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Bank laws, economic growth and early banking in Latin America: 1840–1920☆

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Abstract

This article examines the impact of legal and economic factors on the growth of commercial banking in Latin America in the 19th and early 20th centuries. Using annual data for five countries for the period 1840–1920, this article shows that growth in exports had a significant effect on the growth of bank liabilities (deposits plus note issues). For the most part, changes in banking laws did not have a significant effect on the development of banking. This latter result likely reflects heterogeneity in the meaning of changes, as well as the potential dominance of de facto political factors in shaping the importance of de jure legal changes.

JEL classification: O54; N26; N20; G21
Keywords: Latin America; Banking sector; Bank laws

1. Introduction

During the 19th and early 20th centuries, Latin American economies did not follow a uniform pace of financial development. Some economies had relatively more banks and higher levels of banking services, while others had fewer banks and lower levels of banking services. In Argentina and Brazil, for example, banks already operated in the 1820s, whereas at least ten other Latin American countries had no banks as late as 1850. In the following decades, some economies experienced a faster development of banking than others. As a result, in the early 20th century, as measured by the number of banks and by the level of banking services, Argentina, Uruguay, Chile and Costa Rica were far ahead of the rest of Latin America. In the late 1920s, for example, deposits per-capita were around US$75 in Argentina, more than US $25 in Chile and Uruguay, and less than US$4 in Bolivia,

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Ecuador, Peru, Guatemala and El Salvador.[1] This article takes advantage of within-country variation in banking activity over time to investigate which factors are able to account for times of relatively high banking growth.

One possible influence on banking growth is economic activity. No matter what the nature of the political or legal constraints on banking, it is likely that improvements in economic activity will produce growth in banking. A greater level of economic activity will increase both the demand for banking services and the amount of banks' profits. It should, therefore, promote banking growth through both the demand and the supply side. With respect to the supply side, increases in the wealth of bankers entrepreneurs should boost bank equity, and therefore, permit expansion of bank assets and debts.

Some individual country-studies suggest that the level of economic activity had a significant impact on the development of banking in Latin America. For Mexico, Haber (1991) recognizes the importance of unfavorable economic conditions (small size of the Mexican economy) in partially explaining the slow development of capital markets in Mexico. For Brazil, it seems that economic conditions, in particular the expansion of coffee production, influenced the development of banking. For example, Pelaez (1975) argues that a system of banks of issue developed "when the first impulse of modernization was felt, in the form of expanding coffee trade",[2] whereas Hanley (2005) indicates that in the second half of the 19th century, "the expansion of coffee production stimulated the development of the Sao Paulo capital market by creating a new and large demand for capital to expand plantations and buy or hire workers".[3]

Other factors may have mattered, as well. Recent studies have paid much attention to the impact of political limits on banking systems, and also changes in banking laws, for banking development. Some argue that political or legal limits on the establishment of banks or their funding opportunities in some countries were highly restrictive, and that these imposed important barriers to entry. Haber (1991),[4] for example, indicates that political factors had a significant role in accounting for the financial backwardness and the stunted process of industrialization in Mexico and Brazil, and that these political factors were, to some extent, reflected in legislative limits. Legal or political constraints in these countries, he argues, dramatically reduced the supply of credit below what it otherwise would have been, and also determined who had access to the scarce supply of credit in the banking system. Limited credit resulted in less industrial production and greater industrial concentration in those countries than would have occurred if their banking systems had permitted free entry. In the case of Mexico, for example, the Mexican ruler Porfirio Diaz (1877–1911) relied on support of a small group of powerful financial capitalists, who pushed for restrictive bank laws.[5] For the case of Brazil, Haber (1991) argues that financial markets also were shackled by "public policies designed to restrict entry into banking so as to create a secure source of government finance."[6] Country-case studies for other Latin American economies also support the hypothesis that political or legal barriers to entry had an effect on the development of banking in Latin America.[7]

In this article, I analyze the effects of changes in the level of commercial activity and changes in banking laws on the growth of bank liabilities in five Latin American countries during the period 1840–1920. This article is the first comparative study of the causes of banking growth in Latin America that includes more than two countries in the sample. In particular, the sample includes the following five countries: Mexico, Argentina, Brazil, Chile, and Peru. Until now the literature has been largely focused on the analysis of individual country-cases, or to the comparative analysis of the largest countries in the region. Second, the article relies on an original database which includes the level of bank output and bank laws. I have used a wide variety of primary and secondary sources to calculate bank output. Bank laws have also been collected from primary and secondary sources.

I find that the growth of bank liabilities was substantially influenced by the level of export activity.

[1] These figures were obtained from Bulmer-Thomas (2003).

[2] Pelaez (1975), p. 469.

[3] Hanley (2005), p. 34.

[4] See also Haber et al., (2003).

[5] Maurer (2002) supports Haber's hypothesis that Porfirian Mexican law was restrictive and affected the development of banking. The dependence of the federal government on Banco Nacional de Mexico to finance persistent deficits and the discretion of the government to accept and deny charters caused that the "only banks that would succeed in opening their doors … would be those with close connections to powerful local politicians" (Maurer, 2002, p.37).

[6] Haber (1991), p. 569. Pelaez (1975) and Hanley (2005) also argue that barriers to entry affected banking development in Brazil. In particular, Pelaez finds that the right to issue banknotes promoted the creation of banks in the first half of the 19th century. Banks of issue responded to the increasing demand for credit, even though they did not receive the same privileges as Banco do Brasil, whereas Hanley argues that the reduction of barriers to entry in the late 1880s in the eve of the Monarchy stimulated the creation of corporations, including banks, in Sao Paulo.

[7] In the case of Argentina, Piñero (1921) indicates that the general banking law of 1887 facilitated the creation of banks of issue and the expansion of credit.

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