

INTRODUCTION: THE CONVERGENCE OF NATIONAL FINANCIAL SYSTEMS: WISHFUL THINKING OR IRRESISTIBLE TREND?

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Finance and the Economy

Although they have a very long history, academic studies of financial structures have developed in three general steps apparently sound assumptions during the last fifty years or so.

The first step came after World War I and in the wake of the Great Depression, as a sustained effort to establish reliable data series, while new theories were being put forward, to explain the collapse of the gold standard, as well as the economic gyrations that followed World War I. Thus motivated, states and central banks tried to institute new institutional designs, as during the so-called great conferences of Genoa (1922), London (1933) or Bretton Woods (1944). This set the stage for an international drive towards more comprehensive, reliable and comparable statistics covering monetary and financial matters. At the same time, central banks all over the developed world engaged into more academic-like research, leading to a serious upheaval of both the quantity and quality of their published material, even on a retrospective basis. But whether the institutions were ill-designed or the goal of a Gold-standard built-in balancing mechanism was an illusion, these conferences were mostly in vain, failing to design stable and enduring international monetary and financial systems. At best they ended up with a temporary alleviation of the main problems but succeeded in creating multilateral institutions whose usefulness would prove to be well beyond the scope of their original charters, such as the BIS, the World Bank or the IMF.

Building upon this new ideas and data, a general reappraisal of past monetary and financial history marked the 1960s. Milton Friedman, Anna Schwartz and Philip Cagan¹ at the NBER were among the main contributors to this sec-

ond step, but they were joined by many, most notably John Gurley and Edward Shaw,² Alexander Gerschenkron and Raymond Goldsmith. Economic history started then to accumulate many documented cases and new pools of data related to financial issues, banks and crises. But the last two authors provided economist historians with two key elements.

First, Alexander Gerschenkron³ built an ambiguous but durable analytical framework. Indeed, acknowledging the wide variety in national experiences, he escaped the trap of a 'one size fits all' framework of economic development and replaced it by an agonistic drive to modernization, explaining both complementarity among nation-state economies and non-market solutions to relative backwardness, i.e. banks and state planning and finance (Table I.1).

Table I.1. Stages of financial development according to A. Gerschenkron.⁴

Development Stages	Forerunning Area	Mild Relative Backwardness Area	Severe Relative Backwardness Area
Stage 1	Market Finance	Bank Finance	State Finance
Stage 2		Market Finance	Bank Finance
Stage 3			Market Finance

Raymond Goldsmith,⁵ bridging the gap of the promised second volume from Gurley and Shaw, followed a very different path, that of 'financial deepening': using several ratios, he showed an empirically strong relationship between financial and economic development. This occurred more or less at the time when the basic monetary and economic assumptions upon which rested budgetary and monetary policies in OECD countries started to stumble and shatter. A solution to the problems encountered in most developed countries and in the international financial system at large could be found at the crossroads of Gerschenkron's and Goldsmith's views – whatever they intended. Indeed, a common interpretation of the 1950s and 1960s growth in Europe and Japan rested upon the catching up of the United States that nonetheless provided capitals after the Second World War, but also methods and a stable international environment of gradual commercial opening. In two decades time, Western Europe and Japan had progressed from severe to mild relative backwardness and, most logically, their financial systems should have adapted to this transition, while in fact most states retained the financial power gained during the Great Depression and the War. Another approach to the problem was to pinpoint the limits of an essentially debt-driven growth financed through monetary expansion that did not allow enough financial deepening from the point of view of savers, investors and companies.

The final collapse of Bretton Woods, in 1976, was soon followed by an extraordinary market rally. By rally, we mean that market did not only bully during the 1980s and 1990s as never before in the twentieth century, but also

that political and business executives, backed by academics, declared market mechanisms to be superior to any centralized allocation of capital, leading to a third step in financial structures studies. Building on new methodologies, such as panel and OLS regressions, time-series analysis, and Granger-causality, papers started to study in a systematic way the relationship between finance and growth.⁶ As soon as 1993 and 1996, Robert King and Ross Levine⁷ and John Boyd and Bruce Smith⁸ transformed the correlation established by Goldsmith between financial and economic development into a causality, running from financial development and institutions to economic growth, along theoretical paths formerly developed by Joseph Schumpeter. A few years later, Gerschenkron's intuitions were developed and tested in a more thorough manner by several scholars, notably Richard Sylla, Richard Tilly and Gabriel Tortella⁹ Douglas J. Forsyth and Daniel Verdier,¹⁰ or Carolin Fohlin.¹¹

Consequently, it is not possible anymore to try to understand economic development without paying tribute to financial structures, institutions and incentives. From the bottom – Grameen banks – to the top – deep, large and effective markets – of the ladder, financial issues have been playing a key role in the Washington consensus as well as in the domestic developments in most OECD countries since the ‘Volker’s revolution’.

But there are still issues to be settled. One cannot really doubt the fact that financial innovation has been paving the way for the renewed growth of the 1980s and 90s, but does that mean that finance is a permanent feature of economic development, i.e. that it is a ‘prerequisite’ to growth? Or does that relationship stand the trial only during specific periods of time? Recent studies seem indeed to cast some doubts,¹² at least acknowledging the existence of different periods where causalities can have different directions, i.e. to the right Joan Robinson,¹³ at least sometimes.

Finance and History

Accordingly, the issue of ‘history matters’ is our main drive in this volume. But we intend to push the matter a bit further. Indeed, behind the stories of ‘relative backwardness’ and ‘financial deepening’, lies a convergence¹⁴ theory. Let's state it this way: everything being equal, if an economic system develops it will tend to reduce its relative backwardness towards the leader(s) and so to diminish the role devoted to special-purpose financial institutions, i.e. state finance and banks. Or: everything being equal, financial deepening will allow for a more efficient allocation of capital, which, in turn, will provide for a more effective selection of the innovations and economic opportunities, and more productivity growth. So, everything being equal, countries should tend to converge towards some form of market-based financial system. The problem, of course, is that financial struc-

tures still differ a lot from country to country, even between those of comparable wealth.

Theoretical and empirical inquiries on such issues have been developing for over twenty years, as several review papers testify,¹⁵ fuelled by the apparent bank-to-market shift ignited in OECD countries at the end of the 1970s and the return of financial crises, almost nonexistent in developed countries during the Bretton Woods era. Academic issues also help explain this interest, with the impact of informational economics, either in the form of information asymmetry studies, or in the form of game-theory or institutional economics. This literature is dominated by the assumption that markets are more efficient in relatively developed economies,¹⁶ whatever the broader context, and has been concerned with discovering the main factor behind the different types of financial systems one can observe today. Indeed, such a factor may help explain why a country would rather rely on information-gathering and processing organizations or on individual agents meeting on a market, leaning, for example, towards a 'bank-based' or a 'market-based' system, or a centralized/decentralized process.

Nevertheless one can still roughly divide the explanations for why a country would adhere to the one type or the other in two categories: 1) Structural explanations or 2) Developmental (or evolutionary) explanations.

The first category of explanations relies on almost permanent factors such as the legal basis, the distribution of political power, the existence of entrenched social or economic powers and so on which exert a constant and long-term influence on the institutional development and the economic rules of the game that play a key role in regard to the financial structures.¹⁷ The second category is more concerned with the pattern of economic and financial development over time, and relies on the link between specific difficulties or challenges (regional imbalances, information asymmetry, relative backwardness...) and the build-up of institutional solutions to these difficulties.¹⁸

Academic historians tend to rely more on the second approach, which lets them expand historical explanations and careful contextual analysis.¹⁹ Nevertheless, these distinctly different types of explanations share two common conclusions in most academic works, that convergence among financial systems is not only possible, it is more or less bound to take place given an open international capital market and, second, that path dependency is a very strong feature of financial systems.

But as this volume demonstrates, history is not a quiet river: here and again, crises, upheavals, innovations, revolutions, wars and so on shatter the orderly manner of the world, which is rather the orderly view of it we tend to develop when time passes, taking for granted what does seem rooted. Indeed, if financial structures are dependent on specific historical events, convergence among national financial systems will only be a theoretical construction since any

historical event at any time may disrupt the supposed convergence. More disturbing, the disruption could be embedded into the convergence process itself if one considers that convergence is not a pure economic process – as expressed in a GDP to capita ratio – but also reflects centre–periphery and first–second rank hierarchies among countries and the hegemonic situation of one or several political powerhouses financial structures. In short, some crises could have ended convergence not accidentally, but because being provoked by the challenge to the world order, i.e. to the dominant political and financial power(s).²⁰

The System of Finance

A second issue, related to the convergence story, derives from the fact that financial system literature asks ‘what is finance’ rather than ‘what is a system?’ This question is seldom addressed while it lies at the heart of the significance of the expression ‘financial system’. Many conceptual frameworks and expressions have been forged to describe, classify and define financial organizations, institutions and mechanisms. One of the main issues in this effort for labelling derives from the conception of what finance is: are these organizations, institutions and mechanisms structurally linked one to the other so as to form a system, or are they just a loose set of rules and practices built more or less randomly over time?

One could propose two polar views of what a system is. On the one hand, a system could be defined as a dense web of interrelations between various elements, meaning that a change in one element or one interrelation starts a chain reaction on all the other elements until a new version (equilibrium) of the system is reached. If the magnitude of the necessary change is set high, then different systems will follow one another, each time a sufficiently powerful shock affects the system: we have here a financial system version of the structural changes brought by scientific revolutions according to Thomas Kuhn.²¹ Between two major shifts, the system would evolve without changing its dominant traits. If the magnitude of the necessary change is set low, there is no longer any real difference between ‘evolution’ and ‘revolution’, and the system can experience dramatic changes by simply accumulating a large number of minor modifications. Such a systemic approach, i.e. the very idea that all parts of it are interrelated, means that no institution or area can shield itself from the general evolutions of the system. There is no stability at another level than that of the system itself. But we know that many institutions have in fact been designed to shield participants from evolution and risk. Such a conception of systems can lead to analytical shortcomings, because it becomes very difficult to separate causes and consequences.

From a more general point of view, if one defines a financial system as a risk-sharing and risk-processing system, the fact that it is a closely interrelated could sometimes appear contradictory with its goal of distributing risks along

individual preferences patterns without jeopardizing all participants through an increased systemic risk – but the 2007 crisis demonstrates such contradictions may occur in the real world.

On the other hand, a financial system could be more loosely defined as a collection of a few specific structural traits (i.e. the market-based and banks-based financial systems). A minor or even a major shock will not necessarily affect the overall structure of the system, which reacts to much more ‘long term’ determinants: political and cultural traits, legal structures, etc. The big advantage of this approach is to break up the whole of society into a series of subsystems, each of them becoming the object of more specialized, and as such more competent, academics.²² Besides, each subsystem would be defined by exogenous and endogenous variables, most exogenous variables actually being elements from the other subsystems. In doing so, most social scientists indulge in a degree of ‘hypostasis’, i.e. they transform historical processes which manifest themselves in a variety of traits and institutions, to a large extent not related through necessity or even contradictory between them, into ‘*personas*’, actors in their own right, guiding and giving sense to the flow of time, but themselves almost perfectly stable: national character and prejudiced perceptions of a hierarchy between human races once played this exogenous role. Today, ‘progress’ and its quantitative translation (GDP/capita) is still the main ‘hypostasis’ and the main ground of this finalism, even when dissimulated behind the veil of ‘the one best way’. A good example of such a persona is ‘modernization’: economic modernization is very often associated with market development and the reduction in political risks (wars, civil strife, revolutions). But as advocated for example by Raymond Aron or Peter Katzenstein, modernization²³ tends to have two opposed consequences: from an economic point of view, it leads to enlarged product and services circulation and deeper economic interdependency but from a social point of view, it leads to more social and economic (revenue) cleavages and can disrupt political or cultural links and cohesiveness.²⁴ From an international point of view, one can also show that the usual link long established between foreign exchanges and peace is at best dubious.²⁵ As such, one should be careful in assessing the long-term effects of a single but complex factor.

Linking Sub-State, National and International Stories

In order to propose some answers – we do not pretend they are definitive! – we collectively built a case collection that would address the convergence of financial systems at different geographical and time scales. Indeed, by putting emphasis only on national systems convergence, we forget that national financial structures are not that much more homogenous than financial systems among states. In many ways, what is true of financial convergence at the international

level holds true at the sub-state level, except that the 'natural law' of pure power, in the absence of an international regulation, does not apply except in times of civil war (Chapter 8, Pablo Martín-Aceña, Elena Martínez Ruiz and María A. Pons). Thus, convergence at a sub-state level (Part I) can occur in two different but non-contradictory patterns: either an attempt to seize regulation or through social patterns. Jean-Luc Mastin (Chapter 2) shows how a regional financial pattern is embedded into a social and industrial structure in which the area can resist Parisian interferences but with the major drawback of reinforcing conservatism. Kim Oosterlink and Angelo Riva (Chapter 3) tell us of the extraordinary attempt to capture the fate of doom: in 1940, with France defeated, and its state stunted and moved to a remote third-rank city, Lyon brokers tried to seize the opportunity to reverse the trend of their own marginalization in an increasingly homogeneous/converging national security market. Patrick Verley (Chapter 1) shows a parallel story: that of the social distinctions and permanent concurrence between the official market and 'curb' market brokers in Paris. What made the Parisian market thrive during the nineteenth century is not its organizational qualities or the securities diversification, but rather the 'competition' between regulated and unregulated actors and activities. In that respect, too much convergence impedes dynamism.

On the national level (Part II), long-term analysis helps to uncover some semi-permanent features, but when thoroughly analysed, the result is to stress the importance of the context. A same set of institutions or practices can yield different results, as shown by the contrasted impacts of crises on Swiss banks (Chapter 6, Dirk Drechsel) or the divergent evolutions of German, French and Italian mixed banks (Chapter 5, Carlo Brambilla). Moreover, the very meaning of convergence – integration or complementarity? – starts to get blurred (Chapter 4, David Le Bris). Pure convergence could mean product or services substitutability and increased concurrence ending in centralization – and as such in central or peripheral domination (see also Chapters 1 and 3), while complementarity, by providing a wealth of varying products, processes and services, might lend resilience to the system but also provide convergence in another sense, that is fuel flows of capital, labour and ideas between regions, sectors and countries.

This difficulty of ending up with a univocal definition of convergence appears more clearly when historical shocks (Part III) are taken into account: as such, they should not be part of the process, since shocks are short-term events, when convergence is a rather long-term trend and process. Nevertheless, the long-term impact of large shocks, for example wars, given the path-dependency of financial structures, appears too strong to be overlooked (Chapter 7, Patrice Baubeau and Anders Ögren). This has long been recognized by most historians who tend to define long-term periods by initial events, either national or international. The civil war in Spain (Chapter 8, Pablo Martín-Aceña, Elena Martínez Ruiz

and María A. Pons) is especially relevant because it shows that facing the same constraint, financing the war, albeit with different resources, both camps tended to rely on one major resource: monetary emission. Given the very different conceptions in law, property rights or public accountability borne by the opposing camps, one can figure out how fragile general conclusions on the role of legal systems or property rights enforcement on financial structures appear. In London, the dominant financial place towards which other financial systems seemed to converge before WWI (Chapter 9, Richard Roberts), the war outbreak delineates the characteristics of the system, at both national and international levels, but also the weaknesses of the City in the ensuing competition with Wall Street.

In fact, as one can see from this short introduction, one cannot separate financial structures from monetary matters, which is precisely what Part IV addresses. For example, Kalina Dimitrova and Luca Fantacci (Chapter 10) show how Bulgaria's convergence to the Gold Standard is at least a two-sided story, whose determinants are not solely monetary, because the goal is not only to provide 'a seal of good house-keeping', but also to shield the national economy from deflationary pressures and to enhance national independence by relying on the far powers (United Kingdom and France) rather than on the close ones (Ottoman Empire, Russia). The ability to play on the two sides – national and international – of currency is also what drives Antoine Gentier (Chapter 11) in showing some paradoxical consequences of the Gold Standard: it provide rules but also incentives to break with them for internal motives, with direct consequences on the financial structures. Jeroen Euwe (Chapter 12) kind of link together several lines of the previous arguments by showing how an event – World War I – shaped the financial fortunes of the Netherlands first as an escape route and a haven for German capitals and then as a European financial powerhouse during the Interwar period, part through the diplomatic skirmishes of the time, part through shrewd strategy. But what a war did, another could undo.