actively joined this movement, and with unequal results (successful in South Africa, for instance, but not in continental Europe). Multinational banking formed a part of the large European multinational investment wave of that period; it emerged separately from more traditional international banking (i.e. foreign trade finance and cross-border lending) mainly carried out by merchant bankers (such as Rothschild or Barings in London). Although
the role of multinational banks in the conduct of international investment was
very important, it "was relatively much greater in short-term trade finance and in
foreign portfolio investment of a passive nature than in the active entrepreneurial fi-
nancing of industry across national borders" (Cameron and Bovykin 1991). Banks' role
in the economy to which capital was channeled (40% in the Western Hemisph)ere
varied according to their own geographical origin, the host economy's stage of
development (colonial empire, developing countries, and sometimes developed
countries), and the opportunities offered by the latter. As Fishlow (1985) suggests, it
may be that the efficacy of the investments was greater in "developmental borrow-
ers" (the United States, Japan, Scandinavia, British dominions) than in "revenue
borrowers" (Russia, Ottoman Empire). Foreign banks' influence on the shaping
of national banking systems was particularly strong in those countries where the
requirements for the development of banking were lacking (Brazil, China, Middle
East) (Cameron and Bovykin 1991).

Following a phase of stabilization during the interwar period, the expansion of
multinational banking revived after World War II. This second wave was now led
by American banks (in the 1960s and 1970s) and Japanese banks (in the 1980s). By
creating foreign branches, US banks initially intended to accompany the growth of
American multinational firms in Europe, but they rapidly extended the scope of
their operations to local customers and other businesses. They were pushed in this
direction by the tight regulation of financial activity in the United States. By tapping
the Eurodollar and Eurobond markets, they could alleviate the short-term financing
problems generated by US monetary policy and escape prohibitions on universal
banking of the 1934 Glass-Steagall Act (Sylla 2002). The greater openness of British
policy to international finance, coupled with the knowledge advantage of the City in
international financial services, explains why London, after a half century of relative
decline, reassessed its pre-1913 leadership.

We can also distinguish the domestic behavior of commercial banks along a
number of dimensions. At an early stage of banking development, the scarcity of
information obliged banks to operate within narrow networks. This led to
the creation of two kinds of banks: banks founded by industrialists based on
the principle of "insider lending" (with bank directors as their main borrowers),
as in antebellum New England (Lamoreaux 1994), and those created by credit
professionals and designed to finance bank outsiders, as in England and Wales
(Newton 2001). At a subsequent stage of development, legal and organizational axes
of differentiation became increasingly crucial. These oppose first unincorporated
credit houses and private bankers (such as the Rothschilds in Europe) to new joint-
stock banks working with a higher proportion of external resources and operating
under limited liability, such as the National Provincial Bank of England (1833),
the Crédit Suisse (1856), the Crédit Lyonnais (1863), or the Deutsche Bank (1870).
The main difference between the two groups was less qualitative in nature (most
of the techniques used by the new banks were well known by the older ones and
in continental Europe several joint-stock banks were founded by private bankers)
than quantitative and organizational (Lévy-Leboyer 1976). It was reflected in the
growing activity of the new banks and the constitution of the first managerial
hierarchies.

A second axis of differentiation opposes unit banks and branch networks. These
two types of banks coexist in many countries but the evidence is that while the
creation of national branch networks prevailed almost everywhere by 1913, a small
group of countries including Portugal, Denmark, Norway, and the United States
had failed to develop them. This division appeared during the last third of the
nineteenth century when, following the British example, new joint-stock banks in
continental Europe extended their branch networks. This extension, which went
"hand-in-hand" with the take-off of their deposit business, was the answer to both
the increased benefits of scale in finance and the need for bank diversification
revealed by the widespread financial crises of the period (Fohlin 2000). In the post-
World War II era, only the United States maintained its unit banking system in
many parts of the country. At the end of the twentieth century branch banking
systems prevail everywhere.

A third axis of differentiation opposes specialized and universal banks. The fact
that where one type of bank prevails the other can play only a limited role allows
us to extend this distinction between banks to a distinction between banking sys-
tems. Universality was the predominant form of banking organization during the
nineteenth century in both developed and developing countries. At the beginning
of the nineteenth century, many private unit banks operated as universal banks, and
many new joint-stock banks launched subsequently, whether they were unit banks
or not, followed this model. The first experiences of modern universal banking took
place in Belgium and in France (Société Générale de Belgique, Crédit Mobilier),
but the main successful universal banking laboratories were Germany, Switzerland,
and Austria. From these laboratories, universal banking spread over most parts of
the world during the nineteenth century including continental Europe, parts of
Latin America, and to a lesser extent even New Zealand, Australia, and the United
States. In the latter country, a number of banks as in New England had moved from
a universal (insider lending) pattern to a specialized one, but others such as the
National City Bank of New York had followed the opposite path. By 1915 the most
eminent exception to universal banking was the UK.

Most universal banks were in fact ordinary banks. In continental Europe, privi-
ileged universal banks only flourished at two moments: first, during the period
from 1840 to 1870, when railroadization, coupled with the growing incorporation
of companies, multiplied the opportunities for more intimate connections between
industrial firms and Crédit Mobilier-type banks; and second, at the turn of the
nineteenth century, when the start of the second industrialization allowed Germa-
type universal banks to accompany the growth of public utilities and new industrial
sectors. But few countries were concerned by these connections (Germany, Austria,
Belgium, France, Italy) and even there, direct equity stakes and board representation were limited to a small proportion of firms. It must be added that if German universal banks wielded greater control than British banks over firms they financed, it was more through proxy voting and supervisory board positions than equity stakes; German banks did not take greater long-term equity stakes than British ones (Fohlin 2000).

In spite of some shifts in the opposite direction (such as Faribas in France), universal banking declined in the ensuing period (1913–50). Some European banks, like the Crédit Lyonnais, had started to move in this direction during the great depression of the late nineteenth century. The disappointing economic circumstances of the interwar period increased the number of banks moving towards specialization (Belgium, Italy, Greece, the United States, Japan). However this shift lasted only a few decades and the second half of the century witnessed a renewal of universal banking; “by the 1990s, most systems had reverted to something resembling their pre-World War I state” (Fohlin 2000). Even the UK moved away from its steadfastly specialized system. By putting financial institutions of different types under the control of a bank holding company, the movement of concentration and conglomerate that has occurred in most developed countries since the 1970s created quasi-universal banking everywhere.

A final axis of differentiation arises from the way commercial banks matched the two sides of their balance sheet. If this axis is closely linked with the two previous ones, it is not an automatic consequence of them. At the outbreak of World War I, continental European banks operated with more own capital liabilities relative to deposits than those of the English-speaking world (Table 14.3). Although the gap began to diminish at the end of the nineteenth century, it was still visible in 1913. This enabled or forced the former to keep a smaller proportion of their assets in cash or money on call and to lend out a higher proportion of their funds. On this view, continental European banks can be called low-levered in terms of the ratio of deposits to own capital and high-levered in terms of the ratio of loans and investments to cash: the opposite pattern emerges for banks in the English-speaking world (Michie 2003). But if the lending policy followed by each type of bank reflects the nature of the funds on which it relies, the correspondence is not total so that liquidity differs across countries. Continental European banks maintain lower liquidity positions than their counterparts in English-speaking countries; this is consistent with the presence or absence of a dependable lender of last resort (Feiertag and Margairaz 2003). The example of the German and British banks suggests however that these differences should not be underestimated; using short-term coverage ratios rather than cash-deposit or cash-liabilities ratios, Fohlin (2001) finds that German banks were more “conservative” since they covered short-term liabilities with short-term or liquid assets at higher rates than British banks throughout the years 1883–1913, while the policy of the Reichsbank allowed them to reduce this ratio.

### Table 14.3 Banking ratios of commercial banks (1913–14)

<table>
<thead>
<tr>
<th>Country</th>
<th>Deposits/capital</th>
<th>Loans+invts/cash</th>
<th>Deposits/cash</th>
<th>Loans+invts/capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>3.31</td>
<td>40.17</td>
<td>31.33</td>
<td>4.25</td>
</tr>
<tr>
<td>Denmark</td>
<td>3.30</td>
<td>32.93</td>
<td>26.03</td>
<td>4.17</td>
</tr>
<tr>
<td>Finland</td>
<td>4.55</td>
<td>39.42</td>
<td>33.54</td>
<td>5.34</td>
</tr>
<tr>
<td>France</td>
<td>4.46</td>
<td>11.79</td>
<td>10.43</td>
<td>5.04</td>
</tr>
<tr>
<td>Germany</td>
<td>3.17</td>
<td>21.32</td>
<td>16.98</td>
<td>3.97</td>
</tr>
<tr>
<td>Hungary</td>
<td>5.32</td>
<td>56.71</td>
<td>48.82</td>
<td>6.18</td>
</tr>
<tr>
<td>Italy</td>
<td>3.48</td>
<td>16.85</td>
<td>13.91</td>
<td>4.21</td>
</tr>
<tr>
<td>Netherlands</td>
<td>2.34</td>
<td>23.68</td>
<td>17.13</td>
<td>3.23</td>
</tr>
<tr>
<td>Norway</td>
<td>5.45</td>
<td>51.05</td>
<td>44.47</td>
<td>6.26</td>
</tr>
<tr>
<td>Sweden</td>
<td>3.13</td>
<td>35.89</td>
<td>28.07</td>
<td>4.00</td>
</tr>
<tr>
<td>Switzerland</td>
<td>4.99</td>
<td>64.93</td>
<td>55.53</td>
<td>5.83</td>
</tr>
<tr>
<td>UK/EU</td>
<td>10.71</td>
<td>2.99</td>
<td>3.71</td>
<td>8.62</td>
</tr>
<tr>
<td>Canada</td>
<td>5.73</td>
<td>6.24</td>
<td>5.40</td>
<td>5.56</td>
</tr>
<tr>
<td>USA</td>
<td>5.06</td>
<td>6.21</td>
<td>6.04</td>
<td>5.21</td>
</tr>
<tr>
<td>Argentina</td>
<td>2.56</td>
<td>2.94</td>
<td>2.87</td>
<td>2.62</td>
</tr>
<tr>
<td>South Africa</td>
<td>6.19</td>
<td>5.36</td>
<td>5.63</td>
<td>5.90</td>
</tr>
<tr>
<td>Australia/NZ</td>
<td>5.13</td>
<td>2.39</td>
<td>2.93</td>
<td>4.19</td>
</tr>
</tbody>
</table>


### 14.5 From the Financing Pattern of Firms to National Financial Systems

Do these different sources of finance create distinct national financial systems as they appeared to do between 1950 and 1980? An answer is difficult to provide because of the lack of data concerning firms’ financing patterns and the low quality of data concerning the structure of the financial sector in each country.

Let us first consider the structure of the financial sector. For Rajan and Zingales (2001), who collected data on the financial sector going back to 1913, the distinction between continental European and Anglo-American countries does not hold for the nineteenth century. In 1913 the market capitalization of firms in Belgium, Austria, and France was close to that of the UK and far ahead of the United States; the distinction between the two groups of countries would thus be a past-World War II phenomenon. However this conclusion is in line neither with the strong opposition visible in 1913 between continental Europe and Anglo-American countries in terms of the level of banking development, as measured by Rajan and Zingales themselves, nor with the data collected by Goldsmith (1985): when measured as a proportion of
financial assets, the market value of US and British stocks is double that observed in most European countries. The share of financial institutions in total financial assets shows the reverse position, so that it is a legitimate assumption that banks played a more important part in continental Europe and in Japan than they did in the United States and UK. "The conclusion from this evidence is that there are long-standing and fundamental differences between the financial systems in place in different countries" (Michie 2003).

Second, if we look at the banking system, we observe that in spite of considerable changes, such as in the level of concentration (Pohl et al. 2001), the prevailing pattern of universality versus specialization was in 1913 exactly the same as in 1990. In spite of the major shifts that occurred during the "great reversal", all banking systems had reverted to their original path.

But, third, the connection between the two previous factors seems to be less strong before World War I than in the 1980s. In 1913, the rule that identifies universality with bank domination and specialization with market domination suffers from some exceptions. In many countries (Belgium, Germany, Austria, and even in France where the process of bank specialization was not completed) large universal banks are associated with active capital markets. This undermines the alleged identification of universality with bank domination. The association between universal banking and financial market maturity can be explained by the fact that, at a certain stage of development, as during the years 1850 to 1913, financial intermediaries and markets are complementary rather than competitive with one another. On the one hand, markets add a dimension that banks are not able to provide (as in the financing of railways). On the other hand, the role of the securities markets is not confined to raising capital. The fact that securities were easily transferable made them money-market instruments so that they became an essential component of the global financial system. They were used by the banks themselves. Where banks were highly geared in terms of deposits (UK, United States), banks were attracted to the securities markets, since they obtained a return and maintained liquidity; in addition they provided loans to money-market participants. Where banks were less highly geared (Germany, Japan), banks had a vested interest in building up a market for the securities that they received as collateral from their customers (Michie 2003). The financial crises of the middle decades of the nineteenth century highlight the advantages that banks could draw from the existence of well-developed financial markets.

More precise assessments of the existence of distinct national financial systems require us to broaden the scope of analysis. At the first level of the financial systems, local and fragmented markets have long captured a predominant share of the total business. During the eighteenth century, France's lending system was organized around notaries, not around banks and public markets as in other countries (Hoffmann et al. 2001); although this system was declining after the Revolution it remained very active, especially in periods of financial difficulties. Taking local banks into account also reveals unexpected segmentations. While in Britain the disappearance of local banks resulted in a functional segmentation of the banking system between large specialized banks, and in Germany or Italy the segmentation was between large universal for-profit banks and non-profit local universal institutions, in France by 1913 the segmentation was between large for-profit banks on the path to specialization (the British model) and local universal banks (the German model) belonging (in contrast with Germany) to the for-profit sector (Lescure and Plessis 1999). The role of trade credit is another terra incognita. Yet, in some countries as in France, this still represented a major component of the firms' financing pattern, related in this case to the important part played by bill discounting services (Plessis 2002).

At the upper level of the financial system, the role of the state as a direct or indirect source of finance should be more deeply scrutinized especially for the central period of the twentieth century when other sources were lacking. In 1949, the state financed 60 percent of the gross formation of fixed capital in France, compared with 50 percent in Belgium, 40 percent in Italy, and 30 percent in the UK. Even after the withdrawal of direct financing, the French state effectively controlled 50 percent of the financing of investments between 1948 and 1965 through the "Treasury circuit", credit policy, and banking regulation (Quennouëlle-Corre 2005). This unorthodox system was the consequence of a political consensus that a strong intervention of the state was needed to assure the country's modernization (Margaritza 1991).

### 14.6 Determinants of Variations in National Financial Systems

Previous analyses show how inappropriate are some of the monocausal explanations currently proposed to account for cross-national differences in financial systems. Why for instance in 1913, with similar levels of wealth, did certain civil law countries like Belgium and France have better-developed financial markets than some common-law ones like the United States? Obviously the low quality of legal protection provided to small shareholders in the former did not prevent financial markets from developing. Why did countries like the United States and UK with the same legal tradition and well-developed financial markets have such different banking systems during the second half of the twentieth century? Financial history suggests the influence of a lot of other determining factors.

Some of these are historical in nature and emphasize either the conditions of economic development or of state formation. According to Gerschenkron (1962) it was the relative backwardness of those countries which developed after the UK that called universal banks into existence as compensatory institutions. Not only did these countries need to base their development on more capital-intensive technologies than early-industrialized nations, but they also had to compensate...
for the scarcity of capital, the unreliability of information, and the weakness of entrepreneurship. In this unfavourable environment, the role of universal banks was to channel resources into industrial investment through processes of transformation, and to provide client firms with valuable information and strategic advice. In this perspective, it is the demand-side variables (the asset side of the banks) that determine the structure of the banking system. The strong relationship between financial institutions' structure and growth during the period 1880–1913 and previous economic developments supports Gerschenkron's view that the moderately industrial economies of the time relied more heavily on banks to mobilize capital than more or less developed countries while more developed countries were more market-oriented (Fohlin 2000).

In Forsyth and Verdier's account (2003), by contrast, it is supply-side variables (the banks' liabilities side) that shape the banking system and the historical determining factors are not economic but political in nature. Where the state encouraged the fragmentation of the capital market (by promoting saving and cooperative banks) and hence prevented commercial for-profit banks from capturing a substantial share of the national deposit market, the latter were obliged to combine investment with deposit banking activities; as banks were forced to rely on their own costly resources they could not abandon the field of investment banking. Where the capital market was unified and centralized, commercial banks were able to capture a large part of the national deposit base and thus to concentrate on short-term lending. These differences are claimed to reflect two lines of political cleavage, a socio-economic one (large firms versus farmers, Mittelstand) and a territorial one (center-periphery). Although quantifiable factors (such as government centralization during the years 1880–1913) provide greater power in explaining (negatively) the later development of national capital markets than the structure of banking systems (Fohlin 2000), several individual country histories (e.g. Germany and Italy: see Deeg 2003; Polsi 2003) support the view that the existence of a strong agricultural periphery and the presence of powerful local non-profit institutions created the right conditions for the development of universal banks.

The major interest of these theses, whose effects on financial systems may complement each other, is to shed some light on the initial conditions of financial development. However they explain only a part of comparative financial history. A broader explanation must take into account the multiform role played by the state. The overall influence of the state is first visible during the decades that witnessed the formation of the financial system (the end of the eighteenth and the nineteenth centuries), since the conditions required for an early well-functioning capital market also depended on the process of state formation. The development of financial markets in the Netherlands, Britain, and France was the result of an early financial revolution establishing widespread confidence in the public debt and the principle of free capital markets; conversely in Germany the failure to deeply reform public finance resulted in a stunted financial market that encouraged the development of universal banks (Jonker 2002). Second, the role of the state was also visible through the regulations established during the domination of laissez-faire financial regimes. The Bubble Act of 1720 and the monopoly of the Bank of England over limited liability banking may have kept English banks small and conservative until 1825, while after its removal, the absence of a reliable lender of last resort may have increased banks' reluctance to engage in risky transformation of short-term deposits into potentially illiquid assets. Similarly US legislation, by prohibiting banks from branching across state lines (a legislation that became federal in 1927) and prohibiting interlocking boards of directors (the Clayton Act of 1914), prevented banks from accomplishing the growth of the non-financial sector and restricted their ability to operate as universal banks.

Third, the role of regulatory factors increased in the following period (1930–60); given the tendency of laissez-faire financial regimes toward instability, new financial regulations were elaborated that explain, along with the interwar economic crisis, the shifts in financial developments during the "great reversal" (the weakening of the financial system and the withdrawal from universal banking). In many countries (Belgium, Greece, Italy, Japan, the United States, and later France), the state enacted legislation designed to prohibit full-scale universal banking. In addition, several countries passed legislation aimed at imposing restrictive rules on the development of commercial banks. In United States, the restrictive Banking Acts of 1933 and 1935 aimed at limiting the scope of banking by discouraging mergers and branching. In France, the legislation passed in 1941–8 (including the nationalization of the main commercial banks in 1945) imposed severely restrictive rules on the development of these banks. Germany followed an opposite path since the regulations established in 1931 and 1933 introduced corporatist organization into the banking system, while the US occupying authorities failed to impose a US-style financial system. By contrast with the variety of state actions undertaken in the United States to improve the efficiency of financial markets, the German tax system stunted the development of equity markets while a corporatist bond committee controlled access to bond markets. Through restrictions on banking activity initiated in the 1920s and state control of all securities issues and lending decisions above a certain amount from 1937, Japan moved from an economy enjoying both a competitive banking system and a developed financial market to an economy with a dynamic but concentrated banking system and a small financial market. The Japanese state believed that it could better control capital allocation if funds were channeled through banks; not only did the main bank system by which each munitions company was assigned a major bank give them a prominent role, but, through their control of the Bond Committee, financial institutions stifled the flourishing bond market and replaced it by banking loans. In spite of the US efforts to break up this system, it was to continue until the breakdown of the Bretton Woods Agreement gave a new impetus to international capital flows.

Fourth, it is a new shift in regulatory regimes that explains the revival of universal banks in the final decades of the twentieth century. The US Gramm–Leach–Billey
Act of 1999 that abolished the separation of banking and securities industries put the finishing touches to a legal evolution that began in other countries during the 1950s and 1960s.

Fifth, from the interwar period onwards, the state's influence was not limited to its policies for promoting financial stability. It came also through the way the welfare state organized labor regulation, including welfare regimes. The fact that Germany and Japan have bank-based financial systems is related to their choice of solidaristic retirement systems: the absence of funded pensions, coupled with the relative high income equality (one consequence of the industrial relations in these countries), limits the demand for marketable securities. If the United States is market-oriented, it is also because it has a higher level of income inequality and has opted for an individualized retirement system, which has stimulated the development of a large-scale capitalized private pension system (Vitols 2001).

Financial systems are the result of a lot of different forces and the way these forces interact vary according to the context in which they operate. No historical process that occurs in a given country can be directly reproduced elsewhere. But given the observable strength of path dependency one must be very attentive to the early conditions of financial development itself. Whatever the origins of such precedence (state formation or the timing of industrialization), some countries were early in developing fully-fledged financial markets, while others with small and imperfect markets experienced first the emergence of large (universal) banks (Jonker 2003). In the first case, markets stood from the start at the core of the financial system and it is their development that determined the role played by the banks; in the second case it is the banks which were the driving force (Michie 2003).

In Britain the competition of active financial markets forced banks to concentrate on facilitating payments and short-term credits and to specialize more and more: in Germany the advance of the Berlin universal banks and the internalization of the securities market through their control over underwriting, trading, brokerage, and stock-exchange supervision hindered the development of the capital market (Deeg 2003). Once the hierarchy between banks and markets has been established, only exceptional events, such as war or economic and social crises, could modify the evolutionary path.

### 14.7 Financial Systems and Economic Performance

By contrast with the economics literature, historical research has focused more on the real effects of the various types of banks than on the differences between banks and markets in the allocation of capital. Among historians the debate has long been conducted within a strict comparison between universal banks of the German type and specialized banks of the British type, centered on the period 1880–1913. While German banks were said to have been actively involved in the financing and the conduct of their clients’ businesses, British banks were blamed for their reluctance to commit themselves to their clients and on their obsession with liquidity and security in the lending process. From this perspective, it seemed logical to impute the success of German industry to its active universal banks (Gerschenkron 1966) and the relative decline in the British economic performance to its passive clearing banks (Elbaum and Lazonick 1986; Kennedy 1991). Even though it could be objected that the limited industrial involvement of British banks in these years may have been due to demand-side rather than supply-side factors (Capie and Collins 1992), some authors argued that the failure of British banks after World War I to adapt their lending practices to the changing financial needs of the corporate sector was indicative of institutional sclerosis.

This negative appraisal of specialized banks has received a new impetus through its application to a fast-growing economy, the United States in the gilded age (1880–1913). According to Calomiris (1995), US banks suffered from two handicaps that resulted in a high cost of capital for American industry which curbed the large-scale industrial investment needed at that time. Not only did the fragmented structure of American banks prevent them from benefiting from economies of scale and accompanying their clients' growth (unlike British banks), but US banks (unlike German banks) were also specialized so that they could not benefit from economies of scope. Only powerful universal banks would have been able to vary the firm of financing as the firm matured (direct lending then underwriting and holding of securities) and consequently would have been likely to create a long-term relationship with their customers leading to a reduction in information and monitoring costs. Even in states like Illinois, where banks played a significant role in financing industrial expansion, this role was limited to the "adolescent" stage of the firm's life cycle. It was not until the 1920s, when US banks strove to operate branches and to combine, through affiliates, commercial banking, investment banking, and trust activities, that these banks were to converge (for a short time) on the universal banking pattern. These handicaps were all the more damaging, according to this author, insofar as the standard-criticisms of universal banking (including that these banks might encourage a lack of competition among banks and firms or that they are a factor of destabilization of the financial system and a source of conflict of interest) either lack supporting empirical evidence or are not confined to this type of bank.

However, the recent tendency of historical work has been to reassess the advantages of each kind of bank, thereby smoothing the opposition between German and British banks. As far as universal banks are concerned, the early criticisms pointed out that the main clientele of the large German universal banks were large, old, publicity-traded enterprises so that they were not actively involved in risky and innovative investment (Tilly 1986, 1998) and that by giving priority to the financing
of heavy industries "the industrial financing of the Kreditbanken ... hampered the growth of non-agricultural output" (Neuberger and Stokes 1974). More recent criticisms have proceeded along two fronts (Edwards and Ogilvie 1996). In opposition to Gerschenkron's thesis of universal-bank-led industrialization, the first underlines the limited part played by the large Kreditbanks. Holding less than 10 percent of total financial assets in 1913, large Berlin banks were only one part of the German financial system alongside the Reichsbank, which provided the economy with means of payment and short-term trade credits, and local savings and cooperative banks, which granted credits to craftsmen, small firms, and farmers (Ziegler 1997). If we consider that many regions and sectors followed a decentralized industrial development pattern (based on small firms and Marshallian industrial districts), the role played by local banks may have been more crucial than that of large banks (Herrigel 1996; Deeg 2003). Moreover, in the corporate sector of the economy where large banks were disproportionately involved, self-financing dominated, which allowed most of the large industrial firms to avoid dependence on banks. The growing replacement of 1900 of exclusive relationships with a Hausbank by multi-bank links suggests that industrial firms dominated banks rather than the reverse; the high profitability of the leading firms led to sharp competition among banks to service them. In addition, when large firms turned more to external finance, as after 1895, bank loans generally did not serve as a source of long-term finance (Edwards and Ogilvie 1996).

The second front of criticism opposes the idea that large universal banks were efficient institutions for overcoming problems of informational asymmetry and firm monitoring. During the years 1880 to 1913, the presence of bank representatives on the supervisory board of large firms is claimed to have had no persistent, significant effects on investment, performance, and financial structure. Rather than a response to economic backwardness, the proliferation of formalized bank relationships on this view should be seen as a result of structural changes in the German economy (such as the increasing complexity of the financial system or the growing prevalence of proxy voting) (Fohlin 1998, 1999). In addition, nineteenth-century German bankers seem to have been poorly informed despite their intimacy with industry. Most of these assessments would also apply to the interwar period when the power of the great banks declined and their ability to monitor their customers weakened (Wixforth 1995).

While the image of the German universal banks was revised downward, the assessment of British banks' performance became more favourable. Improved access to banking and industrial firms' archives allowed a more accurate approach to banking practices. At the same time, British banks' role has been placed in the broader context of a financial system in which banks are confined to short-term credit provision supplementing long-term funds raised on large markets (Ross 1996). In various ways, several studies (Cottrell 1980; Watson 1996) highlight evidence of the British banks' supporting business firms during the late nineteenth and early twentieth centuries. Extensive research by Capie and Collins (1999) confirms this view, while emphasizing that this support was achieved through rather conservative prudential criteria. On the one hand, the bulk of commercial bank support for industry came in the form of short-term loans and overdrafts designed to meet cash-flow and working-capital requirements; in addition, as a result of firms' wider adoption of corporate structures and limited liability for shareholdings, the proportion of unsecured loans decreased. On the other hand, thanks to the repeated renewal of overdrafts, the actual duration of loans averaged 19 months, and even though they persisted with an arm's-length approach, banks continued to support their industrial clients during periods of distress.

This approach to business finance was to continue during the whole of the twentieth century. Indeed, on various occasions as in the interwar years, banks were exhorted to intervene more deeply to finance the regeneration of British industry and there is some evidence of their closer involvement in clients' business affairs. But this was largely out of necessity (to protect their own interests) and they withdrew from any such involvement as soon as possible; clearly banks did not use their positions as creditors to implement a coordinated program of rationalization (Elbaum and Lazonick 1986). Similarly, in the post-World War II period, banks developed greater installment credit and leasing facilities and expanded medium-term lending to the corporate sector. But for the core of their business large clearing banks remained associated with a short-term and an arm's-length approach to the business sector (Collins and Baker 2005).

Thus, although the traditional image of British banks providing short-term secured loans is proved true, this view can no longer be considered as a sign of institutional weakness coming from the rigidity created by the growing centralization of the banking system. Instead it can be seen as a source of flexibility and stability since the risks of banking failure were exceptionally low (Baker and Collins 2002). The durability of the British banking model suggests also that it was a rational system. It may be an alternative solution to the problem of asymmetric information, adverse selection, and moral hazard. In relationship banking, as practiced by the Japanese keiretsu or most continental Europe banks, banks invest a lot of resources in gathering detailed privileged information on the would-be borrower, in monitoring debtors, and maintaining long-term relationships with their clients. In transaction banking, as practiced by British banks, banks economize on this type of investment and do not become deeply involved in their clients' affairs. Rather they treat each loan as a separate transaction and emphasize the enforcement of rules aimed at minimizing losses from client default: they carefully screen each project, prefer short-term credits subject to frequent review, and impose collateral requirements that guarantee the recovery of the debt in case of client default (Baker and Collins 2005). The unresolved question is the respective efficiency of these two systems in the allocation of finance. Because relationship banking relies on good information and strong client monitoring, it results in committed finance that may lead to a
long-term perspective and to higher levels of investment. By contrast, transaction banking, because it relies on anonymous relationships, results in liquid finance (in both banks and markets) that may limit the investment horizon of firms and lead to short-term strategies. These differences may also play some part in the innovation process since financial commitment is said to be "a social condition permitting collective and cumulative learning to take place" (Lazonick and O'Sullivan 1997).

On these points most empirical studies are inconclusive: we need more comparative regional, industry, and firm-level research. The efficiency of each kind of bank depends on the way they are managed (Carnevali 1995). But as shown by the Italian case, where relationship banking operated by local banks was efficient in the "Third Italy" of the center and northeast but not in the Mezzogiorno (Conti and Ferri 2004), the efficiency of each kind of bank also depends on the context, including the cultural context (Eichengreen 1998) in which they operate. This pushes historians to engage more deeply in the study of banks and markets as organizations and institutions. Oppositions between universality and specialization, relationship and transaction banking, non-profit and for-profit banks do not allow us to fully understand how banks and markets function, how they coordinate economic activity, how they handle information, how they shape their own processes of organizational learning, how they reflect and manage the various social forces they incorporate (Lamoreaux and Raff 1995).

In addition to the study of firms and markets as organizations and institutions, the question of financial efficiency should lead us to avoid limiting the scope of analysis to separate institutions. Banks' efficiency has to be assessed at the level of the whole financial system. Much recent progress has been achieved by studying banks and markets "in tandem" but other institutions also have to be integrated in a complete appraisal. The example of small and medium-sized enterprise (SME) financing illustrates this point. Small firms are more likely to depend on bank finance than large ones because market costs are too heavy for them. But neither relationship banks nor transaction banks are able to provide small firms with finance on the same terms as larger firms. In both cases new SMEs, the seed-corn of any industrial development, are the most affected. However, the consequences of this financial gap for industrial development and economic growth vary according to the presence or absence of compensatory institutions. The fact that, unlike the UK, Germany has avoided the process of deindustrialization may be attributed to the presence of any number of institutional arrangements which provide some or all of the functions of the financial system on an Anglo-Saxon model. In the country where the personal credit is the most efficient and where the dependence on banking is the greatest (Carnevali 2005). How the different parts of the financial systems complement one another and how this complementarity has been produced may be one of the most fruitful lines of research for the coming decades.

14.8 Conclusions

Do national financial systems converge? The question has been raised for several periods of financial history. It has been hypothesized that after having converged during the years 1890 to 1914 financial systems diverged during the major part of the twentieth century: this divergence was a result of the different regulatory solutions developed by national states. Since the 1980s, it was widely expected that shifts in the international context (such as the implementation of the European Single Market) would lead to a relative convergence of financial systems. In spite of some conspicuous common changes (such as the revival of universal banking and the replacement of banks as mobilizers of funds from economic units with surplus capital) the answer seems negative. At least in the period prior to the creation of the common currency no convergence can be observed between the main European financial systems. The single apparent exception is constituted by the French case and it is imputable to state policy, which consciously sought to reshape the financial system on an Anglo-Saxon model. This lack of global convergence has been "attributed to the effects of strong path dependencies, which are in turn an outgrowth of the relationship of complementarity between the individual system components" (Schmidt et al. 2000: 1).

References


Footnotes

1 Fohlin herself recognizes that for the period post-1900 high debt-equity ratios are associated with provincial bank representation, so that the debt-monitoring hypothesis cannot be completely rejected; similarly, for the same period, higher profit margins are positively related to both provincial-bank and great-bank representation, so that the hypothesis that banks provide useful consultancy services cannot be completely neglected.


