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The great reversals: the politics of financial development in the twentieth century ☆

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Abstract

The state of development of the financial sector does not change monotonically over time. In particular, by most measures, countries were more financially developed in 1913 than in 1980 and only recently have they surpassed their 1913 levels. To explain these changes, we propose an interest group theory of financial development where incumbents oppose financial development because it breeds competition. The theory predicts that incumbents' opposition will be weaker when an economy allows both cross-border trade and capital flows. This theory can go some way in accounting for the cross-country differences in, and the time-series variation of, financial development.

JEL classification: G100; G180; G200; G380; O160; P000

Keywords: Financial markets; Growth; Politics; Financial development; Reversals; Trade; Capital flows

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1. Introduction

There is a growing body of evidence indicating that the development of a country's financial sector greatly facilitates its economic growth (e.g., Demirguc-Kunt and Maksimovic, 1998; King and Levine, 1993; Jayaratne and Strahan, 1996; Rajan and Zingales, 1998a). Why then do so many countries still have underdeveloped financial sectors?

The simple answer, and one favored by many economists, is the absence of demand. Certainly demand is a prime driver of financial development, but it cannot be the only explanation. Demand (as proxied for by level of industrialization or economic development) cannot explain why countries at similar levels of economic development differ so much in the level of their financial development. For instance, why was France's stock market much bigger as a fraction of its gross domestic product (GDP) than markets in the United States in 1913, even though the per capita GDP in the United States was not any lower than France's? It is hard to imagine that the demand for financing in the United States at that time was inadequate. At the time, the demand for more, and cheaper, credit was a recurrent theme in political debates in the United States, and it was among the most industrialized countries in the world even then.

An alternative explanation is that there are structural impediments to supply rising to meet demand. Perhaps a country does not have the necessary levels of social capital (Guiso et al., 2000) or "savoir faire" to create a viable financial sector (e.g., Bencivenga and Smith, 1991; Greenwood and Jovanovic, 1990). Or perhaps it has not inherited the right legal, cultural, or political system. In particular, the seminal work of La Porta et al. (1997, 1998) shows that countries with a Common Law origin seem to have better minority investor protection, and furthermore, these countries have more highly developed equity markets. There has been some debate as to the precise channel through which a country's institutional inheritance affects its financial development (e.g., Berglof and Von Thadden, 1999; Coffee, 2000; Holmen and Hogfeldt, 2000; La Porta, et al., 1999a, 1999b; Rajan and Zingales, 1999; Stulz and Williamson, 2001). Some question whether the influence of certain forms of Civil Law heritage can be distinguished from the influence of a Common Law heritage (e.g., Beck et al., 1999). Yet, there is a burgeoning literature suggesting that a country's "structure" matters.

There are other implications, however, of structural theories of financial development. For instance, once a country has overcome the structural impediments, the supply of finance should rise to meet demand. In other words, we should not see measures of financial development waxing and waning independent of demand. Similarly, conditional on demand, the relative position of different countries should not change dramatically over time. If some countries have a system that is predisposed towards finance, that pre-disposition should continue to be relatively strong since structural factors are relatively time-invariant.

To test these implications, we collect various indicators of financial development for developed countries over the twentieth century. By most measures, countries were more financially developed in 1913 than in 1980 and only recently have they