

Political and Social Sciences Department

**How and Why
Financial Systems Differ:
A Survey of the Literature**

DANIEL VERDIER

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HOW AND WHY FINANCIAL SYSTEMS DIFFER: A SURVEY OF THE LITERATURE

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Finance is a rich field, combining contributions by economists, economic historians, and political scientists. My goal is not to provide an extensive review, but to stress several perspectives from which the question "How and why do financial systems differ?" has been answered. I successively look at (1) developmentalism, (2) capital scarcity, (3) state capacity, (4) fixed costs, (5) information costs, (6) social capital, (7) institutional commitment, (8) legal origins, (9) market segmentation, (10) curb market, and (11) global convergence.

The first approach is extinct. Approaches 2-5 identify a market rigidity or failure—the failure of the price system to regulate the flow of funds between investors and borrowers. That failure elicits an institutional response—a particular firm-bank-state relation—, variations in the type of which reflect variations in the type and intensity of the market failure. In contrast, approaches 5-10 identify a regulatory failure in the form of deficient property rights (social capital, institutional commitment, and legal origins), externalities (market segmentation), or excessive regulation (curb market).

Developmentalism

The simpler and most empirically-researched hypothesis is that the level of economic development is a strong predictor of the degree of development of the financial system. The two most representative historians of this approach are Raymond Goldsmith (1958,

1969, 1971), who built a large comparative and historical dataset, and Rondo Cameron (1967, 1972), who both performed and stimulated a large number of country studies. Goldsmith and Cameron applied to financial systems the central proposition of modernization theory—capital accumulation brings about structural differentiation and functional specialization in capital markets.¹ For instance, Goldsmith wrote that

The development of financial institutions has followed a very similar path in all now developed non-socialist countries. Initially, money issuing and deposit banks dominated the picture. Thrift institutions, long-term credit banks and insurance organization developed later, but steadily gained in importance in relation to the banking system (1975, p. 87).

Although the developmentalist approach did not survive the demise of functionalist and macroeconomic logic in the 1970s, the idea that increasing wealth produces financial systems that are more functionally differentiated and market-oriented has assumed the status of a stylized fact. Wealthier individuals have greater and more differentiated needs for financial products. The relative development of corporate security markets is a direct reflection of the level of economic development.² A larger pool of savings implies a higher demand for bonds, stocks, and commercial paper.

MARKET FAILURE

Capital Scarcity

In an article published in 1952, Gerschenkron authored the most ambitious explanation so far offered for why financial structures differed across nations. The more

¹ See his 1965 essay, reproduced as lead article in Cameron 1992.

² See also Sylla and Smith 1995, p. 182.

capital was needed in the shortest amount of time, he argued, the less could equity markets cope with the task of allocating long-term financial capital; instead, banks and state had to step in. Hence the “orderly system of graduated deviations from [the first] industrialization.”³ British industrialization was self- and market-financed, manufacturers ploughing back profits into their own factories; French industrialization (the 1850-1870 spurt) was financed by investment bankers, who raised long-term capital and lent it to factories; German industrialization was financed by universal bankers, intermediating between depositors and factories; while Russian industrialization was financed by the state, intermediating between taxpayers and foreign lenders on the one hand, and banks and factories on the other. Responsible for the need for banks or the state in a situation of backwardness were economies of scale, which were characteristic of late industrialization, and wanting standards of honesty or mechanisms for the enforcement of contracts.

Gerschenkron's argument is a two-step argument: the first step links backwardness to the timing and rate of industrialization—whether it is continuous or shows a spurt. The second step links the timing and rate of industrialization to the organization of the financial system—the relative degrees of market, bank, and state intermediation in the provision of long-term capital. The first step has been heavily criticized on the ground that not all backward economies did industrialize, or did so with a “big spurt.”⁴ The second step, the contribution of markets, banks, and the state to industrialization, has better withstood the mark of time. Surely, the fit between timing of industrialization and type of credit system

³ Gerschenkron 1962, p. 44.

is far from being perfect: there are cases (Italy and Austria) that exhibited the banking traits of late industrialization, despite the fact that their big spurt, by Gerschenkron's own admission, petered out. There is Denmark, an economy that grew faster than Germany in the prewar decades, developed universal banking but no large-scale, capital-intensive industrialization.⁵

Gerschenkron left the causes of capital scarcity under-explored. Although, it could be a shortage of capital in the national economy as a whole, it most often was a shortage of capital flowing to industry. Prussia is a case in point. No overall capital shortage existed there during the first half of the 19th century—in fact, Prussia exported capital. But this capital was not readily available for industry, as investors preferred government bonds.⁶

State Capacity

The state capacity literature applied Gerschenkron's insights to the study of industrial policy in the postwar period.⁷ Zysman (1983) proposed a threefold typology of banking

⁴ Gerschenkron (1962, p. 234) himself grappled with the Bulgarian case, coining for the occasion the notion of "missed opportunity." For a thorough review of new developments in growth time-series since Gerschenkron, see Sylla and Toniolo 1991.

⁵ Bairoch's (1993, p. 8) data for 1890-1913 show a 2.3 percent annual growth in GNP per capita for Denmark against 1.7 percent for Germany. On Denmark, see Gerschenkron 1962, pp. 16, 361.

⁶ See Barrett Whale 1968, p. 11; Tilly 1967, p. 156; Schmoller 1904, Vol. II, p. 182; Hansen 1906, Vol. I, pp. 580-6; Beckerath 1954, pp. 7-14; Borchardt 1961. Despite its limitations, Gerschenkron's proposition that industrial capital shortage made continental banking less specialized than British banking is widely shared among economic historians. In a recent review of Gerschenkron's contribution, Sylla and Toniolo (1991, p. 24) wrote that "the 'loose' version of Gerschenkron's paradigm still offers a good first insight into [the problem of European industrialization] and provides a powerful guide in framing the meaningful questions that scholars should ask." Still, very few historians have endorsed Gerschenkron's synthesis. An exception is Cohen (1967).

⁷ A second way, not developed here, in which political scientists have used Gerschenkron's theory is to explain cross-national dissimilarities in state-society relations among capitalist countries (Katzenstein 1977, pp. 295-336; Kurth 1979, 1-34; Snyder 1991).

systems, distinguishing between the French-like “state-led” model, the Anglo-Saxon “market-based” model, and the German-like “private-bank organized” model.⁸ This typology is very similar to Gerschenkron’s triptych, with the difference that France, rather than Russia, is offered as the paradigm for state banking. The rationale for the choice of France reveals a key modification that political scientists brought to Gerschenkron’s synthesis when they imported it. Surely there was a strong demand in postwar France for a quick rebuilding of the economy. But such was also the case almost everywhere in Europe. What made France paradigmatic in its credit policy was the specific institutional make-up of the French state—a “strong” state, in Zysman’s terminology. For Gerschenkron, the state is a possible substitute for market failure that is *a priori* identically available across nations. For Zysman, and for Shonfield (1965) before him, states differ in their capacity to intervene in the economy in general, and in capital markets in particular, and this difference, very much like the capital endowment of the economy in Gerschenkron’s theory, is an historical legacy.

The notion that state allocation of credit is superior to market allocation in situations of industrial catch-up has been qualified. Loriaux (1991) in a study of postwar France argued that state banking was not just an efficient way of channeling capital to fast-growing sectors or to overcome market failures, but also a means of buying the political support of the sectors that were condemned by rapid industrialization. In a similar vein, Pérez (1997) attributed banking outcomes in Spain and France to the presence of a strong leftist challenge, forcing governments to choose a “soft model of interventionism” and

⁸ For a similar argument, see Hu (1984). Knutsen (1997, p. 108) endorsed Zysman’s typology in his study of postwar Norwegian banking.

credit expansion.⁹ Selective credit regulation was abandoned in the 1980s in both countries because the governments were too weak governments to designate the victims of credit austerity, but found it politically convenient to delegate these difficult decisions to the market. In sum, for Loriaux and Pérez, political rather than economic considerations were the ultimate gauge of efficiency in French and Spanish credit policies.

The Gerschenkron-Zysman synthesis generally found greater support in studies of East Asian finance than of Western Europe.¹⁰ Yet, even there, Haggard and Maxfield expressed caution, arguing that politically-insulated states are, almost by definition, better able to control rent seeking, but “unless insulation is accompanied by delegation to bureaucratic agencies, then “strong” states can exploit their power for the purpose of predation and patrimonialism” (1993, p. 20). The works of Rosenbluth (1989) and Calder (1993) on the Japanese financial system similarly debunked the myth of the “strong” Japanese state. Whether state banking is a superior or inferior mode of allocation, political scientists—including this one—concur that state structures matter as an explanatory variable. The question is: Which state structure? Political scientists have so far put much weight on the elusive notion of state autonomy or political insulation, overlooking more intuitive and measurable notions such as state centralization.

⁹ Pérez 1997, p. 76.

¹⁰ See Wade (1985); on Korea, see Woo (1991).

Fixed Costs

Besides capital scarcity, economists have identified an additional source of market failure in the development of capital markets—fixed costs.¹¹ Efficient stock markets, in addition to a building and special phone lines, require well-informed investors, reliable intermediaries, and reputable debtors. More importantly, they need to be liquid—demand must elicit supply, and supply must meet demand at all times and at low costs. There is “a chicken and egg problem with liquidity,” Rajan and Zingales aptly write, “people will not trade in a particular market unless they think the market is liquid, but the market will not be liquid unless they trade” (1999, p. 17). Private entrepreneurs and investors could not overcome this free riding problem, but used the services of investment bankers and institutional investors that had built their reputation dealing with public debt or government-financed railway bonds. The public debt was also instrumental in the latter acceptance of the private debt. Though partly correct, the fixed-costs thesis cannot be pushed too far. In places like Italy and Spain, the existence of a large public debt did not vitalize the corporate security market as much as crowd it out.¹²

Information Asymmetry

The information asymmetry literature illuminates the choice between direct and intermediate finance along with providing a rationale for the existence of banks. It justifies the existence of relationship banking for firms that are small or young; and it can be used to rationalize state-promotion of non-profit banks. Yet, information asymmetry only takes

¹¹ This section draws from Rajan and Zingales 1999.

¹² See Pisci 2000.

us so far. It justifies the existence of diverse financial institutions, but is silent on the relative occurrence of each.

Entrepreneurs are better informed than investors about the quality of the projects they want to develop. This is a classic adverse selection problem, which causes the price of projects to be evenly low irrespective of quality.¹³ As a result, only the bad projects get external finance; entrepreneurs with good projects are better off financing those themselves. This inefficient outcome sets up the stage for a new role, that of monitor. An individual who would monitor a borrower—by screening projects, or preventing opportunistic behavior, or performing ex-post audits—could mitigate the adverse selection problem. This monitor could either be an analyst, certifying to investors that a borrower is sound, or he could be a sophisticated investor, whose stake in the borrower's project would signal that the project is sound, or a deposit bank, lending to the borrower its clients' deposits. How to make sure that the monitor is doing the job properly? Reputation suffices to discipline the analyst; the personal stake signals the sophisticated investor's credibility; while diversification into a large number of independent projects guarantees the solvency of the deposit bank. If there are scale economies in monitoring projects, as Diamond (1984) claims, then the deposit bank is the most efficient monitor. Therefore, banks exist, according to Diamond, in order to serve as "*delegated monitors*".

Since markets and banks co-exist, it is worth asking in what circumstances entrepreneurs will prefer direct finance to intermediate debt (commercial paper, bonds, and equity are direct finance, loans are intermediate debt). Two complementary solutions

¹³ The classic formulation is Akerlof's (1970) used car dealer, transplanted to finance by Stiglitz and Weiss (1981).

are present in the microeconomics literature.¹⁴ Both assume that direct debt is less expensive than intermediate debt—a fact that is verified in practice. The first model, by Diamond (1991), rests on a firm's track record. New borrowers borrow from banks initially. If, in the process, they acquire a good credit record, their reputation eliminates the need for monitoring; they may issue debt directly, without using an intermediary. Lower-rated borrowers, in contrast, will still be suspected of moral hazard and remain dependent on bank loans and monitoring. The very-low rated ones will be screened out. In the second model, by Hölmstrom and Tirole (1997), the firms overcome the moral hazard problem through partial self-financing. By investing its own resources in its own project (that is, by having a large capital), the firm credibly signals its private information on the high quality of the project along with its commitment to make it work. Uninformed investors are willing to directly advance the residual funding without monitoring. In contrast, if the firm is capital-constrained and unable to self-finance part of the project, it must fall back on monitoring and make do with dearer intermediate finance.

Despite their differences and respective limitations, the two models concur with casual observation of reality. Information asymmetry creates a *pecking order* among firms that compete for external funding. Firms that get access to money markets tend to be firms that are old and have a good track record, as Diamond's analysis suggests. This fits quite nicely with the common idea that a firm's funding requirements go through a lifecycle: Startups have to rely essentially on internal funds, then on bank assistance as they grow larger, and finally on commercial paper and equity once they are sufficiently established to

¹⁴ I draw from the excellent textbook by Freixas and Rochet 1998, ch. 2.

enable individual to evaluate their earnings with a modicum of confidence.¹⁵ Furthermore, firms that get access to markets tend to be large and well-capitalized, as Hölmstrom and Tirole argue. Firms that are small and collateral-poor, in contrast, typically fall back on bank loans. In a period of credit crunch, when banks find themselves to be overextended and start curbing lending, the small, poorly capitalized firms are hit the hardest. The large firms can either renegotiate their loans or go directly to the markets.¹⁶ In sum, both reputation and capital are substitutes for monitoring. In fact, reputation and capital tend to coincide.¹⁷

Small and young firms are particularly at risk in periods of credit crunch, when banks rein in loans. Firms can insure against this risk, Petersen and Rajan (1994) argue, by entering a long-term, exclusive relationship with a bank. *Relationship banking*—a durable relationship spread across a wide array of products—informs the bank about the credit-worthiness of the firm, thus reducing the cost of lending. The firm commits itself to remain a client of the bank over the long run, and the bank smoothens the cost of capital to the firm over the firm's lifecycle. The bank subsidizes the firm when young and gets repaid later. The bank also bridges the firm over during credit crunches.

However, the borrower cannot credibly commit to relationship banking over the long-run. It has an interest at some later stage, once it has established a track record with the initial bank, to break the relationship with that bank and borrow from competing lenders,

¹⁵ See Lamoreaux 1994, 154 and Calomiris 1995, 262.

¹⁶ See Gertler and Gilchrist 1994.

who can thus free ride on the initial bank's efforts. Unable to recoup its initial investment in information gathering, the initial bank abstains from making that investment in the first place. The problem of time inconsistency has several institutional solutions. A first one is the existence of a local banking monopoly, able to enforce exclusivity over the long run—this may account for restrictions on branch banking of the *unit-banking* type.¹⁸ A second related solution is joint membership in a social network—this may account for the existence of *credit cooperatives*, in which members are liable for any loan on which the cooperative defaults and thus have an incentive to monitor their peers.¹⁹

A third solution is to allow the bank to take an equity position in the firm, enabling the bank to share the surplus to which its lending contributed—this may account for the existence of *universal banking*. That is, universal banking for the small, of course. It is difficult to build an information-asymmetry argument that would make universal banking pertinent to large firms. Large firms need no bank monitoring, unless they are denied access to markets for reasons unrelated to information asymmetry.²⁰

¹⁷ With perhaps the exception of banks, which until recently were able—but are not allowed any more—to operate on very low capital bases. The strong regulatory harness under which banks operated, however, may have been responsible for this anomaly.

¹⁸ See Petersen and Rajan 1995.

¹⁹ See Banerjee, Besley, and Guinnane 1994. Still another solution, according to Haggard and Lee (1995), is a “strong” state. This is how they describe the functioning of capital markets of East Asian NICs. Decisions are made hierarchically and firms are monitored and coordinated by bureaucrats. Bureaucratic coordination helps economize on communication expense and reduce uncertainty.

²⁰ For an opposite view, see Calomiris 1995. Calomiris argues that project diversification and scale economies in monitoring allowed the big German banks to price debt lower than English direct finance, even for the largest firms—a finding at odds with the assumption of the theoretical literature, on which Calomiris draws in part.

The information asymmetry paradigm provides solid microeconomic foundations to the study of financial institutions. It provides a unified explanation for the diversity of financial intermediaries based on a pecking order between borrowers: Large and respectable borrowers directly tap the markets, whereas medium and less-capitalized firms borrow from intermediaries. Small and undercapitalized borrowers are willing to sacrifice their long-term independence and commit to an exclusive relationship with a bank in exchange for steady financial support. The very small put up with the collectivist atmosphere of a local cooperative. As one moves down the hierarchy, the more pervasive and intrusive monitoring gets.

However, the information asymmetry literature says pretty little on the relative importance played by direct and intermediate debt, by center and local banks, by specialized and universal banks, or by banks and cooperatives. The size and age of firms is not a good determinant of what type of funding gets selected, for it is partly determined by what kind of funding is available. Furthermore, many categories overlap. Deutsche Bank—a deposit bank—monitored firms in Germany at the turn of the century in the same way as J.P. Morgan—an investment bank—did in the United States.²¹ Last, and most importantly, microeconomic efficiency operates within the limits of structural constraints. How else to explain that historical accounts of bank-firm relations under turn-of-the-century German and postwar Japanese universal banking systems fit like a glove the

²¹ Contrast Calomiris (1995) account of monitoring by the Berlin Großbanken with De Long's (1991) account of J.P. Morgan. The difference corresponds with the distinction between "intermediation" and "certification" made by Hölmstrom and Tirole (1997, 675).

description of relationship banking, even though the firms and banks involved in these relationships were large enough to qualify for direct finance?

INSTITUTIONAL, LEGAL, OR REGULATORY FAILURE

Social Capital

The present and following approaches do not start from a market failure, but from an institutional failure. The present one stresses the negative role of state centralization in the development of a prerequisite of market development—social capital. The literature on social capital emphasizes the role of trust, sociability, norms of reciprocity, networks, and civic traditions—various concepts that boil down to the propensity, which Tocqueville observed two centuries ago in North America, for individuals to cooperate outside the family and without the help of the state to produce socially efficient outcomes. Exemplary of this revival is Fukuyama's work on trust.²² Fukuyama (1995) argues that all low-trust societies (a category that includes France, Southern Italy, China) share a common industrial structure: Numerous private firms that tend to be small and family-controlled coexist with a few large-scale enterprises that need the support of the state to be viable. In contrast to this "saddle-shaped" distribution of firms, high-trust societies such as the UK, the United States, Japan, and Germany have many large and very large managerial concerns, perfectly viable without state support. A deficiency in trust reflects the

²² Fukuyama 1995. See also the seminal contributions of Coleman 1990 and Putnam 1993. The most comprehensive—and seemingly conclusive—empirical test of the social capital argument was administered by La Porta et al. (1997b). Using for its measure the percentage of people answering yes to a question asking them whether they trust people, these authors ran a series of successful regressions on various measures of government, civic, business, social, and economic efficiency (not including stock market size, unfortunately).

dominance of a centralized and arbitrary state during an earlier phase of historical development.²³

Though Fukuyama does not draw any, consequences for financial markets seem straightforward. The most popular stocks among investors always are those of large-scale private companies. Family firms and state-owned firms are either not listed or, even if they are, do not attract investors' attention as much as large private corporations, for they are controlled by a core of interests—family members in the case of the family firm, the state in that of the state-owned firm—that do not count share value as their first priority. Trust and stock market development should thus be linked.

Levy (1999) applied a telescoped version of the social-capital argument to economic policymaking in post-*dirigiste* France. The success of *dirigisme* in the postwar decades, Levy argues, caused an underdevelopment of social and local associations, which came back to haunt policymakers when they sought to disengage the state from the economy in the 1980s and have banks and private investors take over the financing of industry. In light of the failure of market forms of coordination to relay the state, the latter was forced to intervene anew, rescuing ailing firms.

Institutional Commitment

The institutional commitment literature is even more explicit in condemning autocratic rule. Markets fail to develop not so much because individuals are coordinating on the wrong play, but because absolute monarchs cannot secure their subjects' property rights. Looking at England, North and Weingast (1989) argue that the crown's ability to build a

²³ Fukuyama 1995, p. 98. See also Putnam 1993, p. 180.

large public debt market rested on its promise to repay. The switch from absolutist to parliamentary rule made such a promise credible. Whereas it was difficult for a monarch holding the crown by divine right to commit not to repudiate past engagements, parliamentary rule, by securing individual rights and including wealth holders in the policymaking process, offered the required guarantee and reduced investment risk. France and Spain, who remained absolutist for another century, were unable to match British financial resources.²⁴

Weingast (1995) further specified the notion of limited government as “market-preserving federalism:” a particular type of federalism encountered in 18th-century England and 19th-century United States, in which local governments enjoyed primary regulatory responsibility but could not use it to restrict the circulation of goods and factors of production in the economy. Echoing Root’s (1994, p. 156) study of the development of competitive markets in England and France, Weingast stresses the role of the common law system; unlike French courts, British courts were independent from the Crown and, moreover, they were local and in competition with each other. This made it difficult for possessors of royal monopolies to appeal to judges to defend their rents beyond London. The jurisdictional competition between urban and rural courts was instrumental in blocking the expansion of urban guilds to guild-free rural areas. By contrast, in France, the monarchy managed to bypass traditional local jurisdictions, establish the supremacy of royal statutes, and enforce royal monopolies—on which royal finances depended—

²⁴ Similar themes are raised by Dickson 1967, Brewer 1989, and Jones 1994.

throughout the realm.²⁵ The higher degree of centralization in France relative to England explains the lesser development of competitive markets in France.²⁶

When is federalism market-preserving, when is it destructive? The answer is not a simple one, as too many checks and balances can be as bad as not enough. This is what comes out of Sylla's (1997, 1999) account of the financial peregrinations of the American Revolution. The source of the inefficiency resided not in absolutism, as in pre-Revolutionary England, but in excessive decentralization—each colony floated its own debt, fueling inflation and currency depreciation. The new constitution of 1787 solved the problem by giving the federal government the power of taxation. The U.S. debt became popular with foreign investors, and, upon retirement, was replaced by the equity of incorporated business enterprises. Checks and balances may not always favor the development of financial markets; checks and balances devolve veto power to small coalitions, including those opposing financial development.

Legal Origins

Like the commitment approach, the legal origins approach attributes financial underdevelopment to deficient property rights. Common law secures market players' property rights better than civil law. The causal path between law and market is not unique, but may take two different routes: a direct one (La Porta et al. 1997a, 1998) and an indirect one, mediated by the state (Rajan and Zingales 1999).

²⁵ Weingast 1995, p. 7; Root 1994, pp. 150, 157.

²⁶ Focusing on the 17th and 18th centuries, Weingast and Root, of course, have little to say about the actual development of corporate securities markets, which occurred in the 19th century. For an attempt to apply the argument to 19th-century stock market, see Mabe 2000.

La Porta et al. show that countries with poorer investor protections against expropriation by insiders, as reflected by legal rules and the quality of law enforcement, have smaller and narrower capital markets.²⁷ These rules and the quality of their enforcement, they further show, vary systematically by legal origins—common law and civil law. In the common law system, the judge *de facto* makes the law, whereas in the civil law system, it is the legislator. Civil law systems are further divided into three families—French, German, and Scandinavian types. Common law countries, the authors argue, protect shareholders the most, French civil law countries the least, and German and Scandinavian civil law countries somewhere in the middle. Law enforcement is also lowest in French civil law countries.²⁸

Like the social capital and institutional commitment literature, Rajan and Zingales (1999) start from the premises that markets and centralized power are incompatible. Governments are not ordinarily interested in ensuring investors' property rights against expropriation or, even if law-bound, they prefer to deal with banks than with markets. Governments are also responsive to anti-market coalitions—the landed gentry in the 19th century, the unemployed masses following the market crash of the 1930s—which markets seem to regularly generate by destroying primitive forms of insurance and providing little substitute. Therefore, decentralization of political power, by which they mean the

²⁷ La Porta et al. 1997a. In an earlier formulation of the hypothesis, De Cecco (1983, p. 14) also linked financial innovation to common law: "All this was possible because of the Common Law approach, according to which all that is not expressly forbidden, is permissible, while the Roman Law tradition is, as it is known, rather the opposite, that is to say, that what is permissible is expressly identified by the written law." For a criticism, see Caranza and Cottarelli (1987, pp. 187-188).

²⁸ See La Porta et al. 1998.

precedent-based, judge-administered system of common law encountered in England and ex-colonies, safeguards property rights and promotes financial innovation.²⁹ Common law owes this advantage to its peculiar dynamic, blocking top-down changes ordered by the political center, but open to grass-roots contractual innovation suggested by individual practitioners. For instance, the common law due process is better at legalizing complex ownership structures, as well as notions of trust and good faith, which are typical of the arm's length contracts between firms and investors in financial markets (p. 29). Civil law in contrast cannot evolve on its own but requires an act of the legislator, making it "an easy prey to political movements advocating a command and control system" (p. 11). In sum, Rajan and Zingales offer a plausible argument for the legal origins of stock market performance. Common law is a bulwark against state control and state control is bad for markets.

The legal origin argument has the merit to provide a rationale for a well-known, yet poorly understood, stylized fact—the greater market-orientation of Anglo-Saxon countries. The legal origin argument yields a tangible and testable set of hypotheses, and is more scientific than the standard reference to the Anglo-Saxon cultural and historical predilection for markets. Furthermore, the direction of the causal relationship, if any, is beyond doubt—legal systems were adopted either long ago or in response to conquest or colonization.³⁰ They are not endogenous to financial development.

²⁹ In the common law system, the judge *de facto* makes the law, whereas in the civil law system, it is the legislator.

³⁰ La Porta et al. 1998, p. 1126.

Market Segmentation

Market segmentation points to the externalities that various types of financial intermediaries create for each another. It is not a recognized approach, unlike previous ones, but a collection of disparate studies, which I consider together because of a few commonalities. These studies do not solely focus on the large commercial banks or the security markets, but also look at the non-noble segments of banking—savings banks, credit cooperatives, mortgage banks, local banks, and local security markets—of which the weight in the banking system can be large indeed, sometimes well above seventy percent. Within this broad set, some studies attribute cross-national variations in banking structures to incompatibilities between various banking sectors, and between the banking sector and the securities market.

Gueslin and Lescure (1995), have emphasized the rivalry between state and savings banks. They asked why nonprofit banking, especially in the form of credit cooperatives, did not take root in France the way it did in Germany. They answered the question by pointing to the unfair competition of postal savings. Credit cooperatives could not afford the subsidized rates paid by the state savings bank on small individual deposits.³¹ Deeg (1992) chronicled the secular rivalry between the large Berlin banks and the savings and cooperative banks in Germany, showing how the existence of a very strong non-profit sector at the outset constrained the development of the Berlin banks.³²

³¹ Similarly, Vittas (1997, p. 172) and Guinnane (1994, p. 51) argue that the creation of postal savings in the UK and Ireland narrowed the scope of urban and rural credit co-operatives.

³² Ziegler (1991, p. 11) links, in the German case, the competition of the savings banks and cooperatives to the unimportance of demand deposits for commercial banks, and to the riskier assets of these same banks.

Vittas (1997) argues that large securities markets in Anglo-Saxon countries, by enabling large borrowers to bypass banks, forced banks to concentrate on small firms and the retail market. In contrast, weak securities markets in continental Europe allowed banks to maintain close relations with large firms and neglect households and small and small firms. They left room for savings banks and credit co-operatives to grow (p. 171). The Netherlands, according to Jonker (1996b), was another case of overgrown securities market. However, the banks did not respond to the challenge by crowding out savings banks and credit cooperatives, as Vittas argues they did in Anglo-Saxon countries, but merely stagnated. Norway, according to many Norwegian historians, offers a case in which indigenous banks failed to develop because of the early entry of foreign banks in the primary product sectors.³³ In Britain, in contrast, the presence of London at the heart of the world money market offered banks a unique line of business, which was not equally available to banks in other countries.

Another instance of the zero-sum logic is the thesis that universal banking stifles market mediation. In specialized banking systems, deposit banks specialize in short-term ventures, leaving the business of issuing securities to investment banks and brokerage houses. In universal banking systems, the same banks perform both the commercial and investment functions. Combining lending, underwriting, and brokerage has been generally associated with atrophied capital markets, suffering from low competition, private placement, self-regulation, insiders' trading, and instability.³⁴ In contrast, the institutional

³³ See Knutsen 2000.

³⁴ Riesser, the apologist of German universal banking, bemoaned the extent of private placement, which he blamed for impairing the exchange's capacity to fulfill its function as price setter (1911, p. 772). Tilly qualifies the 19th century

separation between banks and markets has generally been favorable to competition, public regulation, the participation of a broad segment of the population, thick trading, and greater stability.³⁵

All these explanations rest on a “crowding-out” logic, according to which a banking or financial sector came first and succeeded in saturating its market and pre-empting the development of others. These explanations differ, however, with respect to the identity of the sector that is expected to be making the first move—the state, as Gueslin and Lescure argue, the non-profit sector, as Deeg argues, or the financial market, as Vittas and Jonker argue.

What causes fragmentation to vary across nations and how? Two types of answer are discernable in the literature. One builds on an historical process known in economics as path dependency, which obtains when the costs of abandoning institutions that perform sub-optimally may be higher than the resulting inefficiencies. Path dependency surfaces in the works of Jonker and Vittas.³⁶

An alternative to path dependency is interest group politics. Different producer groups have different institutional preferences, which they ask politicians to legislate in exchange for electoral resources. Although this type of study is still underdeveloped in the

Cologne stock market as an “inside” stock exchange (1966, p. 120). Sylla remarks that the German “banks developed something like an internal stock market” (1997, p. 211). However, both Riesser and Tilly acknowledge that issuing security was the banks’ only way out of long-term, sometimes doubtful, credits to a client company; Riesser 1911, p. 364 and Tilly 1966, p. 120.

³⁵ This argument is made by Sylla and Smith 1995 and Sylla 1997.

³⁶ Note that the path dependency model is often underspecified, reducing the present value of a variable to its past value and a random term. More sophisticated modeling would balance the cost of change against the opportunity cost of maintaining existing institutional arrangements, a notion that raises daunting conceptual and empirical difficulties.

field of finance, the literature points to a definite correspondence between financial intermediaries and borrowers. Deeg shows that German banking sectors have clienteles that are specialized, both along geographical lines and on the basis of firm size—large firms do business with the commercial banks, whereas artisans, farmers, and small and medium-sized companies on average patronize the savings banks and credit cooperatives. The financial interests of the small borrowers are articulated by the non-profit organization, whereas those of the large borrowers are articulated by the for-profit banks.³⁷ Echoing aspects of Deeg's findings on Germany are the works of Polsi (1993) and Conti and Ferri (1997) on Italy. They argue that the profit and non-profit banking sectors have differentiated clienteles; the former banks with large firms, the latter caters to the specific needs of local, small enterprises, shopkeepers, and artisans. Looking at Britain, Zeitlin (1995, p. 105) points to the disappearance of regional for-profit banking as a cause for the disappearance of small firms and industrial districts.

The correspondence between financial institutions and producer groups suggests that the latter have a stake in the organization of finance. It also alerts us to the fact that financial regulation may often be no more than another arena for the redistributive conflict between organized producer groups. It brings to mind the "rent-seeking" literature, according to which market failure is more often the fact of government "excess" regulation than of any breakdown in the market mechanism.³⁸ A potential limit of the rent-

³⁷ Riesser, the self-designated apologist for the German credit banks, recognized in 1905 that "German credit banks have hitherto done little for the craftsmen and the small manufacturers and tradesmen" (1977, p. 225).

³⁸ See Stigler 1971.

seeking approach to finance lies in the difficulty in accounting for the relative power between interest groups.

Curb Market

A potential extension of the fragmentation literature is what I call the “curb market” hypothesis: Markets develop to overcome excessive regulation and market fragmentation. The hypothesis is particularly apt at explaining the emergence of international markets, such as the 17th century paper market. It has also been used to account for the emergence of internal commercial paper markets in Britain and the United States. The vigorous inland bill market in Britain, according to Neal (1994, p. 170), grew in the 18th century to make up for two regulatory failures, the disappearance of small coinage, caused by the undervaluation of silver by the Mint, and the Bank of England monopoly on the joint-stock (corporate) status, preventing country banks from opening branches countrywide and settling payments by means of checks. Absent coins and checks, traders resorted to commercial paper endorsed by a reputable banking house. In the case of the United States, legislation protecting unit (single-agency) banking led the largest firms after the Civil War to escape monopolistic lending rates by selling promissory notes on the open market. The market developed without bank endorsement, which banks were unwilling to grant in the absence of a central bank offering rediscounting facility.³⁹

A recent illustration is provided by the development of the Eurobond market in the mid-1960s, as a way for large banks to circumvent reserve requirements and interest rate regulation at home. More generally, product innovation throughout the 1960s-1980s has

³⁹ See James 1995.

been interpreted as an illustration of the principle that state regulation invites market circumvention.⁴⁰ Harmed by tight monetary and reserve regulations, banks evaded the prescriptions of the central bank by creating non-bank subsidiaries and engaged in off-balance-sheet operations and the development of market-based credit instruments. All these explanation are, in essence, instances of the “curb market” theory of market origins, according to which markets develop informally to circumvent government-(over)regulation of market transactions.

The Convergence Thesis

This survey would not be complete without the mention of the convergence thesis. More a null hypothesis than a thesis, it states that whatever institutional variations may exist in financial systems are being erased by the global market-induced convergence on the Anglo-Saxon model.⁴¹ The mechanism for this homogenization is international market competition. Global convergence was the object of an intense controversy that was best summarized by Cohen (1996).

Conclusion

The first and last aside, the approaches that I have surveyed divide into market failure and regulatory failure. Capital scarcity and state capacity together, fixed costs, and information asymmetry, account for financial diversity in terms of second-best responses to market failure. In contrast, social capital, institutional commitment, legal origins,

⁴⁰ For example, see Kane 1981, De Cecco 1987.

⁴¹ This argument is endorsed, in part at least, by Strange 1986, Goodman and Pauly 1993, Gill and Law 1993, Helleiner 1994, p. 201. and Sobel 1994. Andrews (1994) offers a more systemic account.

fragmentation, and curb market attribute financial diversity to a regulatory failure. All these approaches are equally valid a priori and each one captures some aspect of the historical reality.

My work is consonant with the rent-seeking component of the fragmentation approach.⁴² Financial diversity reflects the regulatory competition among various types of lenders and borrowers. I mentioned earlier that the rent-seeking approach has difficulties predicting the outcome of the influence contest between contending coalitions. The study of political institutions helps solve this theoretical difficulty. Political institutions are not neutral, but bias the power game in favor of certain groups and at the expense of others.

⁴² See Verdier FORTH.

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