# THE CRITICAL FUNCTION OF HISTORY IN BANKING AND FINANCE

Studies in Banking and Financial History

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# Introduction

Duncan M. Ross

The papers gathered in this volume were first presented at the *eabh*'s (The European Association for Banking and Financial History e.V.) annual conference, sponsored by the Bank of Cyprus in Nicosia in May 2009. There are few parts of Europe better suited for a group of scholars to consider the relationship between past and present than that divided city, and the conference's theme – the importance of the role of history in banking and finance – offered an opportunity to reflect on the many and multifarious ways in which banking institutions are the products and, at the same time, the determinants of legal, historical, political, and strategic choices. After toiling for almost twenty years in the rich and fertile soils of detailed and focused banking and financial history, the conference offered *eabh* the chance to draw breath and reflect more generally on that most axiomatic of all scholarly statements: history matters! For historians (and, it is to be hoped, economists) this is not in doubt. But important questions remain and, as scholars of path-dependence have made clear, there are no easy answers to these questions: history matters, but how, where, when and how much need to be examined very carefully.[1]

In his paper, Patrice Baubeau engages directly with many of these questions and seeks to outline precisely the ways and extent to which 'history matters'. The literature on the role and determinants of financial structures is one that has offered fruitful conversations between economists and historians for some time. Seeking to understand the relative merits of alternative sets of institutional arrangements for mediating the relationship between finance and economic growth, economists have engaged in ever-more sophisticated and extensive modeling of the role of both banks and stock markets in developing and developed economies.[2] Historians, in turn, have offered a number of historical insights and cases that have in many ways strengthened the theoretical analysis, even if the reliance on stylized facts reduces explanatory power and ignores the complexity and messiness of historical contingency.[3] In offering an alternative set of polar institutions, legal scholars have drawn attention to the distinction between common and civil law structures in determining the sets of relationships between investors/lenders and borrowers.[4]

Baubeau is unconvinced by both of these approaches, arguing that their structural bent is unable to deal effectively with complexity. He notes, in particular, the work of Rajan and Zingales,[5] who identify a number of cases in which countries that were relatively more developed at one point in time become less so, and vice versa. Introducing the dynamic element of change into the analysis is of course what historians do, and it raises the question of the extent to which financial systems – however they are categorized or differentiated - are on a course of institutional convergence. Again, Baubeau is unconvinced, and he notes that there remains, after at least two centuries of economic growth, a continued dispersal of financial systems. His conclusion on this, that 'all countries do not end up having the same financial system, but they do evolve in the same direction' he describes as a weak form of convergence, and his explanation is that there is a powerful

1 S.J. Liebowitz and S.E. Margolis, 'Path Dependence, Lock-in and History', *Journal of Law, Economics, and Organization,* 11, pp. 205-226 (1995); P.A. David, 'Path Dependence, Its Critics and the Quest for 'Historical Economics', Working paper (Oxford 2000). http://www-econ.stanford.edu/faculty/workp/swp00011.html

2 R. Levine, 'Financial Development and Economic Growth: Views and an Agenda', *Journal of Economic Literature*, 35 (1997); R. Levine, 'Finance and Growth: Theory and Evidence', in: P. Aghion and S.N. Durland (eds), *Handbook of Economic Growth*, Volume 1A (2005).

3 See, for example, P. Rousseau and R. Sylla, 'Financial Revolutions and Economic Growth: Introducing this EEH Symposium', *Explorations in Economic History*, 43 (2006); and R. Sylla, 'Financial Systems and Economic Modernization', *Journal of Economic History*, 62 (2002); M. Lescure, 'Banking and Finance', in: G. Jones and J. Zeitlin (eds), *The Oxford Handbook of Business History* (Oxford 2008).

4 An introduction to this literature can be found in C. Mayer and O. Sussman, (2002) 'The Assessment: Finance, Law and Growth', *Oxford Review of Economic Policy*, 17(4), 2001, pp. 457–466.

5 R. Rajan and L. Zingales, 'The Great Reversals: The Politics of Financial Development in the Twentieth Century', *The Journal of Financial Economics*, 2003, Vol. 69, No. 1.

element of path dependence in the institutional structures which cannot easily be overcome. This strengthens the need for careful research and understanding of the historical specificities and contingencies of each case.

Baubeau's suggestion of war as one of the historical specificities that needs to be considered in explaining and understanding the existence and role of a variety of financial systems has ubiquity to recommend it. In the twentieth century, there were few countries that did not experience war, either as an active combatant or as a result of the impact of conflict on their economies. The second argument in its favour is the long-term impact of major wars. As he shows, the financial impact of WWI and WWII were felt decades after the end of the conflict. More importantly for his case, however, Baubeau suggests that political, economic and financial hegemony in the nineteenth and twentieth centuries were inextricably linked and that the convergence of financial and economic systems was, therefore, a 'violent process'. For Baubeau, history matters because it cannot be avoided, and war – which equally cannot be avoided as an important element of history – is an influence in both determining the pattern of individual countries' institutional configuration and influencing the convergence process.

Bonin and Segreto's paper on French and Italian regional banking is also explicitly concerned with the questions of relationships, convergence and the role of historical contingency. By bringing careful historically-informed case-study work to the fore, they are able to examine received wisdom relating to the benefits of 'embeddedness' and challenge some of its pretexts. The question of path-dependency is important in this paper, since embeddedness is an outcome of previous relationships: Bonin and Segreto point to its benefits, its costs and also to the impact of events exogenous to the financial system that might alter the institutional patterns. The benefits of embeddedness derive from two closely related traditions in the literature. The first is transaction-cost economics, which stresses that reductions in asymmetric information as a result of close physical or other kind of proximity will offer clear cost advantages.[6] Many historians have noted that the symbiosis of local banks and businesses in a period of rapid economic growth offered, via cross-shareholdings, kinship networks, deep social interactions and a shared commitment to local economic development, ideal conditions in which to overcome the problems of asymmetric information.[7] The second set of literature that points to the benefits of embeddedness, and with which this paper engages, is that concerned with industrial districts, regional economic clusters and the creation of localised social (as well as economic) capital.[8] In both of these traditions, it is physical proximity and a sense of shared local endeavour that helps to generate the relationships of trust needed to overcome the difficulties of doing business. In banking, it is the reusability of information that is important. Carnevali has convincingly shown, however, that physical proximity is, in itself, insufficient to generate optimal economic outcomes even in a single industry.[9] Bonin and Segreto suggest that, although Bordeaux's economic structure was too disparate to be considered an industrial district, the relationships between banks and local businesses were mutually embedded in a culture of proximity and intimate support, in the face of competition from larger, Parisian banks, which resulted in unhealthy interdependency. The costs and benefits of relationship banking have been much discussed,[10] and Yafeh and Yosha have shown both that banks can invest too much in relationships, and that there may be significant

6 O. Williamson, *The Economic Institutions of Capitalism* (New York 1985).

7 N. Lamoreaux, *Insider Lending: Banks, Personal Connections and Economic Development in Industrial New England* (Cambridge 1994); L. Newton, 'Capital Networks in the Sheffield Region, 1850–1885', in: M. Casson and M. Della Giusta (eds.), *The Economics of Networks* (Cheltenham 2008).

8 A. Marshall, *Principles of Economics* (London 1890); J. Zeitlin, 'Industrial Districts and Regional Clusters', in: G. Jones and J. Zeitlin (eds.), *The Oxford Handbook of Business History* (Oxford 2008); A. Popp, *Business Structure, Business Culture and the Industrial District: The Potteries, c.1850–1914* (Aldershot 2001).

9 F. Carnevali, (2004) '"Crooks, Thieves and Receivers" Transaction Costs in Nineteenth Century Industrial Birmingham', *Economic History Review,* 62: 3 (2004), pp. 533–550.

10 See, for example, A. Boot, (2000) 'Relationship Banking. What Do We Know?', *Journal of Financial Intermediation* 9:1 (200), pp. 7–25.

path dependence which plays out in the structure of the financial system.[11] Both these elements are present in the case of Bordeaux, and the later, deliberate shift towards transactional banking represents a (belated) realisation of the dangers of becoming over-committed. It could then be argued that the shift towards a more transaction-dominated structure in the region represents one element of the convergence – or evolution – that Baubeau discusses. The Italian case in Bonin and Segreto's paper concentrates on the importance of political institutions and the role of external events in shaping the financial structure, but the example of the Casa di Risparmio di Prato reveals the extreme danger of over-commitment. In both countries, the careful and considered historical record adds much to our understanding of the concepts employed.

Brambilla's discussion of the emergence and shape of large investment banks in three European countries – Italy, France and Germany – offers an alternative view of the process of convergence. He notes the importance of the legal and institutional frameworks in the array of financial revolutions that took place in the second half of the nineteenth century and then argues that the nature of these national institutional contexts had a crucial role to play in shaping the activities of a set of institutions that, over time, rather than participating in a process of Gerschenkronian convergence, actually diverged from their common ancestry. This develops the notion – well established in the literature on comparative financial revolutions – of the relationship between institutional framework and emergent financial system.[12] There are two important ideas contained within Brambilla's paper. First, we see again the importance of the historical experience in shaping the nature, purpose and forms of financial institutions and individual financial systems as they developed in the period before 1914. Second, Brambilla's development of the idea of a European perspective on the emergence of these institutions allows us to understand his case study of Italy in a variety of historical and geographical contexts. A clear focus on the recursive and symbiotic relationship between national institutional configurations and the emergence of particular forms of financial systems allows us to make sense of both similarities across countries and the variety of institutional forms that had emerged by the outbreak of the First World War.

The collection of three papers on the financial system in Cyprus brings some of these issues into clearer focus. Demetriadou's discussion of the founding and early history of the Bank of Cyprus speaks very clearly to the well-established European tradition of financial institutions as a form of self-help mechanism.[13] The need for this bank was clearly set in the difficult context and disappointment of the British colonial government after the end of Ottoman rule over the island. The creation of the Nicosia Savings Bank represented a means and opportunity to mobilise small savings and investments in the local economy, but the difficulties were many – from challenging the general indifference of the British government to the specific impediments to gaining legal chartered status. The political and economic institutions and associated priorities of colonial rule conditioned the opportunities for the new bank, but it is also clear that the founders saw themselves as potential agents of change. This paper is valuable not least for asserting the fundamental power and value of the very simple process of savings mobilisation in economies that are not well developed. The value of this insight, has not, of course, been lost on more recent history.[14] Colonial politics are also important in the first paper in this book, by Alexander Apostolides, since the decision of the Ionian Bank to enter the Cypriot market in 1926 was a direct outcome of changes in that bank's operating environment as a result of the difficulties experienced by a Greek bank in Egypt and Turkey. Apostolides deals skillfully with the complexity

11 Y. Yafeh and O. Yosha, 'Industrial Organization of Financial Systems and Strategic Use of Relationship Banking', *European Finance Review* 5 (2001), pp. 63–78.

12 D.C. Mowery, 'Finance and corporate evolution in five industrial economies, 1900-1950' in: V. Zamagni (ed.), *Finance and the Enterprise* (London 1992); P.L. Rousseau and R. Sylla, (2006), 'Financial Revolutions and Economic Growth: Introducing this EEH Symposium', *Explorations in Economic History*, 43 1 (2006); pp. 1–12.

13 J. Wysocki, 'Introduction', in: J. Mura (ed.), *History of European Savings Banks,* Vol.1 (Stuttgart 1996);

14 M. Yunus and A. Joli, *Banker to the Poor: Micro-Lending and the Battle Against World Poverty* (London 1998)

of these relationships and shows how the Ionian Bank came to the decision to expand its network of branches into Cyprus. The island seemed like a good fit for the multinational bank: it was based in London; it had extensive experience in servicing merchant trade across the Eastern Mediterranean; and it was well-used to providing financial services to the larger Greek diaspora. It was not, however, a success, and Apostolides draws two clear lessons from the failure of the Ionian Bank to establish a significant hold in this market. First, and making a similar point to that addressed by Baubeau, there is the non-linear nature of success. The Ionian Bank was initially highly successful in attracting deposits to its branch network – mostly by offering banking services to small businesses that had not previously made use of formal institutions. Despite this initial success, however, the bank was not profitable in the longer term and its losses quickly mounted: the Ionian Bank sold its stake in this market to Chartered Bank in 1957. The second important lesson drawn from this story relates to the strategy adopted by the Ionian Bank. Apostolides notes that, despite its initial and substantial success in attracting deposits, the Ionian Bank was unable to make significant inroads in the lending market in Cyprus. This, he suggests, is because the bank was unable or unwilling to adopt a strategy fitted to the specific conditions of the Cypriot market, preferring to maintain its previously successful approach of engaging primarily in trade finance and investing its resources elsewhere. Comparisons are drawn with the locally-based, information intensive and universal provision of the Bank of Cyprus which, although much smaller than the Ionian Bank, was able to exploit its extensive network of local branches and contacts throughout the island. Apostolides attempts to draw some clear strategic lessons – about understanding the market and being willing to adopt alternative approaches to business – for banks contemplating entry into new markets. These are lessons that we will return to when discussing some of the later papers.

The paper by Theophanus on monetary integration and the impact of the European currency was prepared before the full implications of the financial crisis and subsequent maelstrom in the Euro area had made themselves known. Rather than undermining any of the views presented in this paper, however, its analysis becomes even more valuable as a statement of belief and current understanding of the position in early 2009. In particular, it seems prescient in terms of the key lessons drawn from its highly-informed discussion of the literature on Optimum Currency Areas and the nature of monetary and fiscal integration. Three points should be made. First, Theophanus is very careful to present the emergence of the Euro and the economic and monetary union in the context of the ongoing process of wider European integration, from the early adoption of external customs barriers to the deeper processes designed to establish and support economic and monetary convergence. Second, the paper is clear about the challenges that such a process faces, noting both the conflict between widening of the European Union through the accession of countries whose economies have not attained the levels of growth, integration and development of those of Western Europe, and deepening of the single European market and economic area that is a condition for the continued successful operation of a single currency. The need for cooperative fiscal arrangements to deal with potential asymmetric shocks is clearly identified in the paper. The challenges associated with achieving effective monetary union without fiscal integration – and agreed protocols for dealing with periods of uncertainty and instability – are significant. Third, Theophanus identifies the demand for economic and productivity improvements, the required fiscal discipline and the (political as well as economic) integrationist momentum of the Euro as holding significant opportunities for the island of Cyprus. This paper clearly illustrates the value of an informed historical perspective in understanding the nature and shape of the institutional forces and challenges of the current international economy.

Two of the central questions in the history of central banking relate to (a) what should the relationship be between (central) government and the money supply, and (b) how should this relationship be mediated or expressed – what tools are available to manage it?[15] The two papers in this collection that deal with the role and activities of central banking offer differing perspectives on these questions: Tarkka's analysis of what he calls the proto central banks of the Baltic Sea region in the early part of the nineteenth century notes that these institutions in Sweden, Denmark, Russia, Prussia, Finland and Poland all shared some remarkable similarities. First, they each sought to mobilise and monetise otherwise illiquid assets by accepting long-term mortgages on land as collateral for loans. In this way, they each sought to facilitate the development and growth of economic activity by making use of the resources available to them. Second, Tarkka notes that in doing so, these institutions were responding to the power groups and political constituencies that existed in their respective countries and again we can identify in these histories the importance both of pre-existing economic and political relationships and of the established institutional structures. Third, the paper makes clear that, at some point in the mid-nineteenth century, each of these central banks adopted a more 'classical' organisational structure, either on the model of the Banque de France or that of the Bank of England. As these economies developed beyond rudimentary organisation, the real bills doctrine – which represented a more anonymous and at the same time more effective means of mediating the relationship between currency and economic activity – came to dominate.[16]

The paper by Manea and Tone on the other hand, is much clearer about the role of political power. It deals with the difficulties of the Romanian State during the First World War and the importance of a steady supply of credit from the National Bank. Essentially, it seems that, by the end of the war, the government was insolvent, kept afloat only by extensive borrowing from the National Bank. This dependent relationship was then maintained throughout the 1920s as the Bank and government struggled to establish external convertibility for the currency.

Schubert and Kaltenbeck's examination of the actions of Austrian banks in the post-1918 and then again in the post-1989 period is obviously suffused with the importance of political power and institutional structures. But it also revisits one of the issues raised earlier by Apostolides, the question of strategic choices around when and how to enter new markets, and how these choices might be determined. In the immediate aftermath of the First World War, and the demise of much of what they had come to regard as their domestic territory and market, the Austrian banks made a strategic decision to maintain operations across the broad range of the Successor States. A number of factors influenced this decision but the analysis offered here suggests that the most important element was the history and established relationships of the banks and of Vienna as the centre of the Empire's commercial and financial life. These factors set the scene for continued operations – in a new set of environments and institutional structures – and the banks found the competitive conditions highly challenging. In the post-1989 period, with the fall of the Berlin Wall, the banks had learned some of the strategic lessons of the earlier experience and, buttressed by their moderately successful forays into multinational banking in the 1980s, were presented with a variety of opportunities to develop fully-owned subsidiaries across the rapidly-growing Eastern European region. The conclusion of this paper speaks both to the value of learning from the past and to the ways in which different institutional environments might determine the appropriate strategic response.

The paper by Risto Herrala returns to the lending activities of the Finnish central bank in the nineteenth century and examines the implications for the commercial banking sector of its shift, from mid-century onwards, towards the short-term, less-flexible real-bills dominated portfolio discussed by Tarkka. In Finland, with a slowly developing economy and a relatively small industrial sector, the key ingredients for the success of the commercial banking sector in the late nineteenth century were flexibility and geographical access to

15 See, for example, F. Capie, S.Fischer, C.Goodhart and N. Schnadt, *The Future of Central Banking. The Tercentary Symposium of the Bank of England* (Cambridge 1994)

16 T.M. Humphrey, 'The Real Bills Doctrine' *Federal Reserve Bank of Richmond Economic Review* 68 (1982), pp. 3–13.

loans. Competition in this environment was largely on a non-price basis, but reflected willingness to mobilise intangible assets in the service of economic growth – a conclusion that would surely find favour with many of the authors in this collection searching for a Gerschenkronian interpretation of financial systems, not necessarily built around convergence, but certainly as mobilisers of economic and financial resources.

Abhik Ray's paper returns once again to the questions of relationships, institutional assets and the appropriate strategies to adopt when entering new markets or territories. The advantages of making use of a system of compradores in the Far East are well understood; their cultural and linguistic skills, networks and reputation are all valuable assets which allow new entrants to overcome or at least mitigate the worst effects of the substantial difficulties that they often face.[17] This paper outlines, first, the importance of these *compradores* – or *banians* – in facilitating trade in the Calcutta and Bengal region and, second, how they came to be displaced by more formal banking and commercial institutions and relationships. One interesting aspect of this paper, which has echoes of some of the later criticisms of English industrialists in the nineteenth century, is how the fortunes of many of these *banians* were transformed into landed estates and financial, rather than commercial activities.

Institutional structures, the role of political power, the elements which determine strategic choices, the question of the long-term relationships between the financial and the real economy, and whether these converge over time, are dealt with in this collection of papers. There is much here to support the contention outlined above that history matters: there is also much to support the view that it matters in a wide variety of ways that are highly contingent. Most importantly, perhaps, the insights developed here speak very loudly of the importance of continued detailed historical research as a means to understanding the complexity, variety and operation of banking and financial history. Many years on from its first conference, that is surely the most important lesson of all for the *eabh*.

17 See F.H.H. King, *The History of the Hongkong and Shanghai Banking Corporation, Volume 1: The Hongkong Bank in Late Imperial China, 1864–1982: On an Even Keel* (New York 1987).

# Foreign Banking Entry in Cyprus: History Lessons in Strategy.

Alexander Apostolides

## I.

The financial intermediation sector is currently a very important part of the economy of Cyprus. The sector represented 7.47 per cent of GDP in 2008, while the active participation of domestic financial institutions in several European countries has resulted in the total exposure of the Cypriot financial intermediation sector, worrying international credit rating agencies, as it is far in excess of the total GDP of Cyprus.[1] However, despite these recent concerns, the sector has been producing above average growth in terms of value added, productivity and employment. The financial sector has also proven surprisingly resilient to the economic crisis, since 2009 leading the Cypriot recovery, despite the concerns of the sector's exposure to troubled European economies.

This article focuses on the banking sector of Cyprus. It attempts to place the relatively recent transformation of the industry (due to the increase of competition by non-Cypriot concerns in the domestic retail market) in a historical perspective. By analyzing the banking sectors' transformation in the interwar (1919–1938) period, one can glean how strategic decisions of foreign banking entry in the Cypriot domestic retail banking market affected the overall performance of non-domiciled banks on the island.

The definition of what constitutes a foreign bank is becoming increasingly harder to pin down. In terms of historical research there has been an emphasis on multinational banking, whereby a bank controls branches and affiliates in more than one country.[2] As a result, the multinational banks which have branches in Cyprus, their central offices in another country and who are actively involved in the domestic retail banking sector are considered foreign banks in the context of the article. It is worth noting however that Cyprus today has a number of multinational financial concerns that have exclusively focused on offshore capital management, and as a result they are not a part of the current analysis.

The Cypriot retail banking sector has been transformed by significant foreign banking entries since joining the European Union in 2004. Foreign banks chose a range of different strategies to enter the Cypriot market. Société Générale (SG), Eurobank (EFG), Piraeus Bank (PB) and Emporiki Bank (EB) entered the market through new branches. The market growth of these banks has remained small in terms of loans and deposits, controlling just 2.97 per cent of total deposits and 4.33 per cent of advances.[3]

In contrast, the Dubai Investment Fund (through Marfin Investment Group) purchased a controlling stake in the second largest domestic Bank, the Cyprus Popular Bank. The resulting bank, renamed Marfin Popular Bank (MPB), is the largest bank controlled by foreign interests in Cyprus in terms of market share and deposits, controlling 15.68 per cent of the market in loans and 20.54 per cent of deposits.[4] MPB is now the second largest bank in terms of market share in Cyprus, and it was announced (and subsequently suspended due to the adverse situation in Greece) that it will relocate its central offices from Nicosia to Athens.[5] The

1 *The Economist*, 'Banks in Cyprus: Europe's other island' (European Printed Edition, 3/12/2010). Source: Statistical Service of the Republic of Cyprus, National Accounts 1995–2008 (as accessed 12/10/2009).

2 G. Jones, *British Multinational Banking* (1993; reprinted Oxford 2001), chapter 1.

3 The market shares as provided by the Central Bank of Cyprus for 31 December 2008, viewed on 01 April 2009, www.centralbank.gov.cy.

4 Ibid.

5 *The Financial Mirror*, 'Marfin Popular Bank moving base from Cyprus to Greece' published 25 May 2009, www.financialmirror.com.

buyout caused quite a commotion in Cyprus, since up until that time domestic banks had successfully maintained their dominance of the local banking market, despite several foreign bank entries into the market.[6]

This article is the starting point of a larger project that will attempt to explain the motivation of foreign banks' entry in new markets and how entry decisions consequently affect performance. Domestic banks have proved remarkably resilient in terms of market share in Cyprus. In the last eighty years, Alpha Bank, Gridlays, Chartered Bank, Barclays (D.C.O.), and the Ionian Bank entered the Cypriot market with limited success.[7] This is unusual since the Cypriot government did not undertake direct hostile actions against foreign banks, unlike other newly independent countries in the Mediterranean.[8] Phylaktis argued that 'the success of the local institutions in challenging the well-established foreign banks was […] due to the entrepreneurial failure of the foreign banks'.[9] However, many of these banks were successful international banks, and thus it is not clear why such entrepreneurial failure would specifically occur in Cyprus, especially since the same decision makers have been successful in penetrating new markets elsewhere.

This paper attempts to trace one of the earliest entries of a foreign bank in Cyprus. The London based multinational Ionian Bank (IB) entered the Cypriot market in 1926. The interwar period (1919–1938) was also the period when the domestic banks of Cyprus were first established as national enterprises. By focusing on one of the first foreign bank entries in the island, the paper attempts to determine whether the current advantages of domestic banks over foreign banks are related to their founding. The IB entry can also provide information as to how entry strategies can handicap the subsequent development of the entrant bank in the new market.

The entry of the IB is worthy of study since Cyprus was a British colony at that time. The colonial government was committed to *laissez-faire* polices, even though the new governor of Cyprus, installed around the same time as the IB's entry, was more active in his pursuit of colonial matters.[10] Thus, the case study of the Ionian Bank eliminates the possibility of indirect government hostility; this allows for a clearer understanding of the relative advantages of domestic banks without needing to take into account the role of government interference in favour of local institutions.

The IB opened its first branch in Nicosia on 8 December 1926 and by 1928 it had established eight branches and agencies, covering all the major population centres of the island. In 1957 the IB operations in Cyprus were sold to Chartered Bank. Subsequently, Chartered Bank's operations were acquired by the Bank of Cyprus (BOC) which is currently the largest domestic bank in Cyprus. Thus the entry of the IB in Cyprus was very short-lived.

The article is divided in three parts. Section I contains the introduction. Section II provides a description of the IB's entry in Cyprus and its poor relative performance. Section III evaluates the bank's entry strategy to see the ultimate causes of its poor performance and the comparative advantage of local banks at the time, which successfully increased their market share at the time when the IB was struggling to make an impact in the new market.

6 *The Cyprus Weekly*, 'Banking in Cyprus and investment fund Octopus', published 18 Jan 2007; 'Banking sector expansion' published 26 July 2007; 'Banks again shake up the market', published 10 June 2008; 'Bank purchases, nationalism and business sense', published 17 June 2008.

7 Only Alpha bank remains in the market, being fourth in Deposits (6.1%) and third in advances (8.3%) after a very long time in the Cyprus market. Source: *The Central Bank of Cyprus* for 31 December 2008, viewed on 01 April 2009 at www.centralbank.gov.cy.

8 A. E. Tschoegl, 'Financial Integration, Disintegration and Emerging Re-Integration in the Eastern Mediterranean, c.1850 to the Present', *Financial Markets, Institutions & Instruments*, Vol. 13, No. 5 (2004) p. 247, pp. 262–267.

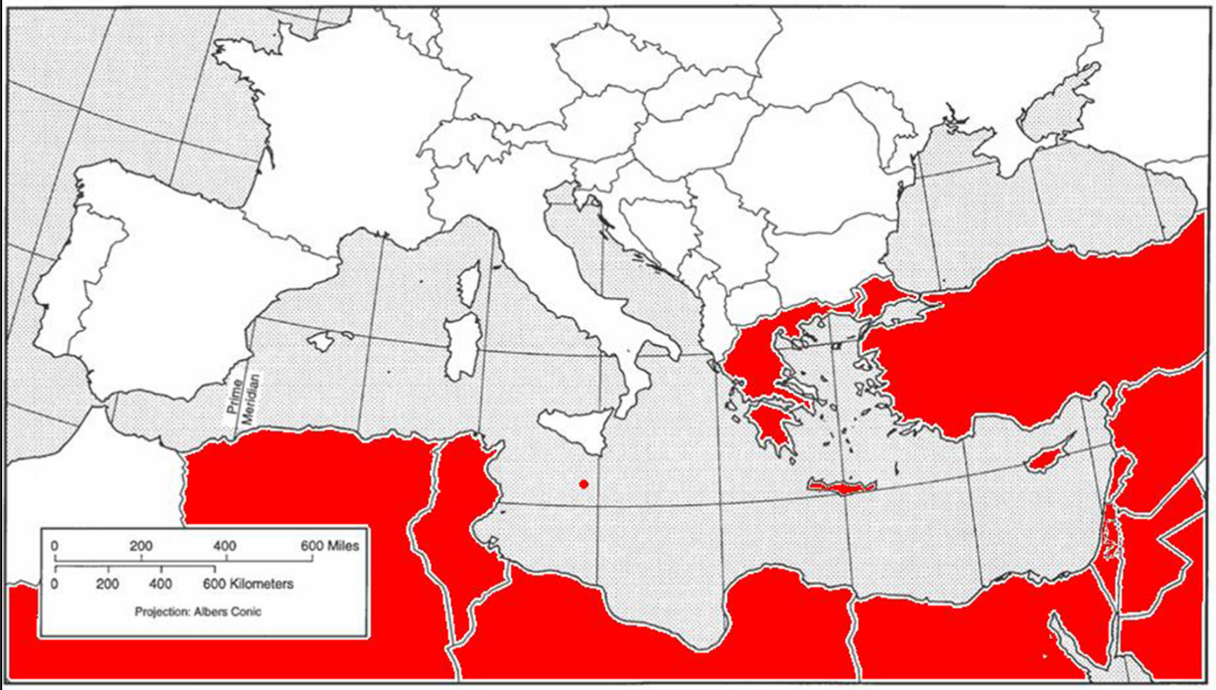
9 K. Phylaktis, *The Banking System of Cyprus: Past, Present, and Future* (London, 1995), p. 18.

10 G. S. Georghallides, *A Political and Administrative History of Cyprus* (Nicosia 1979), p. 137; for a detailed description of Sir Ronald Storrs and his unorthodox ruling style in Cyprus see: G.S. Georghallides, *Cyprus and the Governorship of Sir Ronald Storrs: The Causes of the 1931 Crisis* (Nicosia 1985).

## II.

The IB entry in Cyprus took place during an era of great foreign banking expansion in the Mediterranean. Tschoegl provides an extensive, yet far from complete, list of banking entries and buyouts of local banking firms by foreign multinationals. The countries mentioned are highlighted in red in the map below.

Figure 1: Countries whose banking activities are described by Tschoegl, 1850-2001.




Source: A.E. Tschoegl, 'Financial Integration, Dis-integration and Emerging Re-Integration in the Eastern Mediterranean, c.1850 to the present', *Financial Markets, Institutions and Instruments*, Vol.13, No.5 December 2004 pp.244-284; A.S.J. Baster, *The Imperial Banks* (London 1929; reprinted New York 1977) .

Table 1 divides the banking expansions described by Tschoegl into groups. What is most striking is the interwar period, labelled by Tschoegl as a 'concessionary era', consisted of 37.9 per cent of all banking expansions during the period 1850–2002. The expansion of direct European control in the Mediterranean enabled and encouraged foreign banks to expand their networks around the area, often with some state sponsorship or encouragement.[11]

Table 1: Banking entries as described by Tschoegl (2002).

| | 1850–2002 | The Concessionary Era (1918–1939) |
|---|---|---|
| New Banking Establishments | 42 | 13 |
| Established Banks entering the region | 46 | 6 |
| Total Banking Establishments | 88 | 19 |
| Expansions through New Branches | 107 | 45 |
| Expansions through Buyout – Mergers | 46 | 13 |
| Total Expansions | 153 | 58 |

Source: A.E. Tschoegl, 'Financial Integration, Dis-integration and Emerging Re-Integration in the Eastern Mediterranean, c.1850 to the present', *Financial Markets, Institutions and Instruments*, Vol.13 No. 5, December 2004, pp.244-284, A.S.J. Baster, *The Imperial Banks* (London 1929; reprinted New York 1977).

11 Tschoegl, 'Financial Integration, Disintegration'; p. 254.

The IB was one of the smallest London based international banks during the interwar period, both in terms of assets and branches.[12] Its expansion in the Mediterranean was very gradual; the bank had only expanded from the Ionian Islands to mainland Greece by 1900.[13] As a result of its gradual expansion the bank became increasingly related to Greek client networks, even though operational control was in London and its mode of operation was firmly based on British multinational banking principles. The IB capitalised on the established network of Greek merchants in Egypt by establishing a branch and agent network in Egypt in 1907. The bank's entry in Egypt was successful (at least until the end of the First World War), becoming one of the most important financial institutions in cotton finance. The success was due to British rule being unencumbered by economic nationalism, which aided the IB to appeal to the Greek diaspora that was very active in the cotton trade. This provided ample demand for the services of the IB in trade finance.[14]

By the end of the First World War the IB's operations in Greece were suffering due to increasing political and economic distress. Greece was defeated in the war against Turkey and was forced to pay a heavy indemnity as well as accommodate millions of former Ottoman subjects in the subsequent population exchange. This aggravated the already dire economic situation of Greece that was characterised by inflation, currency depreciation and budget deficits.[15] The political situation was equally grim since military coups and frequent regime changes did not allow Greece to follow a path of economic stabilization. The situation in Greece caused great concern to the bank's executives, since there was an increasing pressure by the successive governments to provide them with finance, with no guarantee that such commitments would be honoured.[16] Likewise, the continual depreciation of the drachma against sterling jeopardised the bank, since its assets were mostly denominated in drachmas, while its profits were denominated in sterling.[17] By 1926 the drachma fell to just six per cent of its pre-war value to sterling, forcing the bank to write down 30 per cent of its assets.[18]

The Turkish victory in the Greco-Turkish War killed the IB's attempt to expand in Istanbul. The bank purchased the branches from the Guaranty Trust Co. of New York, hoping to acquire Greek business from the large population of the city. The venture was loss making, since the defeat of the Greek army in 1922 led to the establishment of a hostile Kemalist government.[19] The IB was forced by the Turkish government to provide unprofitable loans to the Turkish army and faced an ultimatum to increase the number of Turks in senior positions. The bank decided to cut its losses, liquidating its holdings in Turkey in 1929.[20] The losses of the Istanbul branch were so severe that in 1927 it created 56 per cent of total losses, reducing the net profit of the whole bank by 23 per cent.[21]

12 Jones, *British Multinational Banking*, pp. 393–402.

13 For the history of the bank in this period, see: P.L. Cottrell, *The Ionian Bank; an imperial institution, 1839–1864* (Athens 2007).

14 A. Kitroeff, *The Greeks in Egypt; 1919–1937. Ethnicity and Class* (Oxford 1998), Chapter 4; A.S.J. Baster, *The International Banks* (London 1935; reprinted New York 1977), p. 71.

15 K. Kostis, *Synergasia kai Antagonismos: Ta 70 Xronia tis Enosis Elinikon Trapezon* (Cooperation and competition: The 70 years of the Union of Greek Banks) (Athens 1997), p. 24, pp. 35–36.

16 Stavridi, the chairman of the bank, stated that as long as Greece was in 'one long nightmare of revolt, counter-revolt, civil war and financial chaos' the Ionian Bank's profitability would suffer; British Library of Political and Economic Science, London [henceforth BLPES], *Ionian Bank Archives* [henceforth IB], IB,1/2, 'Ionian Bank Reports of Proceedings', Annual General Meeting 12 Jan. 1924, p. 6.

17 A.S.J. Baster, *The International Banks*, p. 19, BLPES, *IB*,1/2, 'Ionian Bank Reports of Proceedings', Annual General Meeting 13 Feb.1923, p. 7

18 LPES, *IB*, 'Ionian Bank reports of Proceedings', AGM 13 Feb. 1923, p.7 ; Exchange rate: B. Kremidas (ed.), *Eisagogi stin Neo-Elliniki Oikonimiki Istoria* (Introduction to Modern Greek Economic history) (Athens 1999), p. 189.

19 BLPES, *IB*, 3/3 'Agenda for the Court meetings'; Losses were reported by both Galata and Stanbul branches, as well as being victims of a fraud scandal, 16 Dec. 1925.

20 The chairman cited government hostility as the reason for losses and liquidation of the Istanbul Branch: BLPES, *IB*, 3/3, 'Agenda for the Court meetings', Ultimatum in hiring Moslems 02 Dec. 1925; *IB*, 3/31, 'Forced Loans by Turkey and Greece' , 10 March 1926.

21 BLPES, *IB*, 6/100, 'Annual Report of the General manager to the Chairman', 12 Dec 1927.

Thus by 1926 the bank was facing economic uncertainty in Greece, and political harassment in Turkey. However, the IB also felt increasingly threatened in Egypt, since British deposit banks chose Egypt as one of their first forays in the international market. Lloyds acquired the branches of Cox & Co in Egypt in 1923, but did not seem to pay much attention to this business.[22] On the contrary the purchase of Anglo-Egyptian in 1920 by Barclays (latter named Barclays D.C.O.) led to the entry of a large clearing bank into Egypt, with the aim of capturing a lion's share of cotton exports.[23] The British deposit banks were much bigger in size than the IB, and held a very large stock of sterling deposits that enabled them to out-compete the bank for sterling denominated trade finance.[24] The competition also intensified with the rapid growth of Banque Misr, a domestic bank run by Muslims that was aided by a growing feeling of national self-determination in Egypt.[25]

The increased competition in Egypt led to problems for the IB. The IB quickly lost its place as the leader in cotton finance, falling from first to fifth in terms of cotton trade finance by 1927.[26] As a result of the competition, the Egyptian branches, some of the most profitable in the bank's network, started recording losses.[27] The manager of the Egyptian branches stressed to the general manager the need for aggressive credit expansion, but he was refused by the general manager who felt that the bank's deposits in sterling should increase prior to any expansion of credit in Egypt in order to minimise exchange risks.[28]

Thus, increased uncertainty in all its markets was the background to the IB decision to enter the Cypriot banking market. Cyprus seemed a complimentary choice to the bank's existing network. The IB was a London-based bank with its main operations in Greece and in important centers of the Greek diaspora. Cyprus was a British crown colony and the majority of the population was Greek. The bulk of the island's trade was with Britain, Egypt and Greece, areas where the IB had already established branches, making the bank well placed to accommodate the credit needs of Cypriot merchants. The fact that Cyprus was a British colony seemed to offer protection from the economic nationalism that troubled the bank's operations in Greece, Turkey and Egypt, as the island was still under an administration that was favourable to British business interests.[29]

However, historical evidence indicates that the decision to enter the Cyprus market was not so much based on the complementarities to the bank, but on the misplaced belief that the colonial government in Cyprus would show preference to the IB over its current banker, the Ottoman bank (OB). In the view of the executives of the IB, becoming the banker to the colonial government would provide the bank with large sterling deposits that would enable it to compete more effectively in Egypt without suffering any of the exchange risks of using drachma denominated liabilities.

The failure of the bank in wresting control of the government accounts from the OB is covered in depth by Apostolides and Gekas.[30] The IB made active efforts to woo the governor, firstly by opening branches in all cities and secondly by providing a generous mortgage loan to a Muslim charity, which quickly defaulted

22 Jones, *British Multinational Banking*, p. 240.

23 M. Ackrill and L. Hannah, *Barclay's: The business of Banking 1690–1996* (Cambridge 2001), p. 82.

24 The chairman commented that 'competition remains keen, and now one of the big five British banks operates in Egypt' BLPES, *IB*, 'Ionian Bank reports of Proceedings'; AGM 12 Jan. 1924, pp. 23–25.

25 R. Wilson, *Banking and Finance in the Arab middle east* (Surrey 1983), pp. 29–31.

26 The IB was replaced as leader by Banque Misr. Reductions in commissions in Egypt: BLPES, *IB*, 'Ionian Bank reports of Proceedings'; AGM 13 Jan. 1925, AGM 05 Jan. 1926, p.15; *IB*, 6/100 Caridia to Stavridi 4 Oct. 1927, 'Short Report for the Year Ending' 31 Aug. 1927.

27 BLPES, *IB*, 6/100, 'Summary Table with Profits and Losses 1922–1930', 10 Aug. 1931.

28 BLPES, *IB*, 'Annual Report to Chairman', 05 Jan. 1927 pp. 4–5.

29 Cyprus was occupied and administered by the British since 1878. Britain had effective control of Cyprus, even though the island was still nominally considered as part of the Ottoman Empire; Cyprus was a British colony in all but name. The British formally annexed the island in 1914, and following the recognition of the annexation by Turkey in the Treaty of Lausanne, Cyprus was formally declared a Crown Colony on 01 May 1925.

30 See: A. Apostolides and A. Gekas, 'Banking Expansion, Success and Failure in the British Mediterranean; the Ionian Bank, 1840s – 1920s', in G. Tortella, J. Consiglio, J.C. Martinez-Oliva, (eds.) *Banking in the Mediterranean: A Historical Perspective,* (Surrey, forthcoming).

on its loan. The IB's attempts to wrest control of the governmental accounts led to OB offering better terms to the government and warning that the termination of the OB's position as the sole government banker would jeopardise the existence of the Cyprus Agricultural Bank, a joint bank established by the OB and the government in 1925.[31]

This threat, combined with the improved terms, seemed to convince the colonial treasurer that it would be unwise to change bankers.[32] The Cypriot branch manager of the IB reported bitterly that the colonial treasurer 'did not know what terms we were prepared to offer and … speaking frankly … did not seem to care what they might be'.[33] Despite the failure of the IB in gaining the most important client (in terms of deposits and foreign transaction needs) in Cyprus, the entry of the IB was beneficial for the government, since the new rates offered by the OB provided more than twice the previous rate of return to the government.

The IB never managed to take a foothold in the government business during its stay in Cyprus. The evidence of the discussion prior and during the entry to Cyprus, shown in Apostolides and Gekas, indicate that the bank entered the market in order to become the government's banker. This is confirmed post-hoc by the bank's general manager who felt the bank was duped as 'we had been very badly treated by the authorities … since no doubt through our entering the field … better offers have been made'.[34]

The Cyprus manager of the IB argued that this failure reverberated in other aspects of its business in Cyprus. He stressed that the OB could offer improved rates to its most important clients due to holding the government accounts and as a result all large companies remained attached to the OB.[35] In 1931 the Cyprus manager wrote to the government of Cyprus, claiming that competing against the OB without a share in government business was 'like a person fighting for air … [as the government accounts] forms the only hope for a successful banking business being set up'.[36]

However, archival research indicates that the bank was initially successful in its primary aim of collecting sterling denominated deposits.[37] The bank obtained large sterling deposits for investment in Egypt despite its failure in becoming the government's banker. Over £174,000 was lent to the Alexandria branch, and since the interest paid on deposits in Cyprus was lower than in Egypt, this lead to an estimated benefit (in terms of reduced interest payments) of £3,776.[38] By 1930 the bank managed 22.8 per cent of Cypriot deposits, despite not having secured the government accounts, which constituted 20 per cent of total deposits. The success of the bank lay in attracting deposits from small businesses that were not previously part of the formal banking market. The local press was very favourable to the opening of the bank. Neos Kupriakos Filax and Eleutheria hoped that the Cypriot merchants would use the increased credit wisely.[39] However credit was not necessarily forthcoming to Cypriot businesses. Over 51 per cent of the total deposits was invested in Alexandria.[40]

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31 Ibid.

32 Cyprus National Archives, Nicosia [henceforth CNO], *Secretarial Archive* [henceforth SA], 11059/1926/1, Memorandum from Du-Boulay (Treasurer) to Sir Ronald Stors (Governor), Confidential, 14 Jan. 1927.

33 BLPES, *IB*, 6/39, Caridia (General Manager) to Reeve (Cyprus Manger), (attachment of a previous undated letter), 14 April 1927.

34 BLPES, *IB*, 6/39, Caridia to Reeve, 14 April 1927.

35 BLPES, *IB*, 6/64, Luard to Caridia for CMC (Cyprus Mines Corporation), 28 Dec 1926; for CAC (Cyprus Asbestos company): 16 Dec 1926, 12 Feb 1927; None moved to the Ionian Bank.

36 CNO, *SA*, 1/1059/1926, Reeve to Gunnis 02 June 1931, Reeve to Gunnis 12 Sep. 1931.

37 The deposits were in Cypriot pounds, which were fully convertible to the Pound Sterling at par.

38 BLPES, *IB*, 6/100, 'Annual Report to Chairman by General Manager', 19 Aug 1931; £174,000 was invested in Egypt. Cyprus deposits received an interest of 3%, costing the Bank £5381. If deposits where raised in Egypt, with its prevailing rate of 5%, the deposits would have cost £9,157. Thus the benefit for the bank was £3376.

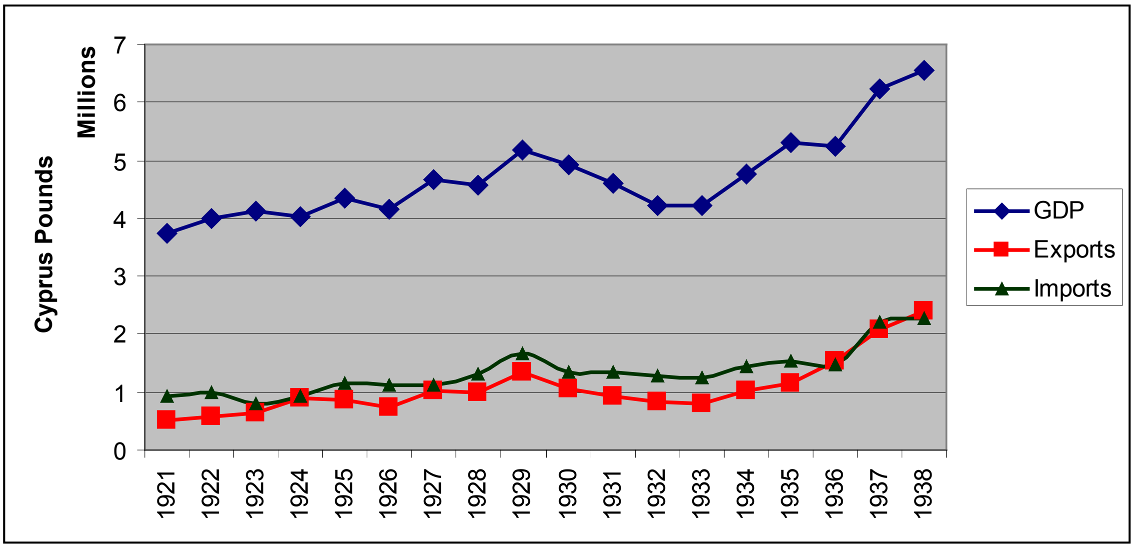
39 *Νέος Κυπριακός Φύλαξ* published 08 Dec 1926; *Ελευθερία* published 01 Dec 1926, 04 Dec 1926, 08 Dec 1926.

40 BLPES, *IB*, 6/100, 'Annual Report to Chairman by General Manager', 19 Aug 1931, p. 17.

Thus the failure of the IB in Cyprus took place despite the initial success in attracting deposits and not because of the failure in wresting control of the colonial government accounts. Sterling was being invested in Alexandria partly because the Cypriot branches of the bank remained loss making until 1937; they did not necessarily make the right decisions when they invested in the Cypriot market. In 1930 the general manager estimated that the cumulative losses of the Cypriot branches were as high as £11,500.[41] Despite the large losses in the period 1926–1937, Jones claimed that the Ionian Bank's Cypriot branches provided a net profit of £11,000 by 1945.[42] However, Jones' estimate does not take into account the cost to the bank due to non-performing loans in Cyprus. In 1929 the Cypriot branches constituted 31 per cent of all immobile loans of the IB, despite generating less than ten per cent of the gross profit.[43] Thus, assuming that such a loss rate was constant, the bank suffered a substantial loss from the Cypriot branches in the period 1927–1945.[44] Even the relative share of deposits in Cyprus fell away by 1945, as the bank was challenged ever more effectively by emerging domestic banks. Thus the entry of IB into the Cyprus market cannot be considered successful.

The receipt of significant deposits by the IB indicated that its venture in Cyprus was not necessarily doomed, but the bank did need to change its *modus operandi* in order to fit within this specific market. For a bank unwilling to change from essentially a trade acceptance institution, the most preferred customer in the limited formal banking market of Cyprus was the government with its substantial deposits and credit transfers. Second in line were the large mining concerns, followed by the various export/import merchants, who already had business accounts in other established banking institutions. However, the rapidly increasing deposits in the local banking system, which made the greater share of the IB deposits, were provided by a new class of smaller businessmen and entrepreneurs and the emerging urban middle class, who needed not only trade facilitations but a universal banking service, including personal finance.

**Figure 2**: GDP and Exports and Imports 1921–1938 (in constant 1938 prices).




Source: A. Apostolides, 'Economic Growth or Stagnation: Estimating the GDP of Cyprus and Malta 1921–1938', (London 2010), p.66.

41 Ibid.

42 Jones, *British Multinational Banking*, p. 207.

43 BLPES, *IB*, 6/100, 'Report to Chairman by General Manager', 19 Aug 1931; *IB*, 7/70 BLPES, *IB*, 6/100, 'Annual Report to the Chairman', 18 Dec 1929, p.13; Gross Profits, 18 Aug 1931.

44 Such an assumption is plausible: Cyprus had a drought and suffered badly due to the great depression, affecting the IB's performance in 1932–1933. BLPES, *IB*, 6/100, 'Report to Chairman by General Manager', 19 Aug 1931, p.8 ; Caridia estimated a loss of £7,000 a year by 1931 when losses of non-performing debts are included.

Thus, the Ionian Bank's failure was down to two reasons: the bank was reluctant to expand lending in Cyprus outside trade finance while the large number of non-performing loans indicates that the bank failed to correctly asses risk on the loans it gave in Cyprus.

The IB was insistent that it should focus on providing trade finance in Cyprus. However, there was insufficient demand for trade finance to accommodate the multinational IB, OB and the Bank of Athens (BA), and OB and BA had incumbent advantages. Figure 2 indicates that the share of the national product of Cyprus exported was small and consisted of agricultural products such as carobs and citrus fruit. The controller of IB branches, responsible in aiding the Cypriot manager to set up the bank, estimated that profits through trade finance would only occur when exports surpassed two million pounds, an amount which was not reached until 1937.[45] Even so, the increase in exports from 1934 onwards was mainly due to the rapid increase of copper sulfate exports by the Cyprus Mining Corporation, a company that was the exclusive client of the OB.[46]

The low demand for trade finance led to strong competition between the IB and the established multinational banks on the island that already controlled it. This led to the manager of Cyprus to complain that 'very small profits [are] earned on each transaction'.[47] Attempts by the IB to induce co-operation in the 1930s failed. There simply was not enough trade finance to go around, particularly during the period of the great depression.[48]

The losses of the IB in Cyprus in the interwar period are in stark contrast to the main domestic bank, the Bank of Cyprus (BOC). The BOC, despite its much smaller size, concentrated on providing retail domestic banking by gaining greater access to information about its clients, and thus was much more successful than the IB throughout the interwar period.

It is not possible to find yearly rates of return for the Cypriot branches of the IB. However, figure 3 indicates that the BOC outperformed the IB as a whole. Considering that the Cypriot branches did not record a profit until 1937, the BOC was much more successful than the IB in the Cypriot market. There was a dramatic drop in the rate of return of the IB to just 0.27 per cent in 1934. However, this might relate to the restocking of the IB's hidden reserves and not indicate true profitability. In contrast to the IB, the BOC was able to employ its modest assets more remuneratively in domestic banking and thus consistently outperformed the IB in the interwar period in terms of the ratio of profit to total deposits.

The BOC was a much smaller local banking concern. The main reason for the stark difference in performance in Cyprus was that the BOC was much more capable in assessing risk than the IB. The success of the BOC, and the failure of the IB to adopt similar practices, can best be evaluated through an economic analysis of transaction costs.

A transaction implies the exchange of ownership rights between individuals.[49] A bank acts as a conduit between creditors and debtors by minimising transaction-costs in lending and borrowing, with the bank profiting from the interest rate differential between the two parties, as long as the borrower does not renege on his commitments. Thus a bank's loans are liabilities to its creditors, the depositors.

A bank needs to possess accurate information on the capability of those who borrow to repay, in order to pay interest to its depositors in turn. In a loan transaction the bank knows less about the ability of the debtor to repay than the debtor, who stands to gain by concealing such information. This informational asymmetry

45 BLPES, *IB*, 6/64, Luard to Caridia, 08 Dec 1926.

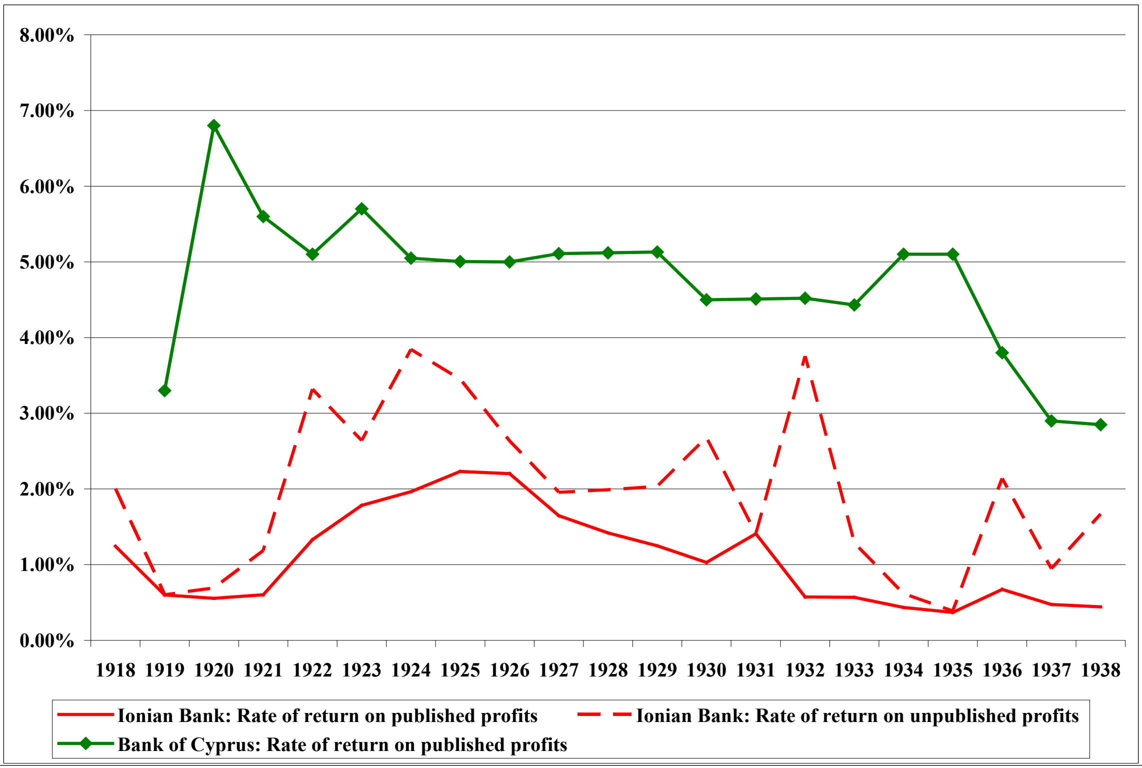
46 BLPES, *IB*, 6/64, Luard to Caridia CMC (Cyprus Mines Corporation): 28 Dec 1926, CAC (Cyprus Asbestos company): 16 Dec 1926, 12 Feb 1927.

47 BLPES, *IB*, 6/36, Reeve to Caridia, 26 April 1927.

48 BLPES, *IB*, File 6/39, Reeve to Caridia, 23 April 1930.

49 T. Eggertsson, *Economic Behaviour and Institutions* (Cambridge 1990), p. 9.

**Figure 3**: Rate of Return (%) in terms of published profits to deposits for the Ionian Bank (IB) and the Bank of Cyprus (BOC).




Source: G. Jones, *British Multinational Banking*, Appendix 5; Cyprus National Archives, *Secretarial Archive*, SA1/566/1912/2.

is costly to the bank, as a failure to choose a debtor correctly entails costs, both in lost profits and in diverting resources to cover the liability of non-performing loans. A lack of correct information by the bank can lead to long term reverses of profitability, as well as exclude transactions that would be mutually profitable since the bank does not have the capability to separate the solvent from the opportunistic.[50] Thus, the failure in collecting sufficient knowledge to overcome the informational asymmetry has a direct impact on its profitability through bad debts and the diversion of business that would be profitable. Thus accurate information on the capability of borrowers to repay is crucial, even today. This is even more important if the clients of a bank are largely small and medium size enterprises (SME), since such businesses have less publicly available information than larger firms.

The failure of the IB to adapt to the Cypriot market and construct an accurate informational network led to a poor choice of borrowers. As it has already been stated, in September 1930, just three years after the bank began operations in Cyprus, the Cyprus branches constituted 31 per cent of the total immobilised loans of the bank, despite the branches constituting less than ten per cent of the total gross profit.[51] This took place prior to the Great Depression, which had a significant impact on Cyprus. By 1929 the Cypriot branches constituted a larger share of total immobilised loans of the bank and the situation worsened with the onset of the Great Depression in Cyprus.[52]

50 G.A. Akerlof, 'The market for lemons: Qualitative uncertainty and the Market Mechanism', *Quarterly Journal of Economics*, Vol. 84 (1970), pp. 488–500.

51 BLPES, *IB*, 6/39, Reeve to Caridia, 02 Jan. 1928. Immobilised Accounts: *IB*, 6/100, 'Annual report to Chairman by General manager', 18 Dec 1929, p. 13. Gross profits: *IB*, 6/100, 'Annual report to Chairman by General manager', 19 Aug 1931. Use of Cypriot funds: *IB*, 6/39 Caridia to Reeve 4 April 1928. Immobilised accounts, 1931: *IB*, 6/36, 12 Feb. 1931, Caridia to Stavridi.

52 BLPES, *IB*, 6/100, 'Annual Report to the Chairman', 18 Dec 1929, p.13; Gross Profits, 18 Aug 1931.

Section three will argue that the reasons for the banks failure, including the failure to obtain accurate information on creditors, is intrinsically related to its strategy of entry. It will also argue that the comparative advantages in information of the BOC are still maintained over green field foreign banking entries.

## III.

The Ionian Bank entered the Cyprus market because it was believed that it would ameliorate problems in its main basis of operations through the acquisition of government sterling deposits. It was not interested in competing for a dominant share of the business in Cyprus. The island was seen as an auxiliary market to the financial market of Alexandria. When competition for government accounts and for trade finance became fierce, the IB was unwilling to enter into an unprofitable competition, and accepted a relatively small share of the market. This was particularly important in the case of the IB, who saw its aim in Cyprus as attracting saving deposits at lower rates than it could offer in Egypt.

However attracting deposits was not enough to maintain the bank's market share in Cyprus. The banking market in Cyprus during the interwar period was not segregated into constituent markets. A businessman in need of trade finance and a deposit account might also require mortgage finance, personal loans, or finance for agricultural investments. This was especially true in the case of the IB in Cyprus, since the majority of the clients were small and medium enterprises (SMEs). The IB could not provide adequate and varied loans to SMEs since most of its deposits were being invested in Egypt, and because loans that were not of a trade acceptance nature were contrary to the ethos of the bank. Even when the bank would consider such loans, it was extremely reluctant to provide loans secured on land as the IB believed such investment was illiquid and would threaten the bank's stability. The comments of the general manager of the IB at the government request to expand mortgage backed loans epitomised the policy at the time. The general manager argued that such loans were 'outside the bank's normal sphere' and that the bank is 'not in a position to finance any […] suitable scheme for advances to farmers'.[53]

The failure in providing mortgage and personal loans to such SMEs resulted in a decline in the IB share of deposits.[54] This was a missed opportunity for the IB as SMEs are more willing to shift their accounts to other banks, since incumbent banks are going to provide much less substantial incentives to SMEs to remain with them than they would to their largest clients. The IB's failure to capitalise on the multifaceted needs of SMEs led to the relative decline of the initially successful attempt to increase their share of deposits.

The story of Mr Polydoros could be familiar to other Cypriot businessmen who dealt with the IB in the 1930s, when its share of deposits was eroded by domestic banks. After opening his first savings and business account with the IB in the 1930s, he required a loan to build a house. The bank, although willing to provide trade credit, was unwilling to grant a mortgage. The BOC was willing to provide the loan based on a guarantee of land, provided Mr Polydoros switched all his accounts to their bank.[55] Thus the success of attracting deposits, the sole achievement of the IB during its stay in Cyprus, was steadily eroded by the IB's unwillingness to cover the multidimensional needs of its Cypriot clients.

This is a relevant lesson for today: Foreign banks in Cyprus need to compete in all types of finance in order to expand their business on the island successfully, since the demand of SMEs are multivariate. The recent relative success of Alpha Bank, the largest foreign bank in Cyprus prior to the Marfin Popular Bank

53 BLPES, *IB*, 6/64, Caridia to Luard, 12 Jan 1927; Luard already stated the unwillingness of the bank to enter on any such scheme financially ; Luard to Caridia, 28 Dec 1926.

54 Phylactis, *Banking System of Cyprus*, p. 11, Table 1.1.

55 Personal Interview of Mr. Polydoros, see bibliography for details.

takeover, took place only after it decided to compete with the domestic banks outside the realm of business services, as many business clients had substantial personal and housing needs.

This could be a warning to Pireus Bank (PB) in Cyprus today. In December 2008 the PB held €776,925 (1.39 per cent of the total deposits), but advanced only €361,336 (0.66 per cent of total advances), less than half of its deposits.[56] This could mean that PB sends a significant amount of its euro denominated deposits to Greece and Eastern Europe. However, if the bank fails to sufficiently provide for all the needs of its SME clients, it might face a reduction of its deposits, and thus lose the ability to invest euro denominated deposits abroad.

Another important implication of the IB entry is that foreign banks that enter the Cyprus market often do so due to reasons that have to do with other, much larger, markets. In the IB case, the bank did not want to actively compete for gaining a large share of the local market, but entered in search of sterling deposits for investments in Egypt. Such a strategy of entry would always keep the foreign bank at a disadvantage in competing with established banks in Cyprus, which like the BOC in the 1920s, find the domestic retail market quite lucrative. Strong banks with significant incumbent advantages might force the new entrant to compete and invest more funds than it thought necessary for an auxiliary market or face losses, leading to an early exit.

Thus unlike Phylaktis' argument that the failure of foreign banks' entry in Cyprus was due to entrepreneurial failure by the foreign entrants, the case study of the IB indicates that it has more to do with domestic banking successes. Perhaps the BOC's greatest advantage over the IB in the interwar period was not its ability to provide universal banking services, but its success in collecting more accurate information on its SME customers.

The peculiarities of the Cyprus lending system meant that the development of an adequate network for information was imperative. The majority of Cypriot credit was given as overdrafts guaranteed by two individuals of known wealth, who were willing to repay the loan in the event of default; no other security was given.[57] Such lending was also undertaken by the established foreign banks on the island and was the principal form of retail and merchant loans at the time the IB entered the Cypriot market.[58] The manager of the Cypriot branches was under pressure from the general manager to avoid such business: the general manager of the IB believed it 'was unfortunate[…] that such large business of the island should be based on such an antiquated system'.[59] Even in 2008, such loans are common (yet declining) in Cyprus; loans based on the guarantee of two solvent individuals were very much a staple of the personal loan business for a substantial period of the Cypriot formal banking industry.

The British manager of the IB Cypriot Branches replied that '[it] is quite impossible for us to expect to change this system […] and we must say […] the other banks have found the system satisfactory […] as the losses they have sustained are far less than in other places where banking is more highly developed'.[60] Mindful of such loans as inherently risky, the general manager of the IB suggested that the bank in Cyprus should develop an information system on local companies, where the SMEs' connections through such guarantees are clearly labeled and understood.[61]

56 As provided by the Central Bank of Cyprus for 31 December 2008, viewed on 01 April 2009, www.centralbank.gov.cy.

57 BLPES, *IB*, 6/64, Luard to Carida, 24 Feb 1927, p. 3.

58 BLPES, *IB*, 6/64, Contract of Rossides to Fieros, (undated).

59 BLPES, *IB*, 6/41, Caridia to Reeve, 21 April 1927.

60 BLPES, *IB*, 6/39, Reeve to Caridia, 05 Oct. 1927. Caridia reluctantly consented to the I.B. introducing similar lending facilities, suggesting to Stavridi 'that we fix a small proportion of our funds employed as a limit for this class of business', BLPES, *IB*, 6/100, Annual report of General Manager to Chairman, 12 Dec 1927, p. 9.

61 BLPES, *IB*, 6/100, Caridia to Stavridi, 06 March 1927.

However, the problem facing the IB was that lending on third-person guarantees required greater information collection about the debtor and his guarantors than the bank was capable of finding. The Ionian Bank's expertise was mainly in bills of exchange where loans were guaranteed on purchase documents, with the goods stored in the bank's warehouses until repayment. This required the bank to know less about the merchants' solvency since the guarantee was based on the value of the goods in storage. Despite an attempt by the bank to create a database of liabilities of lenders and their guarantors, the bank failed to gather sufficient information about the quality of their guarantees and the interaction of indebted SMEs, leading to mass defaults on the loans given in Cyprus by the IB. Part of the problem was that such detailed information about the economic interaction of companies was usually only available to local agents rather than the British manager. The British manager of the IB in Cyprus lamented that 'any information [given to us] is almost invariably found to be wrong', arguing that they have no way of checking the claims of debtors.[62]

The other foreign banks of the island during the interwar period, the OB and the BA, did not need such extensive networks of information, because they had the incumbent advantage of capturing the lion's share of larger industries and manufacturing industries.

The OB and BA relied on the comparative advantages of incumbents in trade finance. They had the largest companies of the island in their books, and did not rely on SMEs for their deposits and advances. Thus they did not need to build an extensive informational network for the SMEs. The IB needed to create a database of lender liabilities and their guarantors since their clients were mostly SMEs. The IB was in competition with the BOC and other Cypriot banks, and not with BA or OB.

Poaching staff from other established banks could have partially alleviated the problem of informational asymmetry. By employing Cypriots in positions of authority, the IB might have reduced the problem of misleading information faced by the British branch manager. Yet the problem could only be permanently minimised by establishing an informational network that cut across all business sectors. This necessitated advice and information from people who were actively involved in the non-banking business.

The BOC board acted as such a conduit for information. The board was comprised of eminent Cypriot businessmen, who provided the domestic bank with a powerful intangible asset, an accurate informational network on the 'goings-on' of their individual SME clients. This powerful informational network was and still is crucial in the continuing success of the BOC in the domestic retail market.

The IB case also seems to indicate that the choice of how a bank enters a market has a direct impact on a bank's ability to evaluate risks in the new market. By purchasing a domestic bank you acquire an established informational network that allows the foreign bank to compete more effectively for the crucial SME market, whereas a direct entry places a foreign bank at an informational disadvantage in the SME market. The IB case study demonstrates that the SME market is crucial in early competition with strong incumbents as they are more flexible in changing banks than larger clients. Thus the purchase of a local institution allows better access to a market that is crucial in increasing one's market share in Cyprus.

The current purchase of the Popular Bank by Marfin allowed the new foreign bank to compete with the BOC without it being at a disadvantage in informational knowledge, since it has also purchased the former domestic bank's informational network. Marfin Popular can compete on better terms with the local banks than other foreign banks, partly due to the established information network that can attract SMEs business.

This problem of asymmetric information was not unusual and several multinational banks had created several systems to try and minimise it, which was public knowledge, and thus probably known to the IB executives. By the time the IB entered Cyprus, the Hong Kong and Shanghai Bank (HSBC) had long realised the potential of financing small business and its inability to directly collect information about their solvency.

62 BLPES, *IB*, 6/36, Reeve to Caridia, 26/04/1927; IB, 6/38, Caridia to Reeve, 12 June 1929.

In order to be able to profitably lend to small business without facing the informational disadvantages of a multinational bank, the HSBC developed a system of *compradors*: these Chinese merchants were provided with funds by HSBC in order for them to finance business in the Chinese interior.[63]

This outsourced the problem of information to the Chinese merchants. The bank did not capture the very high interest rates charged by *compradors* to small business, but placed the onus of assessing the risk of potential debtors on the experienced Chinese middle men, reducing the need of information, save the solvency and character of the middle men. The middle men had an incentive to asses risk correctly or face bankruptcy.[64] Their roles were numerous: they made transactions with Chinese citizens, they operated the businesses for which a *comprador* was connected, and they provided commercial advice on the local market conditions and the standing of Chinese merchants, as well as providing guarantees for the Chinese staff of the bank.[65] This system seems to have been quite successful, and the HSBC did not branch out to the interior of China, partly because of the success of the system. By the interwar period this system was becoming ever more acceptable, both within the bank and the local foreign community, as King states that 'as far as the foreigner [bank worker] was concerned the *comprador* brought business which the eastern staff could never hope to reach'.[66]

Thus the IB could have adapted to local conditions by modifying such a system to tackle the specific problems of information it faced in Cyprus. The lack of domestic middle men resulted in the Cypriot branches becoming a drain to the organization as a whole. Thus the most difficult problem facing a bank's entry into a foreign market is how to minimise the informational asymmetry; failure to do so could result in serious losses in terms of immobilised loans.

The case study of the Ionian Bank does suggest that the relative failure of foreign banks in making a large impact in the Cypriot market is directly linked to the causes of entry in the market. Many foreign banks see the Cypriot market as auxiliary to larger markets, and thus they are unwilling to compete strenuously with domestic banks that hold the incumbent advantages of holding the largest clients and having access to an accurate information network. The SMEs' business sector is more easily enticed away from the incumbent banks. However, in order to do so effectively, the entrant needs to compete in all sectors of the banking market, since SMEs require a multidimensional service of personal and business finance. The SME sector of Cyprus is peculiar since it is still partly based on a system of guarantees that creates significant informational asymmetries for the entrant. Thus in order to compete effectively in the Cypriot banking market one needs a capable informational network to assess the solvency of a person not just in terms of loans, but also in terms of guarantees provided. This is a powerful intangible asset held by established banks. Unless the entrant bank can outsource it (such as HSBC in China in the 1920s) or purchase a local bank that has developed it (such as the case of Marfin Popular) the lack of an efficient informational network can inhibit its development in Cyprus through a large number of non performing loans.

63 F.H.H. King, *The History of the Hongkong and Shanghai Banking: The Hongkong Bank Between the Wars*, Vol. III (Cambridge 1988), p. 78, p. 347.

64 Ibid., p. 349.

65 Ibid.

66 Ibid., p. 348.

# Militarisation: A Political Clue to Financial Structures?

Patrice Baubeau

## Introduction

Studies of financial systems are very often concerned with finding one main factor which determines whether or why the financial system of a country can be categorised as a 'market based system' or a 'bank based system'. Explanations for why a country would adhere to one type or to the other can roughly be divided into structural or developmental. The first category of explanations relies on institutional factors such as the legal basis, the distribution of political power and so on which exert a constant and long-term influence on the financial structures.[1] 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.[2] Academic historians tend to rely more on the second approach, which lets them expand historical explanations and careful contextual analysis.[3] There are two common conclusions to these distinctly different types of explanations. First, the convergence of financial systems is not only possible, it is more or less bound to take place given an open international goods or capital market. Second, path dependency is a very strong feature of financial systems, which can be explained by the ability of a complex set of institutions to harness and resist 'pure' market forces. In that respect, recent work by Youssef Cassis offers a vivid picture of the long-standing resistance of most financial centres to the relative decline of the national economies that host them.[4]

This paper suggests, as did Charles Calomiris,[5] that there exists a third type of explanation: the impact of specific historical events, such as wars or political unrest. I argue further that if the type of national financial system is dependent on specific historical events, convergence will only be a theoretical construction since any historical event at any time will disrupt such a theoretical convergence. Last, when convergence occurs, it is, most of the time, the obvious result of hegemon-dependent relationships between states, as shown by Michael Loriaux – but this could be expanded to a sub-state scale.[6] As a consequence, convergence as a process builds over time the very forces bound to resist it, either by sheer violence (war) or through internal or international crises, as shown by most recent events. To make my point clear, I concentrate here on the two world wars and the shift in national financial systems (broadly defined as bank-based or market-based, whatever the limitations of such a simplistic distinction), and try to explore the consequences of war, from a qualitative point of view, upon a group of financially developed countries, members of the Organization for Economic Cooperation and Development (OECD).

1 R. Carney, 'The Political Economy of Financial Systems: why do developed countries have such financing arrangements?', Paper presented at the annual meeting of the American Political Science Association, Boston, 28 Aug 2002. R. La Porta, F. Lopez-de-Silanes, A. Shleifer and R.W. Vishny, 'Legal Determinants of External Finance', *The Journal of Finance*, Vol. LII, No. 3, July 1997. R. Levine, 'Bank-Based or Market-Based Financial Systems: Which is Better?', *William Davidson Working Paper*, Number 442, February 2002.

2 A. Gerschenkron, *Economic Backwardness in Historical Perspective. A Book of Essays*, (Cambridge 1966). C. Fohlin, *Finance Capitalism and Germany's Rise to Industrial Power* (Cambridge 2007).

3 P.L. Rousseau and R. Sylla, 'Financial Systems, Economic Growth, and Globalization', *NBER Working Paper* 8323, June 2001. D.J. Forsyth and D. Verdier (ed.), *The Origins of National Financial Systems, Alexander Gerschenkron reconsidered* (London 2003). M. Lescure, 'Banking and Finance', in: Ge. Jones and J. Zeitlin (dir.), *The Oxford Handbook of Business History* (Oxford 2008).

4 Y. Cassis, *Les capitales du capital. Histoire des places financières internationales, 1780-2005* (Paris 2008).

5 C. Calomiris, 'Financial History and the Long reach of the Second 30 Years War', in: T. Guinnane, W.A. Sundstrom and W.C. Whatley, *History Matters: Essays on Economic Growth, Technology, and Demographic Change* (Stanford 2004).

6 M. Loriaux, *France after Hegemony: International Change and Financial Rreform* (Ithaca 1991). M. Loriaux (dir.), *Capital Ungoverned. Liberalizing Finance in Interventionist States* (Ithaca/London 1997).

The paper proceeds in three steps: First, it explains how most attempts to study the factors of financial structure choices have discarded the impact of historical events and some of the epistemological issues involved. Second, using data previously accumulated by other scholars, mainly Demigûrc and Levine, it will show the long-term impact of the two world wars on financial structures and try to explain discrepancies. Third, it will propose, through examples, some explanations of the relationships between wars and financial structures and, more specifically, address the issue of convergence.

## I. Financial Structures: Does History Matter?

Most studies on the emergence and evolution of financial structures acknowledge the question of history. Indeed, these studies try to address the question of why different financial systems emerged over time, and what, in the context of their emergence, oriented their characteristics. Most of these studies state that 'history matters'.

But a historian will undoubtedly notice two elements. First, once a given system is on track, it almost never changes its main traits, unless a major shock reduces it to fragments, which implies that financial systems are prone to a very high degree of path dependency. Second, the explanatory factors used and tested in cross-correlations are not only stylised facts: they seem to be independent of any context and to wield about the same results whatever the period, the country or the complex set of institutions in which they are embedded.

A good example of such an approach is given in the attempts by La Porta et al. to assess the importance of 'legal structures' on financial systems.[7] The basic approach is to investigate a relationship between two polar typologies, the first one opposing common law and civil law judicial systems, and the second one opposing bank-based and market-based financial systems.

I consider such a methodology and the results driven from it to be highly problematic. Many critics, for example Lamoreaux and Rosenthal,[8] have shown the low explanatory value of relying on stylised facts that fail to address the complexity of even one specific legal issue such as the legal status of the firm. In some respect, such polar typologies indeed reduce history to 'common sense evidence'.[9] Rajan and Zingales have also shown that such structural explanations fail even to take into account shifts that occurred in the past among countries in terms of relative financial development.[10]

A key feature of all these attempts to find and test a few proxies of the causes for financial development is that they cannot escape the *ceteris paribus* clause. Indeed, the study of financial development over the 1880–1990 period has to cope with many international shocks of major magnitude, such as the First and Second World War, the Cold War, the two Great Depressions (1873–1896 and 1929), the Colonial Crises, the collapse of the Bretton Woods system and the great stagflation crisis from around 1974, notwithstanding national, or more recent events.

In such a moving context, to control for GNP or population helps, of course, but fails to address the fact that history is not a quiet and continuous flow. Besides, the *ceteris paribus* clause supposes that individual phenomena can be identified as being either 'internal' or 'external', relative to the issue under discussion.

7 R. La Porta, F. Lopez de Silane, A. Schleifer and R.Vishny, 'Law and Finance', *NBER Working Paper Series*, No. 5661, July 1996.

8 N.R. Lamoreaux and J.-L. Rosenthal, 'Legal Regime and Business's Organizational Choice: A Comparison of France and the United States during the Mid-Nineteenth Century', Draft of 22 Jan 2004. I thank the authors for kindly providing their draft paper.

9 M. Bloch wrote in *Apologie pour l'Histoire*: 'le sens commun, c'est-à-dire, trop souvent, les préjugés communs' ['common sense, that is, too often, common prejudices'], quoted in: F. Weber, 'Métier d'historien, metier d'ethnographe' (1996), in: F. Weber, *Manuel de l'ethnographe* (Paris 2009), p. 59.

10 R.G. Rajan and L. Zingales, 'The great reversals: The politics of financial development in the twentieth century', *The Journal of Financial Economics*, Vol. 69, No. 1, 2003.

But this simple assumption might be misleading or even entirely wrong. For example, most 'non-economic' factors are considered to be potential external factors. But what if such factors are actually linked, through non-economic or hidden relationships, to economic forces? What if historical events, however random they might seem to some, contribute to the financial structure? This very serious question was addressed by Jean Jaurès, the prominent French social-democrat of the early twentieth century who was shot dead on the eve of the outbreak of World War I because of his opposition to the war. At the Deputies Chamber, in 1895, he declared that:

> '[…] war can be born from any possible chance… Always your violent and chaotic society, even when it longs for peace, even when it lays in apparent rest, bears the war in itself, as a sleeping cloud bears the storm.'[11]

Jaurès made clear that war was on the horizon, not because it could eventually happen, but because it was part of the very structure of the social and economic system. This analysis was soon summarised in apocryphal form: 'capitalism bears the war as the cloud bears the storm'.

What Jaurès meant is that there is no clear-cut distinction between the capitalist economic system and the probability of war – that war is actually an element in the regulation of this economic system. That idea might today seem naïve, or overly ideological – after all, war is far more ancient than capitalism.

There is, however, another way to look at this linkage between war and economy. All countries, nations, polities or cities face war – either internal or external – as a probable outcome of actual tensions. But this very probability differs to a considerable extent from one city or one country and from one period to the other. When the War of Independence ended in 1783, the United States was indebted, but with considerable differences among the states. Some were highly indebted, others, mainly the Southern states, had circulated only a limited public debt.[12] The debate about who was going to repay this debt – and whether any repayment was due – can be analysed as an ideological debate, confronting theories relating to state, debt, banking and money principles. In addition, however, there is a high correlation between a state's debt and its position concerning the constitution ratification process (1787–1789) and Hamilton's reforms (1791) relating to the mint, the public debt and the national bank.[13] In sum, war had a significant impact on the United States' financial structure for the century to come.

Such a line of argument can be extended to other issues at the sub-national scale. For example, in the US, post-1800 large cities were not surrounded by fortifications. Neither was this the case in the UK. But in continental Europe, large cities were kept fortified, not as a memory of medieval towns with little military value but to face the immediate menace of war and a siege: Paris, Strasbourg, Belfort in France, Liège, Brussels or Anvers in Belgium, etc.

Wars can then affect the very structure of the territory, the way it is occupied, equipped and constructed. War may have consequences for the fiscal, political and financial structures of the state, as debt heritage or as looting profit, but perhaps also as an influential building component or as an element in the planning and implementation of budgetary and fiscal policies. And, most prominent among historical events, war looms

11 Original quotation in French – the passage translated in the text is in italics : 'Tandis que tous les peuples et tous les gouvernements veulent la paix, malgré tous les congrès de la philanthropie internationale, la *guerre peut naître toujours d'un hasard toujours possible… Toujours votre société violente et chaotique, même quand elle veut la paix, même quand est à l'état d'apparent repos, porte en elle la guerre, comme une nuée dormante porte l'orage.* (Très bien ! très bien ! à l'extrême gauche.); Jean Jaurès, 7 mars 1895, à la Chambre des députés, in: J. Jaurès, *Textes choisis*, éd. sociales (1959), p. 88.

12 F. Grubb, 'The distribution of congressional spending during the American Revolution, 1775–1780: The problem of geographic balance', *NBER Working Paper Series*, No. 14267, August 2008.

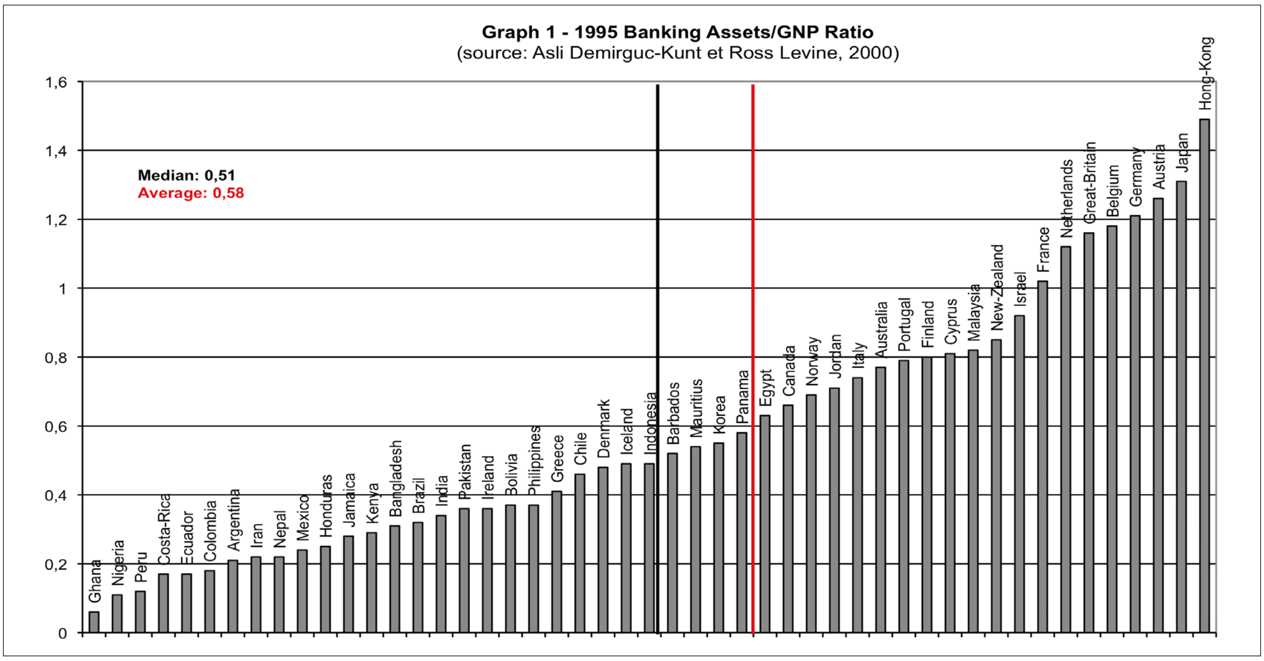
13 Id. and L. Desmedt, 'L'expérience Nord-Américaine au XVIIIe siècle', Séminaire Souveraineté monétaire et souveraineté politique, Working Paper, 27 March 2009, pp. 20–21.

over the twentieth century. For all these reasons, war is a reasonable candidate as an 'independent' variable. But at the same time, because of its previous consequences, war may well be already integrated in many of the structural features of given economic, judicial, political or even territorial systems.

## II. The Unmistakable Impact of the Two World Wars on Financial Structures

It is war that I will explore as an independent variable, because any history book teaches us that the two world wars had a major impact on the belligerents and on neutral and colonial territories. Of course, the idea to consider war as a major explanation of national structures is not new: it would be very presumptuous to think that no scholar ever put war forward as an obvious explanation for economic or financial national structures, from inflation and collapse during the Roman Empire inflation to the long term consequences of the Thirty Years War upon German countries. Charles Calomiris takes a very similar line when addressing the Thirty Years War.[14] But my point is slightly different. First, I want to gauge the impact of wars on the structure of financial systems. Second, I believe that this impact is not mechanical, i.e. a straightforward reaction of the financial structures to war, but that it must take into account indirect costs as well as anticipated costs. That means, for example, that war, and this is the third point, could act as the 'hidden' linkage between La Porta's legal structures and financial systems. Last, being 'built in', as stated by Jaurès, war might as well be the result of tensions as the escape from these tensions – meaning that a financial system can be transformed by war as well, which is quite evident, or contribute to the ignition of war because it is an element in the whole process of planning and financing a future war.

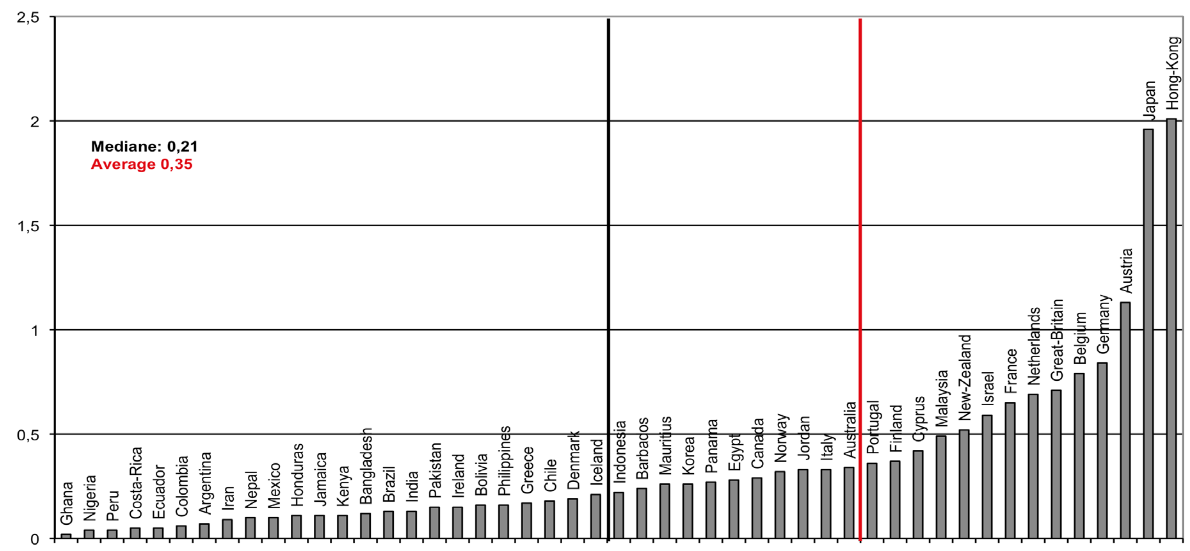
To implement this, I will start with data from Demirguc-Kunt,[15] building a market-to-finance scale of countries. First, I compute the banking assets/GNP and market capitalisation/GNP ratios, for the year 1995 – late enough to evaluate path-dependency – from their figures (graphs 1 and 2). It is easy to check the strong correlation, stressed by the authors, between banking and stock market development: the two go hand in hand. But one can also see that the distribution is quite different between the two ratios, as exemplified by the differences between the median and average: 0.07 for the banking ratio and 0.14 for the market ratio. In




14 C. Calomiris, op. cit.

15 A. Demirguc-Kunt and R. Levine, 'Bank-Based and Market-Based Financial Systems: Cross-Country Comparisons', *World Bank Working Paper*, No. 2143, 2000, pp. 42-43.

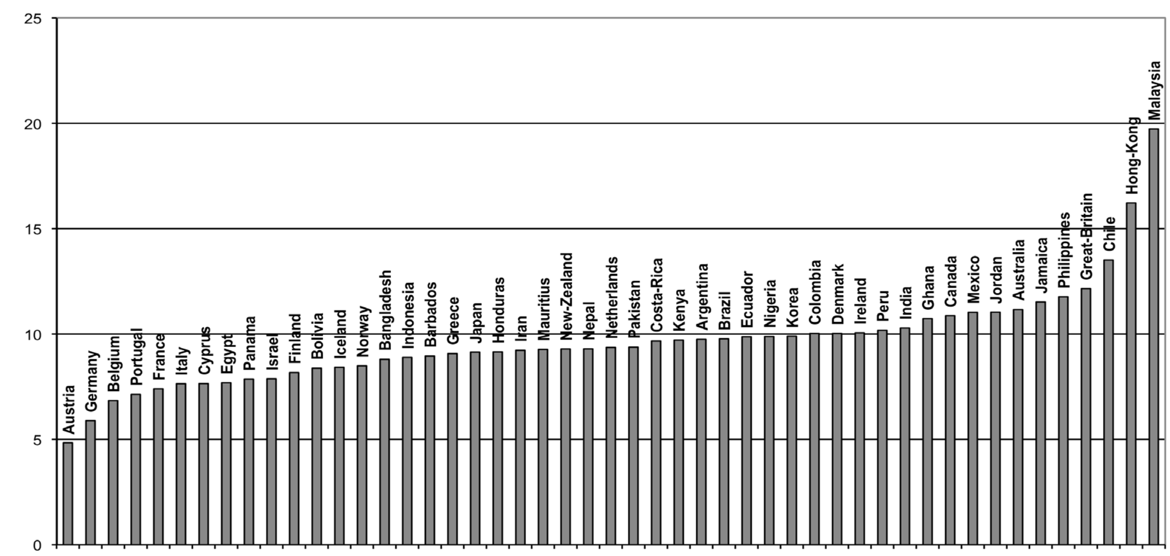
**Graph 2 - 1995 Market Capitalisation/GNP Ratio**
(source: Asli Demirguc-Kunt et Ross Levine, 2000)

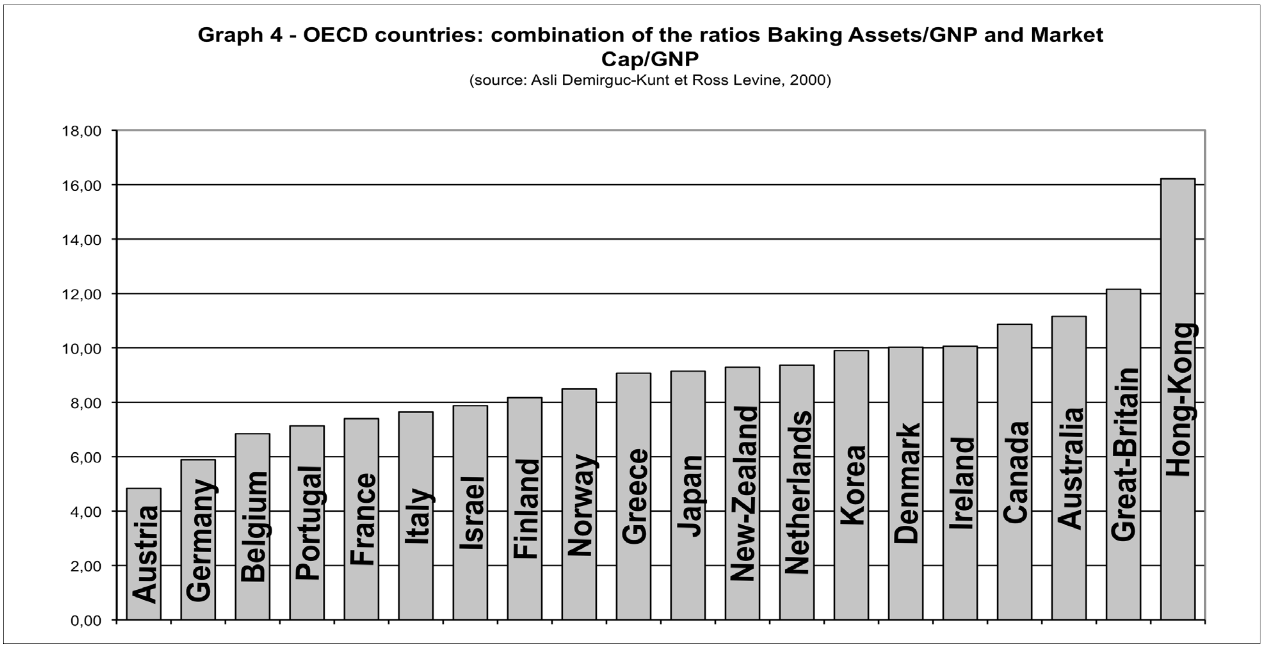



consequence, one has to take into account these differences between the two ratios before building a synthetic ratio, to avoid overrepresentation of one of the two series. Using the standard deviation of the two series to normalise them, I can build a synthetic ratio. With these normalised results, graph 3 ranks countries from being relatively more banking-oriented on the left side of the series, to more market-leaning on the right.

As one can see, no clear-cut distinction appears that fits with general categories, such as developed/emerging economies or federal/centralised states. For example, Great Britain and the Philippines are together on the right hand side of the graph, Egypt and France on the left. Coming to the federal/centralised issue, Germany (federal state) and France (centralised) appear on the same left-hand side of the graph while Hong Kong (centralised) and Malaysia (federal) occupy the right hand side of the graph. This outcome suggests that use of OECD data might offer additional insights, for two reasons. First, these nations have a roughly comparable level of development and second, their history is easier to track and most were affected by the two world wars and the Cold War one way or the other.

**Graph 3 - Combination of the ratios Baking Assets/GNP and Market Cap/GNP**
(source : Asli Demirguc-Kunt et Ross Levine, 2000)






Graph 4 captures the 'common sense' opinion about financial systems well, with Austria, Germany, Belgium or France considered rather bank-based and Canada, Australia, Great-Britain and Kong-Kong usually being labelled as market-based. This leads to the next question, i.e. whether that overall structure fits the war issue or not. But just using belligerence itself as a proxy variable would not help much. Indeed, most countries experienced belligerence during the twentieth century, and as one can see in our sample, all countries were belligerent at one period or other (table 1).

To decide whether a country was belligerent or not during WWI and WWII is quite easy. The issue is more complex when it comes to the Cold War, first because of its duration – over 40 years if one takes the shortest period 1947–1989[16] – but mainly because most countries did not engage in actual military operations during the Cold War, but were members of one of the two major alliances. Alliance meant larger military expenses, but also direct and indirect budgetary and military support from one of the two superpowers, the USA and USSR, which could actually limit the financial impact of the Cold War. For example, France's war in Indochina , even if colonial by nature, was embedded in the Cold War and resulted both in American financing of French military expenses (and current account imbalance) and in the United States replacing France as the guarantor of the independence of South Vietnam after 1954. A few countries did take part in wars that were part of the Cold War, either by considering colonial wars as being part of the global fight (Indochina War for France; Suez expedition for the UK and France) or because they were the location of an actual war (Korea). The cases of Austria and Germany are ambiguous, since they were clearly occupied states at the beginning of the Cold War (1945/7–1955) and then evolved, Germany being divided until 1989, while Austria was reunified in 1955 on the condition of remaining 'neutral'.

Another difficulty is the extent to which the 'same' war affected different countries: both Poland and Denmark were occupied by the Nazis during WWII, but the suffering endured in the first country went far beyond that encountered in the second one. In general terms, and with the exception of Norway, Nazi-occupied or controlled North-European states (Netherlands, Denmark, Sweden) suffered a much less strict occupation regime than the other European countries and were not looted to the same degree. Nevertheless, the occupation regime and everyday conditions became stricter and harder as Germany entered 'total war' mobilisation in 1942, while the Netherlands were severely bombed in 1944–1945.

16 G.-H. Soutou, *La guerre de Cinquante Ans. Les relations Est-Ouest 1943-1990* (Paris 2001).

| Table 1: Country sample belligerence during the twentieth century. | | | |
|---|---|---|---|
| | **Word War 1** | **World War 2** | **Cold War** |
| **Austria** | Belligerent | Belligerent | Allied |
| **Germany** | Belligerent | Belligerent | Allied |
| **Belgium** | Belligerent[16] | Belligerent | Allied |
| **Portugal** | Belligerent | Neutral | Allied |
| **France** | Belligerent | Belligerent | Belligerent |
| **Italy** | Belligerent | Belligerent | Allied |
| **Israel**[17] | N.A. | Belligerent | Belligerent |
| **Finland** | Belligerent | Belligerent | Neutral |
| **Norway** | Neutral | Belligerent | Allied |
| **Greece** | Belligerent | Belligerent | Belligerent[18] |
| **Japan** | Belligerent | Belligerent | Allied |
| **New-Zealand** | Belligerent | Belligerent | Allied |
| **Netherlands** | Neutral | Belligerent | Allied |
| **Korea** | Belligerent | Belligerent | Belligerent |
| **Denmark** | Neutral | Belligerent | Allied |
| **Ireland** | Belligerent[19] | Neutral | Allied |
| **Canada** | Belligerent | Belligerent | Allied |
| **Australia** | Belligerent | Belligerent | Allied |
| **Great Britain** | Belligerent | Belligerent | Belligerent |
| **Hong-Kong** | Neutral | Belligerent | Allied |

Such an approach raises several questions:

- If all countries are affected by war, how could such an event be used to predict very different outcomes in terms of financial organisation?
- How should the impact of the war event be evaluated when considering, for example, New Zealand and Germany? The first country did not suffer civilian casualties or material destruction, while the second was moderately looted during WWI, but severely occupied afterwards, and extensively bombed and looted during WWII.
- How should the *ex ante* and *ex post* costs of the wars – i.e. the heavy expenditures by pro-war and belligerent countries prior to its outbreak as compared with more pacific governments that limited the expenses of building up their military might – be accounted for?
- What if war had a positive impact on some countries (export-led economic boom, improved strategic situation, technology transfers, etc.)? The same event would then have reversed overall effects.

I therefore propose, in the first place, to concentrate on the impacts of the two world wars, which rules out the state of Israel from the sample, since Israel was only created as a fully-fledged state in 1948. Secondly, I distinguish two categories of countries: First, those that suffered from military occupation, a likely proxy of a higher war cost through combination of defeat and post-war punishment; and, second, those that suffered pre-war peacetime military-oriented dictatorship, a situation which is also very likely to have exerted war-related costs even before the start of either WWI or WWII. Taking this approach allows to reach a measure of the 'militarisation' of any given country; that is, the extent to which its financial system was integrated with military matters.

If one breaks down the country sample in two, the first half being considered more bank-based and the second one more market-based, on obtains table 2. A second correction has to be made, because the arithmetic breakdown puts Japan in between the market-based and the bank-based countries. The average and median of the 19 countries' indices are 9.14, the same as Japan's. Japan has long been considered a bank-

Table 2: Breakdown of bank based and market based countries along combined financial ratios.

| Most bank-based countries | Most market-based countries |
|---|---|
| Austria | New-Zealand |
| Germany | Netherlands |
| Belgium | South Korea |
| Portugal | Denmark |
| France | Ireland |
| Italy | Canada |
| Finland | Australia |
| Norway | Great Britain |
| Greece | Hong Kong |
| Japan | |

based country and its medium position in the sample does not make it a likely market-based country, even in relative terms.[17]

Table 3 indicates whether these countries were occupied or under a military-oriented dictatorship: The correlation between the different criteria appears to be fairly good, and one is faced with the task of explaining only three exceptions: the Netherlands, South Korea and Denmark appear to have relatively more market-based financial systems than the other countries that suffered from military occupation or peace-time dictatorship.

The easiest case to explain is South Korea. This is a combination of figures bias and political history. The recent political history of South Korea is that of a state created after the demise of Japanese colonial rule, heavily patronised by the United States as an outpost of the 'free world' against the soviet-led North Korea. As such, the country suffered heavily both from Japanese exploitation and the Korean War (1950–1953), but also benefitted from substantial American support, which oriented the legal and financial structures of the economy towards the American model. The figures bias comes from the specific features of the Korean financial system. Indeed, the economy was until the 1997 crisis dominated by over-leveraged and over-diversified industrial groups, known as *Chaebols*. Supported by the state and financed through large debts accumulated in the form of reciprocal claims inside the *Chaebols*, debts were poorly screened and supervised by dependent banking structures. A high debt–to-own-funds ratio testify that the country is actually far

Table 3: Proposed breakdown of country sample along combined financial ratios, military occupation and peace-time dictatorship.

| | Military occupation | Peace-time Dictatorship |
|---|---|---|
| **Bank based** | Austria<br>Germany<br>Belgium<br>France<br>Italy<br>Finland<br>Norway<br>Greece<br>Japan | Germany<br>Italy<br>Portugal<br>Greece<br>Japan |
| **Market based** | Netherlands<br>South Korea<br>Denmark | South Korea |

17 A more detailed analysis, with a larger sample group of countries is under way and preliminary results let Japan among the bank-based countries.

more bank-based than market capitalisation figures indicate. Those figures reflect large amounts of short-term foreign capital flows, which fuelled a stock bubble, already noticeable in 1995. That year the three main stock markets merged and a new stock index was computed, starting on 1 January 1996. Nevertheless, the real change came with the 1998 crisis, after which the financial system was reformed, the *Chaebols* were broken up into independent firms, and the banking system was overhauled.[18]

The Netherlands and Denmark are quite similar cases in terms of financial structure. Almost neighbouring, the two countries were part of the German economic sphere on the eve of WWI and stayed neutral during that war, which proved very beneficial for both. In particular, neutrality fuelled the development of Danish and, on a larger scale, Dutch capital markets through the export of German capital. During WWII, both countries were engulfed in the conflict and invaded by Germany. But contrary to other countries that were extensively looted to fund the German war effort,[19] the Netherlands and Denmark were subjected to a relatively mild economic regime – until at least 1942 – thanks to the racist Nazi ideology that labelled them 'Aryan'. For example, these countries were not heavily bombed until 1943 – and this affected primarily the Netherlands – and were not occupied after the war. Among the occupied countries of this sample, they undoubtedly bore the lightest occupational costs relative to their wealth.

There are, therefore, plausible explanations for the three exceptions in our table: it holds explanatory value rather than a convincing correlation. In short, wars have had a deep impact on financial systems and, over fifty years after the end of WWII, the main structural characteristics of OECD countries' financial systems continue to be shaped by the impact of the two world wars.

## III. Wars and Financial Divergences: Accidental or Structural Link?

The qualitative explanations offered above have to be strengthened, but these first results offer interesting perspectives. One avenue of further enquiry is the question of whether this alignment of war costs and financial systems is accidental or structural, i.e., whether *ex post* costs were translated afterwards in a specific financial structure, or whether these costs were already embedded in the general financial system. Specifically, two questions will be addressed here: What is the historical significance of our work and how does it compare to other works looking for the one best factor? Does this work shed some light on other factors, such as the legal factor or the choice between several sets of financial institutions?

One can easily address many criticisms to the tentative approach proposed here. Specifically, it adopts a similar, structural explanation to the one already dismissed above. The first goal was to show that, whatever their apparent explanatory value, La Porta's, Carney's and other approaches were largely ahistorical and reflected hidden or shadow relations. Wars, being the most prominent among events, were a very good candidate to test whether more traditional history – the '*histoire bataille*'[20] despised by Braudel or Febvre – added some measure of understanding. I believe this is the case and will develop a more nuanced approach in the future, to introduce a more comprehensive evaluation of these events, so as to judge as precisely as possible the impact of the event on each country. As shown in table 3, however, the correlation is already very strong and can be elaborated into nuanced qualitative analysis. Moreover, measured 50 years after the end of WWII, the correlation still holds, which confirms the long path dependence impact of wars, as hypothesised by Charles Calomiris. One question that has to be addressed in the future, then, is whether this correlation

18 E. Bidet, *Corée du Sud. Economie sociale et société civile* (Paris 2004).

19 F. Occhino, K. Oosterlinck and E. White, 'How Much Can a Victor Force the Vanquished to Pay? France under the Nazi Boot', *The Journal of Economic History*, Vol. 68, No. 1, March 2008.

20 Battlefield history.

since 1945 holds from decade to decade or if a gradual evolution led to this situation, which would encourage the search for other explanations.

Second, we do believe that this work offers new insight, not because it replaces one tested general explanation by another one, but because it offers some directions to understand jointly path-dependency and evolution, a point strongly stressed by Rajan and Zingales, and that that should allow us to avoid one-sided explanations.[21] A good start is the following statement from Demirguc-Kunt and Levine:[22]

> We see that countries with a Common Law tradition, strong protection for shareholder rights, good accounting standards, low levels of corruption and no explicit deposit insurance tend to be more market-based, even after controlling for income. On the other hand, countries with a French Civil Law tradition, poor protection of shareholder and creditor rights, poor contract enforcement, high levels of corruption, poor accounting standards, heavily restricted banking systems, and high inflation tend to have underdeveloped financial systems in general, even after controlling for income.

Their regression methodology, as we have seen, leads to fairly good results, but, as shown by our own attempt in using wars and not legal systems, other candidates for 'one best factor' explanations can be offered. What are the links between financial systems, legal systems, corruption, heavily restricted banks and high inflation? Our answer, still preliminary, is: Wars. Not wars as events, but war 'as the cloud [that] bears the storm'. Countries facing a high probability of a war, either by their own will or that of their neighbours, will tend to adapt their polity, their institutions, their financial structures to that probability, because of all events, it is the most disruptive – with the exception of major epidemic or natural shocks that cannot be planned.

For example, decades before WWI, France engaged in a '*politique de l'or*' (gold policy), i.e. a gold and silver hoarding based partly on the central bank's metallic assets[23] but also on the forced circulation of coins against the French people's preference for notes.[24] It is an example of how war planning had an impact on financial structures decades before the effective event.

The probability of war is, by all accounts, an effective tool for promoting centralisation, bank finance and low levels of government control. We would even add that civil law should be more associated with countries facing the menace of invasion. Centralisation, for example, can be easily associated with war: French, German or United States' centralisation ('big government') has progressed every time that war planning or war efforts have been the key element on the political agenda. Reciprocally it is very interesting to see that the first serious attempt at decentralisation in France, in 1982, was more or less linked to the vanishing of the 'German menace' on its Eastern borders (epitomised by the Mitterrand-Kohl meeting on 22 September 1984). Bank finance is most evidently linked to war: the two national banks created in the US before 1913 were a result of the War of Independence, as the Bank of England (1694) resulted from the need to fund the English war on the Continent. The first Reichsbank, on the other hand, is a direct outcome of both German unification – a first step in centralisation – and the Franco-Prussian war. The reason why there is a link between wars and banks, is that banks, through monetary control and creation, offer the opportunity to fund wars. As written by Benjamin Franklin:

> This currency, as we manage it, is a wonderful machine. It performs its office when we issue it; it pays and clothes troops and provides victuals and ammunition; and when we are obliged to issue

21 R. Rajan and L. Zingales, 'The Great Reversals'.

22 A. Demirguc-Kunt and R. Levine, op. cit., pp. 36-37.

23 R. Vignat, 'La Banque de France et l'Etat (1897-1920) : la politique du gouverneur Pallain', PhD dissertation in history (Paris 2001).

24 P. Baubeau, 'The monetarization process in late 19th century France: the social value of banknotes', Paper presented at the 15th WEHC in Utrecht, Session 'Revisiting Money As A Unified Unit Of Account From A Complementary Viewpoint' organised by Akinobu Kuroda, August 2009.

a quantity excessive, it pays itself off by depreciation.[25]

As early as the eighteenth century, a link could be traced between war, bank finance and inflation. But banks can also offer a good measure of governmental discretion, reducing parliamentary control over the state budget and war planning. Markets tend to be disrupted in a violent crisis, because prices lose their meaning and must be replaced by direct government management (price setting, quantitative measures, rationing). This discretionary aspect of governmental policy is also an important fuel for corruption: corruption is not so much a cultural trait as a consequence of loose supervisory institutions. Wars, reducing election frequencies and supervisory powers are a very strong incitement to corruption, notwithstanding the fact that they offer almost unique opportunities for very large capital gains, as exemplified by Ouvrard during the First Napoleonic Empire or Halliburton in the most recent US war in Iraq.

Finally in this context, what is the link between civil law, common law and wars? Common law means power of the judge, while civil law allows parliament, with nuances, to rein judges in, combining stronger judicial security in some sense (homogeneous rules) with more effective implementation of national rules.[26] Centralisation through war may also be linked to war because countries more prone to war are endangered on their borders: they need instruments to guarantee the legal integration of border areas, or even permit the annexation of new territories. Law, in this respect, is both a nation-building instrument and a symbol of national identity.

Of course, one should not push such arguments too far. But the prejudice expressed – most likely involuntarily – in the sentence 'countries with a French Civil Law tradition, poor protection of shareholder and creditor rights, poor contract enforcement, high levels of corruption, poor accounting standards, heavily restricted banking systems, and high inflation tend to have underdeveloped financial systems in general, even after controlling for income', is the result of too narrow a conception of history. When I state that 'history matters', I do not mean that one should take into account as extensively as possible one stylised fact, 'proxied' into a quantitative measure, but that one should look at the underlying links between several 'mattering' dimensions.

This would be achieved if one could internalise war. I used war in some respect as an independent variable and showed the enduring link between the cost of wars and financial structures in OECD countries. I then showed how war could be linked to some structural traits, such as legal structure, corruption, centralisation, etc. But to some extent, war also bears its own outcome. Gerschenkron or Demirguc-Kunt and Levine consider that market-based finance tends to be more efficient than bank-based finance and, as such, is positively related to overall economic development. This given, economic development should lead to convergence in terms of financial structures, something Rajan and Zingales showed is only partially true; because of a high level of path-dependency, financial structures across countries continue to show wide dispersal. But, at the same time, most countries tend to evolve in more or less parallel directions. For example, even if Germany has remained a bank-based country compared to France and the United Kingdom since the 1980s, it has incorporated a larger market dimension.[27] This could be considered as a weak form of convergence: all countries do not end up having the same financial system, but they do evolve in the same direction. Such an

25 B. Franklin, *Autobiography*, Vol. VII, 1777-1779 (1907), quoted from: L. Desmedt, 'l'expérience nord-américaine au XVIIIe siècle', Séminaire souveraineté monétaire et souveraineté politique, Working Paper, 2009.

26 See E.L. Glaeser and A. Shleifer, 'Legal Origins', *The Quarterly Journal of Economic*, Vol. 117, No. 4, pp. 1193-1229, that stresses, but on a rather vague basis, the more or less peaceful characteristics of France and England since the twelfth century. An informed and critical approach to the historical shortcomings of the Legal origin theory, as formulated on too schematic historical evidence by La Porta or Shleifer, can be found in: D. Kleman and P.G. Mahoney, 'Legal Origin?', USC Center in Law, Economics and Organization, *Research Paper Series*, No. C07-5, USC Legal Research Paper No. 07-3, 2007.

27 R.H. Schmidt, A. Hackethal, and M. Tyrell, 'The Convergence of Financial Systems in Europe', Johann Wolfgang Goethe-Universität Frankfurt am Main, Fachbereich Wirtschaftswissenschaften, *Working Paper Series: Finance & Accounting*, No. 75, May 2001.

explanation also lends force to history as a method to assess differences, even among converging countries, in financial structures.

The question, then, is what is the rationale behind this weak form of convergence? My hypothesis builds upon the work of Michael Loriaux on the idea that financial constraints are embedded in the international rules implemented and supported by the hegemonic state – the UK in the nineteenth century and US in the twentieth century.[28] These rules, like Janus, have two faces: they bear constraints, but also allow for international flows of capital that may support client-states or help the hegemonic state to bridge the 'commitment gap' derived from its overseas involvement. Convergence is then a political feature of client-states, looking for a 'Good Housekeeping Seal of Approval' which try to get closer to the political centre by implementing a national financial system embedded in the general rules of the international financial system.[29] For example, Dimitrova and Fantacci studied the case of Bulgaria trying to cope with the gold standard at the end of the nineteenth century.[30] The drawbacks of this monetary and financial system were excessive for such a backward country, but it played a major political role and helped integrate Bulgaria into the diplomatic agenda. Convergence is also one of the means through which centre-states or hegemonic states will try to enforce their influence, because capital lending and distribution or financial support will typically follow the general rules of the international financial system, which are established by hegemonic states. Because the superiority of one or several financial centres is based upon these same rules, there is a strong alignment between the interests of the hegemonic power and that of financial sector professionals.

In this light, the adoption of the gold standard by Germany shortly after its 1871 victory prepared the following war, by creating the conditions that set Germany, with rising strength, in conflict with the United Kingdom. In sum, the convergence process eventually builds the very forces bound to resist it, either because a challenger will emerge within the system, or because peripheral countries will challenge the system itself. Sometimes, such challenges may be solved through mainly economic and financial means. Sometimes, the stakes are so high that financial hegemony is only one part of them, and the challenge will be solved only through war.

Convergence is, therefore, fundamentally a violent process – either from a social, political or diplomatic point of view – and that as such, one of its likely outcomes is war. And, conversely, financial systems are built to enhance a hegemonic position; that is to limit the costs of war while providing the same benefits, from the League of Delos to the First Gulf War in 1991. As such, war is part of the convergence process, or the convergence process is the continuation of war by other means. WWI was not only a nationalist war, it was also an attempt by some powers – in each of the two main camps – to challenge the British imperial order supported by the French secondary empire. The attempt failed, but not the challenge: sterling domination was clearly shattered, and it entered two decades of decline. The following twenty years, until Bretton Woods, saw the progressive building of a new financial hegemony, based upon one currency – the US dollar – one (main) financial centre – Wall Street – and the military might of Washington. Not only did NATO, ASEAN and the Baghdad pact embody the extension of US hegemony, but they also served as a guarantee of financial support from the US (starting with the Marshall Plan) or to return financial support to the US by budget-sharing or refraining from converting dollars into gold, as experienced in 1967 when the gold-dollar parity crisis began.[31]

28 M. Loriaux, *Capital Ungoverned. Liberalizing Finance in Interventionist States* (Ithaca 1996), pp. VII-234.

29 M.D. Bordo and H. Rockoff, 'The Gold Standard as a "Good Housekeeping Seal of Approval"', *The Journal of Economic History*, Vol. 56, No. 2, Papers Presented at the Fifty-Fifth Annual Meeting of the Economic History Association (June 1996), pp. 389-428.

30 K. Dimitrova and L. Fantacci, 'The establishment of the gold standard in Southeast Europe: convergence to a new system or divergence from an old one?', Draft to the Patrice Baubeau (dir) Cosidyna project, Codisyna closing conference, Fréjus, September 2008.

31 M. Dickhaus, 'The International Monetary Policy of the German Central Bank 1958-1970', *EUI Working Paper*, HEC No. 2001/7.

## Conclusions

This paper has shown that, first, structural explanations for the characteristics of financial systems, built upon OLS or multiple regressions, have been unable to seize the complexity of the different factors at work; second, that they have tended to overlook shadow correlations, which are more crucial to our understanding; third, they do not explain correctly shifts and time variations, most notably the 'great reversal' stressed by Rajan and Zingales; fourth, they tend to privilege particular historical traits, leaving too much room for cultural explanations verging on prejudice and confusing long-term path-dependency with anachronism; and fifth, that war is a likely candidate for broader explanations, as previously stressed by Calomiris.

But it is also shown that the reason why war is one of the more convincing explanations is its role of a shadow correlation with other factors and allows the inclusion of not only agents, but actors and acting, i.e. volunteer action and policies, that use financial structures to reach economic or non economic goals. As such, this is complementary to the 'incumbents' analysis from Rajan and Zingales. A consequence is, that if war can be tested as an independent variable it derives its full meaning from the fact that it is actually embedded within the very structure of society, international relations and the economy. This is not an attempt to revive the old 'financial capitalism' critique,[32] but I simply want to state that the twentieth century was a very violent century, over which war and mass destruction constantly loomed, and that this menace – and opportunity – had significant influence.

In conclusion, I would like to engage in a very ahistorical question: Does the ongoing crisis offer an example of the way financial convergence and war work together? The convergence process that has been taking place for the last thirty years and labelled 'globalisation' is no exception to our story: extraordinarily violent in scope and reach, it might as well include wars to settle the very imbalances it has produced, including financial imbalances.

32 J.A. Hobson, *Imperialism, A Study*, (1902); Rudolf Hilferding, *Le capital financier*, (1910); Lenine, *L'Impérialisme, stade suprême du capitalisme*, (1916). These three texts are available on the website http://www.marxists.org.

# 'Good' versus 'Bad' Embeddedness: The Case of Bordeaux and of some Italian Regions.

Hubert Bonin & Luciano Segreto

## Introduction

Generally speaking, the 'virtues' of embeddedness have been praised for banks, because taking root deep within local business connections cannot help but loosen the haunting asymmetry of information. Beyond a classical firm's management demands, banking organisations – considering corporate commercial banking only here – dedicate a large part of their portfolio of skills to knowledge management and the collection of information about risks, because part of their decision-making processes are mainly based on risk assessment.[1] Sure, personal connections have been emphasized in key literature, for example in case studies about banking and finance in Great Britain,[2] or Lamoreaux's study in finance in New England.[3] Regarding the latter, a further study is still pending about what happened when the Philadelphia economy crumbled (with de-industrialisation causing a US record for unemployment) and when bankers were facing collapsing customership. Our argument will on one side still advocate banking embeddedness, mainly in the case of some Italian regions. But on the other side, it will deliver a reappraisal of embeddedness, arguing that such a *modus operandi* would transform into a threat to the ability of bankers to gauge sensitively the prospects of their customers. This aspect will be scrutinised throughout this paper with regard only to their position as borrowers, because we shall focus here on the sole risks caused by loans. Surely, embeddedness constituted an advantage over the Paris banks, because relationship banking opened more doors and supplied more information among customers-to-be or being against mere transaction banking, endorsed by big Paris banks' management rules – and the same in Italy for numerous regions, where, conversely with France, habits of developing business independently from a sole money centre prevailed, as was the case in the Florence or the Emily-Romagne areas. On the contrary, a close investigation of the events convinced us that we could even contend that local banks in Bordeaux were put at risk because they were too embedded, either during the punctual crisis of the 1930s, or during the harsh crisis which marked the demise of the Gironde economic model in the 1970s-1990s. And, in Italy, the move towards banking amalgamation, the crisis of renewal of several district centres and the globalisation of a large part of Italian family businesses led to the questioning of the 'house bank' system and the knots of connections woven for decades.

Despite the interconnection of regional economies through national flows and their frequent insertion into internationalised streams (either for the Bordeaux harbour or main industries active in the outskirts of Florence), and despite some kinds of centralisation of money markets through the policy and rediscounting of the central bank or through the discount practice of the banks from the 'capital' (in France: Paris; in Italy: Milan or Rome), local levels of decision-making were predominant in both countries. This is because of the importance of small and medium-sized enterprises (SMEs), the chains of credit fuelled by local productive

1 See G. Hodgkinson and W. Starbuck (eds.), *The Oxford Handbook of Organizational Decision Making* (Oxford 2008). Kenneth Arrow, *Théorie de l'information et des organisations* (Paris 2000). M. Casson, *Information and Organisation* (Oxford 1997).

2 F. Carnevali, 'Les banques régionales en Angleterre au XXe siècle', in: M. Lescure & A. Plessis (eds.), *Banques locales et banques régionales en Europe au XXe siècle* (Paris 2004). Michael Collins, *Banks and Industrial Finance in Britain, 1800-1939* (London 1991). Michael Collins & Forrest Capie : 'Industrial Lending by English Commercial Banks, 1860s-1914 : Why Did Banks Refuse Loans?', *Business History*, Vol. 38, No. 1, 1996, pp. 26-44.

3 N. Lamoureaux, *Insider Lending: Banks, Personal Connections, and Economic Development in Industrial New England* (Cambridge 1994). N. Lamoureaux, 'Regional financial institutions', in: C.-E. Nunez (ed.), *Finance and the Making of the Modern Capitalist World, 1750-1931*, Twelth International Economic History Congress, Proceedings B9, Seville, Fundacion Fomento de la Historia Economica, 1998.

systems, and the existence of local banks. The issue can therefore be raised even concerning micro-economic case studies, all the more so because Bordeaux was among the five main French harbours and oversaw a hinterland and overseas array of trade; and because Florence reigned over a strong industrialised area. Both cities thus provided opportunities to constitute thick layers of business bourgeoisies with decision power over capital and credit, and to cement city communities of shared interests, thus paving the way to commonplace business connections of which banks could take profit by assessing firms' health and near future.[4] Clearly, embeddedness could be considered as a means of leverage to achieve competitive advantages for local bankers.

## I.

One could assume that Bordeaux had never benefitted from the economic model of an 'industrial district',[5] as it lacked specialisation; contrary to other French regions,[6] the business connections lacked the density and stability highlighted by the historians of districts. But there were nevertheless a few solid and durable productive rings established for decades around wine and the alcohol trade, port activities (shipping, shipyards, maritime foodstuff, transformation of imported foodstuff), specialised metal-transformation and mechanics (and recently aeronautics). Such settings helped to foster enduring family firms, and thus built a framework for active social and business networks among local bourgeoisies. Networking prevailed as elsewhere, through family sociability (family unions, etc.), culture institutions and events, the Chamber of Commerce[7] or even Caisse d'Épargne de Bordeaux, because the French saving banks were confined to deposit-taking without getting access to lending,[8] and businessmen there practised only philanthropic patronage. But three key paths were opened to practise banking embeddedness along with a specific corporate culture. First, a practice of 'proximity banking' expressed first through the presence of local businessmen on the board of the two leading local banks, Société Bordelaise de Crédit Industriel et Commercial,[9] a sister bank to Paris CIC-Crédit Industriel et Commercial, and Soula bank, set up in 1924, and through close day-to-day relationships with these bankers. Second, membership of the local discount committee of Banque de France's branch. Third, active stake-holding amid the circles patronising and managing the two local mutual banks, Crédit Agricole

4 See G. Krippner, 'The Elusive Market: Embeddedness and the Paradigm of Economic Sociology', *Theory & Society*, Vol. 30, No. 6, 2001, pp. 775–810. B. Edmonds, 'Capturing Social Embeddedness: A Constructivist Approach', *Adaptive Behavior*, 7, 1999, pp. 323–348. M. Granovetter, 'Economic Action and Social Structure: the Problem of Embeddedness', *American Journal of Sociology*, Vol. 91, 3, 1985, pp. 481–510. I. Huault, 'Embeddedness et théorie de l'entreprise. Autour des travaux de M. Granovetter', *Annales des Mines. Gérer et comprendre*, June 1998, pp. 73–86. M. Casson, 'Entrepreneurial Networks: a Theoretical Perspective', in M. Moss, A. Slaven & C.-E. Nunez (eds.), *Entrepreneurial Networks and Business Culture* (Seville 1998), pp. 13–28.

5 B. Asheim, P. Cooke & R. Martin (eds.), *Clusters and Regional Development. Critical Reflections and Explorations* (London 2008). R. Martin, M. Kitson & P. Tyler (eds.), *Regional Competitiveness* (London 2008). P. Cooke & A. Piccaluga (eds.), *Regional Development in the Knowledge Economy* (London 2008).

6 M. Lescure, 'Entre ville et campagne, l'organisation bancaire des districts industriels : l'exemple du Choletais, 1900-1950', in: J.-F. Eck & M. Lescure (eds.), *Villes et districts industriels en Europe (XVIIe-XXe siècles)* (Tours 2002). A. Colli & M. Rose, 'Family Business. Industrial Districts, Networks, and Family Firms', (pp. 207–208); J. Zeitlin, 'Industrial Districts and Regional Clusters', chapter 10 (pp. 219–243), in: G. Jones & J. Zeitlin (eds.), *The Oxford Handbook of Business History* (New York 2007/Oxford 2008). H. Bonin, 'Les banquiers grenoblois des années 1890–1940 : un modèle spécifique?', in: H. Joly (et alii) (eds.), *Des barrages, des usines et des hommes. L'industrialisation des Alpes du Nord entre ressources locales et apports extérieurs*. Études offertes au professeur Henri Morsel (Grenoble 2002), pp. 185–209.

7 P. Butel (ed.), *Histoire de la Chambre de commerce et d'industrie de Bordeaux des origines à nos jours (1705–1985)* (Bordeaux 1987).

8 H. Bonin, 'Les Caisses d'épargne françaises (1914–1945): une croissance mouvementée sans évolution stratégique', in: *L'histoire des Caisses d'épargne européennes,* Tome 4, *Conjoncture & crises, 1914–1945*, Les Éditions de l'épargne, (1999), pp. 105-175. H. Bonin, 'Histoire aquitaines de Caisses d'épargne : de la prévoyance à la banque', in: H. Bonin & C. Lastécouères (eds.), L*es banques du grand Sud-Ouest. Système bancaire et gestion des risques (des années 1900 à nos jours)* (Paris 2006), pp. 365–382.

9 H. Bonin, *Histoire de la Société bordelaise de CIC (1880–1990)* (Bordeaux 1991).

de la Gironde and Banque Industrielle et Commerciale de la Gironde (belonging to the Banques Populaires confederation).[10]

In the interwar period, local banks were still very active throughout French regions,[11] and Bordeaux had also tried to resist the amalgamation and concentration wave around the big Paris banks and to preserve the special process of 'trust' established between family businessmen and their 'house bankers'.[12] Banque Nationale de Crédit[13] had absorbed the follower of the family bank Samazeuilh,[14] the leading Bordeaux bank until its collapse in 1913, and Crédit Commercial de France had afterwards purchased De Trincaud Latour-Soula Bank in 1917. Both banks had intensified competition already underway between Crédit Lyonnais, Société Générale and Comptoir National d'Escompte de Paris (and even a few British banks after WWI) within a liberal banking economy.[15] The very culture of 'transactional banking', along with drastic standards of risk assessment, had gained momentum; all the more so, because, when Société Bordelaise de CIC had faced a crisis of confidence during the ephemeral but harsh banking crisis (in Paris or in province) of 1913, its Paris godfather CIC had placed conditions on its refinancing help, which required a stake in its equity, representatives on the board and the exercise of better patterns of risk assessment and of liquidity rules. Even the challenger bank, Banque Nationale de Crédit, which had softened its risk assessment methods in the post-war period to undermine the predominance of big banks, had to return to strict rules in the mid-1920s after having endured too many bad loans throughout the French regions.

But a local business mindset still prevailed in Bordeaux as it did in several regional markets; businessmen grumbled about Paris hegemony and they favoured the recreation by Soula of a local bank, capable of resisting

Table 1: Members of the board of Société Bordelaise de CIC in the interwar period (with dates of presence on board).

| | |
|---|---|
| Daniel Guestier (1885-1928) | Barton & Guestier wine trading house |
| Edmond Besse (1895-1922) | Besse neveux & Cabrol jeune rum trading house |
| Pascal Buhan (1898-1930) | Buhan & Teisseire wholesale trading house in Sub-saharan Africa |
| Jean Segrestaa (1902-1941) | Segrestaa overseas trading house |
| Alphonse Denis (1909-1928) | Denis wholesale trading house in Indochina |
| Daniel Dollfus (1918-1973) | Johnston wine trading house |
| Paul Maurel (1919-1942) | Maurel & Prom wholesale trading house in Sub-saharan Africa and Huileries Maurel oil company |
| Paul Magne (1912-1930) | Magne fisheries company |
| Étienne Denis (1928-1951) | Denis wholesale trading house in Indochina |
| Christian Cruse (1929-1972) | Cruse wine trading house |
| Daniel Guestier II (1930-1960) | Barton & Guestier wine trading house |
| Pierre Desse (1932-1967) | Desse metal building company |
| Philippe Chalès (1935-1971) | CEO of Société Bordelaise de CIC and chairman of Maurel & Prom trading house |

10 É. Albert, *Les Banques populaires en France (1917–1973)* (Paris 1997). É. Albert, *Les Banques populaires en France, 1878–2009, 130 ans de coopération* (Paris 2008).

11 M. Lescure and A. Plessis (eds.), *Banques locales et banques régionales en Europe au XXe siècle* (Paris 2004). A. Plessis, 'Les banques locales, de l'essor du Second Empire à la 'crise' de la Belle Époque', in: M. Lescure & A. Plessis (eds.), *Banques locales et banques régionales en France au XIXe siècle* (Paris 1999).

12 See M. Casson, *Studies in the Economics of Trust* (Aldershot 1995).

13 H. Bonin, *La Banque nationale de crédit. Histoire de la quatrième banque de dépôts française en 1913–1932* (Paris 2002).

14 H. Bonin, 'La splendeur des Samazeuilh, banquiers à Bordeaux (1810-1913)', *Revue historique*, 1993, No. 288, pp. 349–389.

15 H. Bonin, *Les banques françaises dans l'entre-deux-guerres, Tome I : L'apogée de l'économie bancaire libérale française (1919–1935)* (Paris 2000).

the normative pressures of the Paris bank and able to rekindle competition, and to spur Société bordelaise de CIC, still the leading bank, to stick to its traditional trust relationships with local firms and families. Embeddedness was at stake: could Bordeaux preserve its way of business life against Paris banking norms? Heads of the medium-sized firms tightened their connections with their local bankers.[16] Their key influence on bankers was the power they could exert on the whole chain of credit opportunities. The linkage between the firms and banks were close, because a few dozen families managed a huge part (in value and volume) of Bordeaux trade exchanges, overseas (African staples: Caribbean rum, sugar, cocoa, coffee, wine, etc.) and locally (through warehousing and the upstream supply chain for the export of goods). Almost all the Société Bordelaise de CIC directors also belonged to the board of the Chamber of Commerce (some of them as the president), and a few to the discount committee of Banque de France.

This class of business bourgeois was so strong that Société Bordelaise de CIC could only rely on its business *modus operandi*; that is, low key accountability and low grade accountancy. They did not practice the art of the balance sheet, they oversaw broad arrays of subsidiaries in Bordeaux and overseas, with rapid treasury moves through extended accounts and a long chain of internal signatures covering bills of exchanges all along this chain. The very length of this chain itself fostered 'durable credits' from six to eighteen or even twenty-four months, in which banks ran up against their culture of liquidity because they were part of the 'package' of banking services to their customers and because returns were far more interesting on such overdrafts than on mere discounting. The bankers could do nothing but 'trust' their partners. At Société Bordelaise de CIC or Soula, members of business dynasties were lasting members of the board and, moroever, entertained bankers as  a part of local social life.[17]

But local banks needed their customership because they drew their business deposits, and thus fuelled the financing of the credit chain. Moreover, they drew on the wealth of families for purposes of wealth management. They also constituted their main outlet for the brokerage of securities which they had to distribute as sub-participants to the Paris underwriting and brokering syndicates – and CIC demanded its sister banks broker the packets of securities it acquired on the Paris market – and returns were substantial thanks to brokerage fees and charges on the management of private banking portfolios. All in all, therefore, the very profitability and even *raison de vivre* of such local banks against the big Paris banks depended on their connections with the local *Mittelstand*, on 'obligations networks' and the reciprocity of business favours, and on their submission to its needs and practices alongside the 'social construction' of the banking business.[18] The results may have increased risks, and lightened patterns of transactional banking and *crédit réel* in favour of relational banking and *crédit personnel*, which were based on trust and embeddedness. The balance of power on the Bordeaux market place was thus at stake because businessmen, taking profit from their influence on ('embedded') local banks Société Bordelaise de CIC and Soula, exerted a genuine power on and within the decision-making process, as directors, advisers, partners or 'connected' customers. And one had to ponder the margin of manoeuvre of the bank. Betting on such circles of family businesses as a wedge to counter big Paris-based banks' competition may have placed too much reliance on them as it did not diversify enough of its portfolio of activities. The profile was two-fold: it consisted of either wholesale traders or industrialists – and many of the latter were suppliers of the former, which reinforced the 'pro-cyclical trend'. Even if they avoided practicing some kinds of 'investment banking' and mixing corporate

16 P. Butel, *Les dynasties bordelaises. Splendeur, déclin et renouveau*, (Paris 2008). P. Butel, *Les dynasties bordelaises, de Colbert à Chaban* (Paris 1991).

17 See S.N. Eisenstadt & L. Roniger, *Clients, and Friends: Interpersonal Relations and the Structure of Trust in Society* (Cambridge 1984).

18 M. Granovetter, 'Economic Institutions as Social Constructions: A Framework for Analysis', *Acta Sociologica*, 31-1, 1992, pp. 3-11; 'Les institutions économiques comme constructions sociales', in: A. Orléan (ed.), *Analyse économique des conventions* (Paris, 1994), pp. 79–94. J. Scott, *Social Network Analysis. A Handbook* (Beverly Hills/London 2000; 1st edition 1995).

banking and financial holding, conversely to some bankers active further south in Dax or Bayonne,[19] local banks were too dependant on  the fate of a small range of clients. And because they were not 'regional' or 'pluri-departmental' institutions, they were strictly focused on the Bordeaux area and harbour.

Meanwhile clever businessmen had penetrated the mutualist institution set up in 1904, Crédit Agricole de la Gironde,[20] to help peasants bridge seasonal treasury gaps and to borrow for agricultural investment. In a first step, those Gironde and Bordeaux bourgeois, who were also wealthy landowners and managers of vineyards, supplemented their wine trade with their own crops and only patronised local mutualist institutions (*caisses locales*) as members of their boards and sometimes chairmen in order to prop up the creditworthiness of this young popular credit institution. These profited from their reputation and acceded to a rough version of embeddedness: the popular bank attained embourgeoisement. In a second step, from the 1920s wealthy sponsors of Crédit Agricole understood how useful it could be for their own business and started borrowing themselves to modernise their farm or to finance wine stockpiling, pending its maturation and bottling. They convinced their co-operative managers of *caisses locales* and of Bordeaux Caisse Régionale that favouring big wine-producers would sustain the prices for the whole wine community and downstream for the rural population.

Such forms of 'embeddedness' offered great advantages for the bankers on the level of information, volume of credit and resources, prestige and thus creditworthiness, and as markers of resilience in the face of the competitive onslaught of Paris banks. But such a way of life was blurred by two events at the turn of the 1930s.

First, both credit systems at Société Bordelaise de CIC and at Crédit Agricole had to face the 1930s crisis of sales deflation and fast-growing bad loans; debtors prolonged delays for repayment or reneged on their debts, when they did not collapse. Among them were a few important customers: In overseas trading (Devès & Chaumet and Martre & Vézia in 1935–1936, whilst Maurel & Prom had to be refinanced and restructured); in foodstuffs (Dandicolle & Gaudin and Rödel in 1935–1937) or in wine trading (Latrille, in 1932–1936). Bordeaux was stricken by a commonplace slump (mainly with the crunch on overseas commodities and on the wine exports business). The Bordeaux market thus endured a dire crisis of illiquidity, which proves that the lessons of the 1913 sharp, local crisis had not been remembered; embeddedness provided bankers with a sense of security which could have blinded them, despite the fact that a huge majority of their clients were SMEs, which in the interwar years faced difficult paths to finance their growth.[21] Several key clients (Denis, Nathaniel Johnston, Schröder & Schyler, etc.) had to renegotiate and consolidate their credit.

Second, despite its advantageous use of embeddedness, Société Bordelaise de CIC did not fare better than other banks, when it was revealed that bankers had been misled to lend to rum wholesale trading houses, which constituted in Bordeaux a competitive group (challenging Le Havre houses). In the midst of the booming years, rum families originating in the Antilles islands and extending to the port of Bordeaux, had piled up inventories and tried a 'corner' (*Compagnie générale du rhum*)[22] to speculate on a further rise and thus provoke an artificial increase of prices. But they were disappointed by the sudden and sharp turn-around and the depression. With one exception (Bardinet), the whole Bordeaux rum community and its biggest houses (Faure, Besse-Cabrol neveux, Feuillate, etc., the two former being important clients to Société Bordelaise de

19 C. Lastécouères, 'L'émergence des banques à l'allemande en Aquitaine dans les années 1930 : un anachronisme?', in: M. Lescure & A. Plessis (eds.), *Les banques locales et régionales en Europe au XXe siècle* (Paris 2004). C. Lastécouères, 'Le financement bancaire d'une économie régionale : le cas du Sud-Ouest (1880–1914)', in: O. Feiertag & M. Margairaz (eds.), *Politiques et pratiques des banques d'émission en Europe (XVIIe–XXe siècles). Le bicentenaire de la Banque de France dans la perspective de l'identité monétaire européenne* (Paris 2003), pp. 223–245.

20 H. Bonin, *Le Crédit agricole de la Gironde. La passion d'une région, 1901–1991* (Bordeaux 1992).

21 M. Lescure, *PME et croissance économique. L'expérience française des années 1920* (Paris 1996).

22 H. Bonin, 'Les élites provinciales entre position et déconfiture : la crise des grandes familles girondines dans les années 1930', *Hommages à Annie Cocula* (to be published 2009).

CIC) collapsed in 1931. But bankers had trusted it, clung to their speculative scheme, and granted credit. Sure, they had been embedded and, in bed, financially raped; houses had hidden the truth about the size of their engagements and risks and about their 'bubble system'. Banks were therefore trapped because of huge bad debts, and the Bordeaux market was swept by this little banking (and rum) tsunami. Soula had to stop lending, putting a thaw on its operations until WWII (and its purchase by Société Bordelaise de CIC); and, even if it resisted the crisis, Société Bordelaise de CIC had to take losses, to cut deeply into its provisions and reserves, and it required a decade to liquidate the pledged assets it received from debtors.

The wine crisis also pushed Crédit Agricole de la Gironde to the brink of collapse; its main *caisse locale* had granted too many and too large credits – they had doubled in 1929–1931 – to its wealthy directors and clients, among them many wholesale wine traders. Its manager and the CEO of Caisse Régionale had in fact been tricked by *grands bourgeois*, who had cheated them about the size of their wine inventories, the actuality of the pledges granted to warrants discounted by Crédit Agricole, and abused their trust when they had convinced them of the short duration of the crisis – which in fact lasted until WWII. Wine guarantees had been reduced to nil, interests could not be honoured any longer, the value of property fell, and apprentice bankers discovered the tricky effects of embeddedness – when trust was short-circuited by excessive 'proximity' or 'relationship' banking. The Paris-based state institution itself, Caisse Nationale de Crédit Agricole, concerned that numerous such *caisses régionales* were on the brink of collapsing, had to intervene directly, to dismiss their CEO, even to impose a thorough reshuffling of the compromised boards of local and regional institutions and also to establish a code of procedures in risk-processing and assessment, which big banks had generally adopted from the 1870s–1890s (because of their own infantile misadventures).[23] Mutualist structures and procedures had to be structured in a way that they could not be circumvented by influential members using their array of connections to set up an artificial embeddedness in favour of the prestige of their bank. This explains the thorough reorganisation of the Gironde Crédit Agricole in 1934-35, after its rescue through FRF 60 million of advances,[24] whilst the new chairman was a retired state marine officer and the new CEO and *ancien* head of Banque de France branches. Thus this change disrupted false embeddedness and the professionalisation of banking practices.

All these cases prove that embeddedness does not need to be a mere *bonna fide* formula, because bankers could risk being blinded by their trust in 'partnership attitudes'. Bad practices of embeddedness could lead to fostering the perception among clients that bankers are keen to tolerate some kind of collusion, if not 'balance cheating', at least; a willingness to be open toward over-growth, over-stockpiling, hyper-procyclical moves, and even speculative exhilaration. A position of 'active caution' from the bank (against myopia and a tendency to underestimate risks), a lucid anticipation of risks and business turnarounds, and rigour in risk assessment, could be threatened by such drifts toward embeddedness. Codes of 'good practices of embeddedness' are thus required in business and banking life to avoid the dangers of influential customers conflating their interests with those of the bank.

23 H. Bonin, 'Les banques et la fraude : un risque permanent (1850-1950)', in: G. Béaur, H. Bonin and C. Lemercier (eds.), C*ontrebande, fraude et contrefaçon, de l'Antiquité à nos jours* (Geneva 2007), pp. 345-362. H. Bonin, 'La gestion des banques françaises. La construction empirique de modes de gestion des systèmes d'information, des risques et des organisations (1800–2007)', in: É. Godelier (et alii, eds.), *Encyclopédie de la pensée et des pratiques managériales françaises, XIXe-XXe siècles* (to be published 2009).

24 H. Bonin, *Un siècle de Crédit agricole mutuel en Gironde* (Bordeaux 2002), pp. 54–59.

In both cases, corrupted embeddedness trends led to bad practices, based upon the nowclassical 'tragedy of commons',[25] when stake-holders of a community of business interests do not respect the collective rules – here, transparency, balance of information, trustworthy balance sheets – and thus pave the way to a common subsidy of the community, swallowed in the dire results of such a unilateral *modus operandi*. The untold pact, based on self-enforcing agreements, is torn up by bad players.[26] These customers misused banking processes and loans, and they over-appropriated bank-money in favour of speculation instead of restructuring and investing. Standards of business morale were therefore blurred, and bankers, surely lured by opportunities of sales and returns, fell into the trap; and, far from being embedded, became bogged down.

## II.

In Italy the banking system has always been a mixture of highly centralised big banks and a myriad of local or regional banks. Their interaction has been one of the less scrutinised factors of Italian economic and industrial development. A few studies underline the importance of the constructive dialogue between these two very different (by size and scope) actors. The history of Italian economic growth cannot be completely understood without the intervention of the mixed banks (or universal banks). On their role generations of scholars fully agree, despite the intellectual survival of some iconoclasts. Their presence and their size in the national economic landscape, mainly in the period of industrialisation (between the second half of the 1890s and the beginning of the First World War) has hidden for a long time the importance of other actors, especially that of savings banks and popular banks. Although not definitively smaller, since some savings banks like Milan-based Cassa di Risparmio delle Provincie Lombarde can be considered a big bank in view of the amount of its deposits, figures were (and are) not questionable.[27]

Nevertheless, from the very first studies on the Italian national banking system, and the relationships between banks and industries, some elements concerning the importance of other banks, which are different from the key actors, the universal banks, are clear. These features emerged more clearly through case studies about the history of a firm or a sector. Usually under these circumstances the usual strategy of the firms and the entrepreneurs appeared evident: just in a few cases the German idea of the 'house bank' was dominating.[28] Most historical evidence shows that firms, the big ones as well as the small and medium size ones, have always had a strategy of diversification concerning their financial resources. The big national banks (Banca Commerciale Italiana, Credito Italiano, Banco di Roma) were necessary to maintain contacts with a larger scenario both economically and politically. The presence of some other local banks (commercial banks, savings banks, popular banks) was, in a different way, linked with the idea of keeping a sort of independence from the big banks or a sort of escape from the strict ties these banks could impose. In the end, even from a quite long period (from the mid-1890s until the beginning of the 1930s) when the universal banks were dominating the Italian banking landscape, the firms and their owners wanted to have some other contacts with different actors of the banking system.[29] Some case studies show that in many circumstances those

25 G. Hardin, 'The Tragedy of the Commons', *Science*, 1968, No. 162, pp. 1243–1248. D. Feeny, F. Berkes, B. McCay and J. Acheson, 'The Tragedy of Commons: Twenty-two Years Later', *Human Ecology*, 1990, No. 18, pp. 1–19. E. Ostrom, *Governing the Commons: The Evolution of Institutions for Collective Action* (New York 1990). J. Acheson, 'Capturing the Commons : Legal and Illegal Strategies', in: T. Anderson and R. Simmons (eds.), *The Political Economy of Customs and Culture: Informal Solutions to the Commons Problems* (Lanhaw 1993). E. Ostrom, R. Gardner and J. Walker, *Rules, Game and Common-Pool Resoures* (Ann Arbor 1994).

26 K. Cool, J. Henderson and R. Abate (eds.), *Restructuring Strategy, Strategic Management Society Book Series* (New York 200x). L. Telser, 'A Theory of Self-Enforcing Agreements', *Journal of Business*, 1980, No. 53, pp. 27–44. M. Olson, *The Logic of Collective Action* (Cambridge 1965).

27 See A. Confalonieri, *Banca e industria in Italia 1894-1906*, Vol. 3 (Milan 1974–76).

28 See P. Hertner, *Il capitale tedesco in Italia dall'Unità alla prima guerra mondiale. Banche miste e sviluppo economico italiano* (Bologna 1984).

29 See A. Confalonieri, *Banche miste e grande industria in Italia (1914–1933)*, Vol. 2 (Milan 1994).

entrepreneurs were more likely shareholders, if not members of the board of directors, of local banks. The roles of direct, even personal contacts, as well as the interconnections in the governance structure, were of crucial importance. On the other side these 'special relationships' between the local banks and firms (and their owners) highlighted the structural presence of some forms of conflict of interests, which was in the end solved according to mutual interest so as to maintain the relationships between the two social and economic actors.

In the 1920s, when fascism came into power, the regime slowly introduced the fascistisation of the banks by pressuring the local banks to open the boards of directors or even the position of general director to well-known personalities of the fascist national party. But even in that case, although the central bank underlined the strong desire of the regime to increase its control over the banking system, the final result evidenced just some local representatives with close ties to the regime, who did not interfere with the governance issues nor the historical links between firms and banks.[30] The new banking law, approved in 1936, strictly separated commercial banks from investment banks[31] and gave the state control over 70 per cent of the Italian banking system.[32] The law was quite weak in offering strong support to small and medium-sized firms, which were not, by and large, the zenith of the political and economic interests of the government. On the other hand, big private as well as state controlled groups could rely on the new long term credit institute, Istituto Mobiliare Italiano, set up in 1931.[33]

This gap was to some extent eliminated by the democratic government and parliament in the late 1940s and 1950s, when special credit institutes at the regional level (*Mediocredito regionale*) were created to support small and medium size firms. These were no longer considered a sort of negative heritage of the past, but a strong pillar on which the country could recover after the war.[34] The dual structure of Italian capitalism was finally finding a complete and coherent banking system. The very big industrial groups faced a system within which they had a different audience for different needs. The new merchant bank Mediobanca offered a list of sophisticated financial services (capital and/or bond issues, both in Italy or abroad; financial and governance restructuring), and the rest of the system gave regular financial support for short term necessities.[35]

The banking law had much larger consequences for small and medium size firms. The banks who usually worked with them were savings banks and popular banks, and to a limited extent (considering their large number) the big national banks. The commercial banks still in private hands were too few and in any case the rules governing industrial financing were as strict as in the other segments of the banking system.[36] The preference for banking credit instead of the larger capital market and the limited number of listed companies (in the 1950s there were fewer than in 1907, when a stock exchange crisis dissuaded many firms from entering capital markets; the number of listed companies of that year was finally equalised in the mid-1980s) built a

30 See C. Bermond, 'La banca tra Grande Guerra e grande crisi', in: A. Cova, S. La Francesca, A. Moioli and C. Bermond (eds.), *Storia d'Italia*, Annali 23, La banca (Turin 2008), pp. 481–502.

31 See M. Porzio (ed.), *La legge bancaria : note e documenti sulla sua 'storia segreta'* (Bologna 1981). S. La Francesca, *Storia del sistema bancario italiano* (Bologna 2004), pp. 190–203.

32 See E. Cianci, *Nascita dello Stato imprenditore* (Milan 1977).

33 See G. Lombardo, *L'Istituto Mobiliare Italiano. Modello istituzionale e indirizzi operativi* (Bologna 1998).

34 See P. Cafaro, 'Una rete per lo sviluppo: i mediocrediti regionali (1950–65)', *Storia d'Italia*, Annali 23, La banca, pp. 824–864.

35 See S. Battilossi, 'L'eredità della banca mista. Sistema creditizio, finanziamento industriale e ruolo strategico di Mediobanca 1946–1956', *Italia contemporanea*, No. 185, 1991. N. Colajanni, *Il capitalismo senza capitale* (Milan 1991). F. Tamburini, *Un siciliano a Milano* (Milan 1992). G. Galli, *Il padrone dei padroni. Enrico Cuccia, il potere di Mediobanca e il capitalismo italiano* (Milan 1996). N. Colajanni, *Un uomo, una banca 1946-1991: storia di Enrico Cuccia e della prima Mediobanca* (Milan 2000). G. Piluso, *Mediobanca. Tra regole e mercato* (Milan 2005). L. Segreto, 'Il Caso Mediobanca', *Storia d'Italia*, Annali 23, La banca, op.cit., pp. 785–823.

36 See F. Giordano, *Storia del sistema bancario italiano* (Rome 2007), pp. 69–89.

sort of Hegelian servant-owner relationship, where it was to difficult to distinguish who was more necessary for whom.[37]

The situation was particularly true in the provincial areas where small and medium size industries were located. Strong links – stronger than before – were set up. Local political parties and elites played an important role because nominations to the boards of directors of the savings banks as well as the popular banks were largely influenced by a political decision-making process. Government coalitions (basically the majority was the sum of the Christian Democratic party, the Socialist party and some small liberal-democratic parties) usually took most, if not all the seats. In a very limited number of cases, the largest opposition party (the Italian Communist party) had the opportunity to take part (especially after the 1970s and, in any case, just in some regions, where it was the majority party) in this selection process.[38] The importance of this complex system ran parallel to the decrease (if not the collapse) of big private industrial groups, a destiny soon followed by state owned companies during the 1970s; and the increasing role of industrial districts, both in terms of the proportion of exports to the total amount of the national commercial balance, and of the proportion of the number of employees out of total industrial employment.[39]

## III.

Far later on, when the productive systems crumbled at the turn of the third industrial revolution and globalisation, Bordeaux' economic system was reconfigured by strategic considerations like those of other European regions. Its 'model' was questioned by the repositioning of the division of labour on an international scale.[40] This section will thus contend that what had been 'good' embeddedness since the interwar period – when local Bordeaux banks had woven useful connections within Gironde SME's – became 'bad' embeddedness, because such business networks hinder the resiliency of bankers in their capacity to evolve rapidly enough and to cut into their traditional portfolio of customers. They were involved in sharing the 'business culture' of the Bordeaux business area, in which they were deeply embedded, which reduced their margin of manoeuver and their ability of 'disruption'. They were committed to stay faithful to their clients, however condemned to disparition they might be, which inserted them durably into forms of path dependency.[41]

Almost the whole Bordeaux community of interests (banks, chambers of commerce and industry, business organisations, even local political powers, influential businessmen or *notables*) clung to an economic mindset consisting of a desire to modernise a productive system, which was in fact condemned to be rubbed off by the changes of productive systems. And bankers could imagine that granting new loans and helping firms to evolve would allow them to gain time, so as to overcome the threats of 'decline'. Blind conformity

37 See G. Aleotti, *Borsa e industria. 1889–1989. Cento anni di rapporti difficili* (Milan 1990). G. De Luca (ed.), *Le società quotate alla Borsa valori di Milano dal 1861 al 2000. Profili storici e titoli azionari* (Milan 2002). A. Volpi, *Breve storia del mercato finanziario italiano dal 1861 ad oggi* (Rome 2002).

38 S. Gatti, 'Guerra di banche', *L'Espresso*, 12 August 1984, pp. 96–99.

39 See G. Becattini, *Distretti industriali e Made in Italy. Le basi socioculturali del nostro sviluppo economico* (Milan 1980). G. Provasi (ed.), *Le istituzioni dello sviluppo. I distretti industriali tra storia, sociologia ed economia* (2002). M. Fortis and A. Quadrio Curzio (eds.), *Industria e distretti. Un paradigma di perdurante competitività italiana* (Bologna 2006).

40 J. Dumas, *Les activités industrielles dans La Communauté urbaine de Bordeaux*. Études de géographie économique et sociologique (Bordeaux 1980). H. Bonin and O. Pétré-Grenouilleau, 'Deindustrialisation and Reindustrialisation: the Case of Bordeaux and Nantes', in: F. Amatori, A. Colli and N. Crepas (eds.), *Deindustrialisation & Reindustrialisation in 20th Century Europe* (Milan 1999), pp. 233–262. H. Bonin, 'L'industrie agroalimentaire du grand Sud-Ouest aux XIXe-XXe siècles. Un renversement historique du positionnement dans les flux économiques', in: Jacques Marseille (ed.), *Les industries agroalimentaires en France. Histoire & performances* (Paris 1997), pp. 121–160.

41 M.-L. Djelic and S. Quack, 'Overcoming Path Dependency: Path Generation in Open Systems', *Theory and Society*, 2007, 36, No. 2, pp. 161–186. R. Burt, *Brokerage and Closure. An Introduction to Social Capital* (Oxford 2007). M. Stack and M. Gartland, 'Path Creation, Path Dependency, and Alternative Theories of the Firm', *Journal of Economic Issues*, 2003, 37, pp. 485–492. S. Ghezzi and E. Mingione, 'Embeddedness, Path Dependency and Social Institutions: An Economic Sociology Approach', *Current Sociology*, 2007, 55, No. 1, pp. 11–23.

to well-established positions and the replication of basic paradigms prevailed over self-reflection, and bankers were affected by a herdist attitude. If we consider the well-known formula, bankers were perceived as 'lenders of last chance', even though family firms were to change their business model and invent new paths of entrepreneurship, innovation and strategic scales of action. Their very embeddedness led bankers to be committed to the survival of an obsolete business culture,[42] that of a community which had not clearly understood how to rid itself of its heritage and to jump into the globalised *modus operandi* shaped by the 'third industrial revolution'. This explains why bankers were addicted to business 'routines' which reduce the scope of businessmen in their ability to confront broad economic challenges;[43] like the Darwinian processes which eliminate firms that resist cultural changes and revolutions of knowledge.[44] The case study of Société Bordelaise de CIC epitomises such a deadend, a form of 'bad' embeddedness. The local bank – which since the 1930s had become a regional bank, active in the whole of south west France, but which had preserved the power of its Bordeaux 'central branch' – could not help but being involved in the successive crises of Gironde SMEs.

## Gates to Decline in the 1970s–1980s

Wine family businesses were swept by a wave of bullish speculation in the mid-1970s and the same years were marked by a first industrial 'tsunami' which destroyed numerous family firms in foodstuffs or mechanics/light metallurgy. Bankers trusted family firms, which used large overdrafts to pile up huge inventories so as to speculate on prices. This led to vast losses in 1973–1975 and to the collapse of a dozen firms. Banks' archives are rich with records relating the surprise of bankers who discovered all at once that balance sheets and reports from well-trusted customers had been massaged; that *notables* were acting as white-collar swindlers; that relational banking was crumbling.

> 'Conversation became painful because the boss (of the largest building company of Bordeaux) confessed that we could not find out in the documents the actual turnover of his firm; because accounting documents did not take into account the whole array of participations and joint deals [...].'

True, the generation of managers of the bank had emerged in the 1940s and had aged parallel to the economic system; for decades it had rarely, if ever, left Gironde, and was not quite able to perceive the (genuine) 'decline' of Bordeaux' economy or France's position because their 'business culture' had been immobilised. Before opening doors to local 'rust belts', the 'invisible crisis' of strategic scale and scope had led to 'rusted brains'. The rupture imposed by such historical embeddedness was difficult: when Société Bordelaise de CIC approached its Ginestet customers, the owners of the prestigious Ginestet wine house and (since 1920) of Château Margaux, to mobilise their personal assets (Margaux & Co.) to repay their bad debts,[45] they were shocked by such a 'revolution' of distrust and the crumbling of long term banking relationships. They even denounced a 'conspiracy' of bankers against them, who were still insensitive to the crisis of their business

42 M. Casson, 'Entrepreneurship and Business Culture', in: J. Brown and M. Rose (eds.), *Entrepreneurship, Networks and Modern Business* (Manchester 1993), pp. 34–50.

43 M. Becker and N. Lazaric (eds.), *Organizational Routines. Advancing Empirical Research* (Cheltenham 2009). M. Becker (ed.), *Handbook of Organizational Routines* (Cheltenham 2008).

44 B. Noteboom (ed.), *Knowledge and Learning in the Firm* (Abingdon 2006).

45 Dossier du Contentieux, 'Ginestet', liasse 164, Société bordelaise de CIC archives. These archives have not been classified nor preserved after the removal of the headquarters of the bank in the 1990s.

model. But the local bank had set up a pool of banks (with Crédit Agricole and BNP) and decided to evolve to 'transactional banking'. The same misunderstanding between businessmen and bankers could be noticed by the Cruse (a family company), who could not imagine that the former could reappraise their financial and patrimonial assets and their loss of accounting power. This resulted in the boycott of the family by bankers in 1975 and even the rejection of Cruse managers from the company to prevent them from controlling the trade branch. Paris-based banks decided to abandon 'relationship banking' and to admit to Cruse's practices of embezzlement. A bunch of local 'stars' dating back to the nineteenth century,[46] like Ginestet,[47] Cruse or De Luze, were thus condemned to leave their family business model and to join institutionalised capitalism, and were bought out by Paris-based or foreign firms.

## Gates to Transactional Banking in the 1970s–1990s: The End of Embeddedness?

Later on, when the long-term crisis of the Gironde productive system bordered on completion, a last array of firms closed down, all along the harbour banks, and wholesale trading almost thoroughly stopped, beyond a few wine houses, mostly belonging to outside companies. But Société Bordelaise de CIC also had to tackle the difficulties of its customers in other areas where it had spread its network. Having been nationalised, then privatised (and bought by Crédit Mutuel Centre-Est-Europe group), the CIC group had to reinvent itself, because the disappearance of its historical clients had deprived its regional banks from accessing their commercial outlets. Besides developing 'mass banking' on one side, it had to rebuild a business foundation and to recreate connections among the firms which had emerged from the 1970s-1980s. Like in every region, such clients were often financially fragile, in the process of balancing start-up entrepreneurship and intense consumption of treasury resources. This demanded large amounts of current credits. How could a system of 'trust', of 'connections' between bankers and businessmen/women be rebuilt? Paris-based and local banks (joined by Banque Populaire du Sud-Ouest and Crédit Agricole de la Gironde, then by Crédit Agricole d'Aquitaine, and later on by Caisses d'Épargne, when these specialised banks were allowed to join universal banking and therefore corporate banking) competed sharply to draw in these new clients. Numerous heads of branches and regional headquarters were tempted to cede to the exhilaration of rapid growth to 'conquer' these fresh segments of clientele for the sake of 'trusting' these layers of 'entrepreneurs' who were highly praised by local authorities as leverage against unemployment and in favour of developing an 'Aquitaine Valley' alongside Silicon Valley.

Once more, embeddedness practices flowered, through new networks of business connections, more oriented towards technology, entrepreneurship, citizenship, etc. A new community of interests took shape at the turn of the 1990s. But the 1993-1995 recession revealed the illusion of such confidence. A few Paris-based banks, among which most prominent were Crédit Lyonnais and BNP, suffered from their bad debts to SMEs. The same can be said for Société Bordelaise de CIC. Crédit Lyonnais almost stopped such credits, but the other banks, either from Paris or local, had to reinvent their business models once more. This led to a thorough rebuilding of risk processing. Société Bordelaise de CIC for example created new levels of scrutiny concerning collective loan records,[48] moved or dismissed its branch managers, and set up rigorous processes

46 H. Bonin, *Les patrons du Second Empire*. Bordeaux & en Gironde (dictionary) (Paris 1999).

47 H. Bonin, 'The Ginestet Case Study. Internationalisation as a Way to Renew Bordeaux Wine Economy's Entreprise Spirit (1978–2000)', in: H. Bonin (et alii, eds.), *Transnational Companies (19th–20th Centuries)* (Paris 2002).

48 H. Bonin, 'Faire de la banque d'entreprise dans le grand Sud-Ouest. La reconstitution d'un système de gestion des risques à la Société bordelaise de CIC (depuis 1994)', in: H. Bonin and C. Lastécouères (eds.), *Les banques du grand Sud-Ouest. Système bancaire et gestion des risques (des années 1900 à nos jours)* (Paris 2006), pp. 439–466.

for assessing the financial situation of clients. The same attitude was adopted at Caisses d'Épargne and Crédit Agricole to avoid incurring losses which had undermined several *caisses régionales* of Crédit Agricole.

Thus everywhere transactional banking put a halt to traditional ways of embedded banking life. Local banks even adopted a rule stipulating that heads of branches ought to be moved every two to three years to prevent them from being circumvented by clients and to dissipate 'bad' embeddedness. This left room for the cold cross-examination and 'scoring' of the situation of clients. Experts noticed that bankers had to preserve their margin of manœuver which allowed them to 'cut rotten arms off', even if they belonged to friendly customers. And this explains the very refusal from banks, since the 1990s – even at mutual institutions which were accustomed to longer terms – to maintain branch managers beyond an average scope of three to four years. Such a permanent reshuffling of managers is supposed to help them avoid becoming too 'embedded'.

## IV.

Under the new framework and circumstances that took shape within the Italian banking market in the 1970s, the 'special relationships' between the banking system and new industrial Italy demonstrated their strategic importance.[49] The consequences were both positive and negative. We shall consider a few case studies to explain this very delicate situation. For any bank the information about the economic territory where it was supposed to work was a prerequisite for any form of intervention. All clients, but especially industrial clients, were not only their targets, but also their main material for a concrete, coherent and comprehensive analysis of the performance of a sector and of its actors. To know the true figures of the balance sheet of a firm and/or its long term strategy was absolutely necessary in order to establish correctly the amount of a credit line as well as any other special form of short or medium term financing. In a sense, the embeddedness of the bank was a natural or an obvious quality: like a fish swimming in its usual waters, the banks were supposed to have a regular and very deep contact with the firms. Their capacity for monitoring them and the effectiveness of this process was a crucial variable affecting not only the decision-making process concerning a single firm, but even the whole sector or, in some cases, the entire industrial district.

### Trust to be circumvented?

The strong backing of the political system was extremely important. The rise of a manager or CEO of a bank was strictly linked to his personal contacts with the local political system. The political parties were actually concerned about social and political stability from which they derived their legitimacy. The regular flows of credit to small and medium size firms were coherent with this programme. Not only the nomination to the board of directors or as head of the bank, even some official prizes were strongly linked with a managers' capability to answer the different questions raised both by entrepreneurs and their firms as well as by the political system.[50]

The case of the chairman of the Cassa di Risparmio di Prato (the savings bank of one of the most important industrial towns for the wool industry, located some 25 kilometres west of Florence) illuminates this assumption very well. Strongly supported by the Christian Democratic Party and working in an area where the putting out systems of production, even in the 1980s, were not an industrial relic of the past, but a concrete and spectacular form of division of labour among different firms, this banker had to face

49 See G. Conti and G. Ferri, 'Banche locali e sviluppo economico decentrato', in: F. Barca (ed.), *Storia del capitalismo italiano dal dopoguerra ad oggi* (Rome 1997), pp. 446–450.

50 Ibidem, pp. 454–455.

the fact that the town (as well as the surrounding area) was supportive of left wing parties, especially the Communist party, after the end of WWII. In 1984 this banker was awarded the 'banker of the year' award for his contribution to the excellent performance of his bank and for the strong and large network he set up with the local industrial community. This helped many firms to develop and to strengthen their market position. The official results of the bank showed a very solid situation in many aspects. One year later the shock: he was arrested on the basis of a very severe accusation of being the official responsible for the dramatic situation of the bank's accounts. The figures were showing a long series of very risky loans, opening a period of financial destabilisation for the bank. The balance sheet offered a completely different picture compared with that shown only one year before.[51] The most dramatic plunge from the award to jail in less than twelve months showed the vulnerability of a system where bankers, even the better, could fail just because they were too strictly linked to the territory. In fact, the real risk evaluation of any single industrial client was affected by many other non-economic factors (the image of a firm, its importance in the social and economic local network, the political consequences of a bankruptcy or even of some financial difficulties) that were not measurable by the more or less strict banking criteria for a credit line. Even worse, in many cases they were becoming more important than any other criteria.

## Regional Bankers: Balance-cheating their Business Community?

This behaviour put into evidence the relevance of the sense of responsibility of a bank towards the local business community. This attitude opens the doors to some possible parallels with the experience of mixed banks in the 1920s, a period in which they accepted any request from the big industrial firms to give them some credit. Waiting for an improbable recovery, they were forced to transform their credit into shares without actual value and which they could not sell to the market.[52] Like the latter, banks of the 1980s were ready to collapse; they hid the real situation of their balance sheets in order to permit credit flow to industrial firms, some of which were probably just struggling for survival. Only the 'superior' interest for social and political stability could explain that conduct. But this attitude put under scrutiny the efficiency of the banking criteria for credit and showed excessive discretion. In some cases, there was an absence of objective elements (financial parameters, specific ratios to access banking credit, etc.) that could be used for any firm and under any circumstances. Technical procedures instead of political and social evaluations: this was the lesson to take from that case, and it showed the high risk of embeddedness.[53]

The objective criteria used to check the economic and financial health of a firm have been implemented to a different degree and mainly in very different moments by Italian banks. Both the Bank of Italy and the Italian Banking Association (ABI) supported this process to a very limited extent. The reasons for this behaviour lay in the very differentiated conditions the banks were working in, depending on the economic and social structures they were faced with at the local level.[54] Nevertheless, the first European directive on banking, which introduced the concept of the bank as a firm, permitted a more objective approach to many aspects of banking activity. It also included rules about credit financing, which were reinforced by the first 'Basel agreement' in 1988.[55]

51 See L. Fanti, 'Note su alcune tendenze della Cassa di Risparmio pratese', in: IRES-CGIL Toscana, Produzione e credito nell'area pratese nei primi anni '80 (Florence 1986); M. Valentini, 'Sofferenze in banca', *L'Espresso*, 5 March 1989, pp. 233–235.

52 See A. Confalonieri, *Banche miste e grande industria in Italia*, op.cit.

53 See P. Ciocca, *Banca, finanza, mercato. Bilancio di un decennio e nuove prospettive* (Turin 1991), pp. 40–55.

54 See P. F. Asso and S. Nardozzi, *Storia dell'ABI. L'Associazione bancaria Italiana 1944–1972* (Rome 2006), pp. 380–390. L. Conte, 'L'azione della Banca d'Italia', *Storia d'Italia*, Annali 23, La banca, op.cit., pp. 683–687.

55 See F. Giordano, *Storia del sistema bancario*, op.cit., pp. 184–194.

For a long time discretion increased in the Southern regions. There the political framework was influencing – if not conditioning – the banks' strategies and behaviours. Personal, non-political (or pre-political) contacts, based on a series of mutual understandings and mutual knowledge, played a decisive role. On one hand, embededdness was at its peak here. On the other hand, it was showing its worse face. The Southern Italian banking system encountered increasing difficulties in the second half of the 1980s and in the beginning of the 1990s.[56] Many small private banks were close to collapse or bankruptcy. The same destiny awaited some bigger banks, some with hundreds of employees and billions of euros in deposits. The Bank of Italy came slowly to the conclusion that only permitting mergers and acquisitions (previously permitted to a very limited extent, because this kind of process was, in the opinion of the Italian central bank, destabilising the system) by clean, healthy, and well managed banks, it was possible to give new stability to the banking system in the Southern regions.[57] These were usually based in the North of the country and desperately sought an enlargement of their branches and subsidiaries network (a possibility the Bank of Italy permitted to a very restricted extent).

## Modernising Embeddedness?

Big national banks were not always ready to accept such an invitation if it was not proposed by the Bank of Italy, which was against the concentration of the banking system. Middle-sized banks were better suited, because of their size and of their (potentially) more aggressive strategy. Moral persuasion worked very well, because it met real needs by this segment of the Italian banking system, which sought expansion in other regions. In exchange they were more than happy to give their support for a concrete, sometimes even decisive contribution to the rescue of an important part of the national banking system. One of the most active actors in this very complex strategy has been Credito Emiliano, better known as Credem. Credem is a commercial bank controlled by many industrial families of Reggio Emilia, around a very big name of Italian industry, the Maramotti family, which is founder and owner of the fashion group Max Mara. Between 1989 and 1992 this bank took control of more than a dozen banks located in Sicily, Apulia, Calabria, and Campania. Among many other novelties the most important one involved its credit strategies. In order to avoid any negative aspect of embeddedness (mainly personal contacts between bankers and firms) Credem centralised any decision concerning credit. The experience of the 1980s was decisive. In that decade banks implemented a very complex and sophisticated system to scrutinise any financing request by industrial clients with a series of very objective criteria based on sane management principles. Clients of the newly controlled banks in Southern Italy, even before the merger with Credem, were no longer able to have direct contact with local managers to discuss their financial requests. Everything was decided in Reggio Emilia. This strategy was very successful, and contributed to a more serious approach to credit by small and medium size business. In the end this could be considered, paradoxically, a secondary effect of a new way to interpret embeddedness; stay close to the business community and understand its needs without any interference which could compromise the correct use of financial resources.[58]

There is another case, more famous and well-known on the international level that could be mentioned in this framework, namely the Parmalat case. This food and dairy industrial giant became a big multinational in this sector between the end of 1980s and the end of the 1990s. This firm, controlled by the Tanzi family – rooted in Collecchio, a small village not far from Parma – went into bankruptcy between 2003 and 2004.

56 See P. Bongini & G. Ferri, *Il sistema bancario meridionale: crisi, ristrutturazione, politiche* (Rome–Bari 2005). F. Panetta, *Evoluzione del sistema bancario e finanziamento dell'economia nel Mezzogiorno*, Servizio Studi-Banca d'Italia, No. 467, March 2003.

57 See C. Conigliani, *La concentrazione bancaria in Italia* (Bologna 1990), pp. 25–30.

58 See G.L. Basini and L. Segreto, *Le radici di un successo. Storia del Credito Emiliano (1910–2010)* (Rome–Bari forthcoming 2010).

Its managers and the owner, Callisto Tanzi, went to jail. The accusation dealt with the insolvency of the firm. Huge volumes of bonds, as well as many other more sophisticated financial instruments,were issued by the firm from the end of the 1990s to finance a spectacular acquisition strategy and permitted it to become a global actor. These rapidly lost their value because of default.

In the Parmalat case, the local banking system intervened to a very limited extent. The scale and scope of the firm apparently excluded, by definition, these banks from many activities with regard to this industrial client. The amount of financial operations was a very selective tool. Recent research also suggests that the decision to establish contact mainly with big banks, both national (Banco di Napoli, Banco di Roma) as well as international (especially American banks), was also due to the fact that Parmalat management and the Tanzi family preferred to avoid any contact with the local banking network. In some cases, the opinions there about the firm were radically different from official ones and especially from those proposed by the banks charged with placing the shares and the bonds issued by the firm among the public of small saviours.[59]

## V.

Business and banking history also follows conceptual trends, and the fashion towards embeddedness paved the way to a socio-cultural history of business connections.[60] One could have ascertained from such a topic that banks would be able to reduce the assymetry of information thanks to their insertion within business networks which constitute an immaterial capital to market places, whatever their scope. An immediate access to businessmen in charge of SMEs should therefore have allowed regional and local bankers to reduce the range of risks because of kinds of relationships based on 'trust' and direct access to ('on the spot') information. This also allows the by-passing of gaps in still emerging balance sheets and accounting methods. Sure, such 'good' embeddedness could be fruitful, and living at the heart of a community of interests, could fuel flows of data and foster a precise perception of businessmen's mentalities ('honourability', relations to pace of growth and to 'profit maximisation', etc.). But an evolution towards 'bad' embeddedness could conversely result in 'the social construction of failure' (K. Lipartito), when bankers were blinded by their confidence in their business partners. 'Horizontal' relationships between bankers and clients, based on 'relational banking', could incentivise over-confidence as well as an osmosis with the mindset of the local business community. For instance, in Bordeaux, which too easily trended towards speculation, excessive stock-piling and borrowing through overdrafts or documentary credits during bullish terms at the height of booms. Bankers became more and more puppet lenders as they stuck to pro-cyclical attitudes and over-lending or were far too lenient in their assessment of risks, because of the opportunities supplied by fat loans to their big historical clients.

One should establish an index which charts the propension of a business culture toward speculation across the market places of a country; but because Bordeaux frequently adopted speculative moods on commodities, wine or other goods, practicing banking there ought to have focused on the anticipation of such risks, and more on transactional banking. But competition from Paris-based big banks (and British banks) surely enticed local banks to bet on risky business because they contended that they could rely on their embeddedness within business circles and thus cultivate confidence. This would lead to a 'social destruction of trust' and hinder them from anticipating turnarounds and the decline of well-established industries and trades, and of well-off families and houses. Embeddedness could have sapped resiliency and flexibility as bankers could think of their customers as 'eternal' layers of business, inherited from generations upstream,

59 See V. Malagutti, *Buconero Spa. Dentro il crac Parmalat* (Rome–Bari 2004).

60 K. Lipartito, 'Business Culture. The Embeddedness of Business', in: G. Jones and J. Zeitlin (eds.), *The Oxford Handbook of Business History* (New York 2007/Oxford 2008), pp. 605–610.

a promise of durable growth, and able to absorb short term shocks thanks to their financial cushions and their patrimonial fortunes. Such 'embeddedness habitus' could have reduced their ability to remain open and watchful for permanent business and market intelligence. It could have also blurred their skills in refreshing their patterns of 'knowledge management' within 'learning' corporations,[61] which leads us to a commonplace conclusion about the required balance between 'good embeddedness' as a leverage against the asymmetry of information; and 'bad embeddedness' as a source of complacency towards risky customers to be with the risk of increasing the role of 'moral hazard' and even paving the way to 'adverse selection' at the expense of the banker acting as a 'principal agent'.

61 See D. Belet, *Devenir une entreprise apprenante. Les meilleures pratiques* (Paris 2003).

# Investment Banking Patterns, 1860-1914: Italy in a European Perspective.

Carlo Brambilla

## I.

The rise of investment banking in continental Europe around the mid-nineteenth century has been connected with the advent of railways and of related industries, but also with the appearance of other new sectors which emerged in the following decades and that marked the process of economic development known as the second industrial revolution. In fact, the financing of these new technological and capital intensive industries – characterised by differed profitability and a high degree of risk – emphasised a dilemma, that is how to make capital investments stable and 'permanent' as a whole, while taking into account the unwillingness by the single investor to commit to 'illiquid' investment purchases. Such a dilemma can be solved by organising proper markets in which these investments can be easily traded. Investment banks fulfilled the function of solving that dilemma, because by acting as intermediaries between borrowers and lenders, and as such performing delegated monitoring over borrowers, they were able to enhance investors' confidence, and thus to raise new capital and to allocate it to new industries and investments. Moreover, by creating and issuing tradable securities representing those investments and organising secondary markets where these could be traded, they increased – at least to a certain extent – the willingness by individual investors to purchase capital assets. These intermediaries fulfilled the same functions in continental Europe. That is, they financed new, capital-intensive industries and public utilities, thus starting a financial revolution as well as fostering both financial and industrial growth in second or latecomer countries.[1] Although a vast literature has pointed out how they often had a common origin, the observation of their structures, organisation and activities have shown how these investment banks were not all the same, but that they often adopted different patterns and degrees of specialisation.

This paper retraces the financial revolutions which took place in continental Europe, focussing in particular on investment banking patterns in Italy, as compared to those which were adopted in France and in Germany, between the 1860s and the First World War. It also tries to verify and assess differences and similarities among the main great investment banks of the three countries. In fact, quantitative analysis shows that relevant differences emerged in the evolution of investment banking patterns in these three countries, during those decades. The permanence or even better, the deepening of these differences during the period could be explained – to a certain extent – in Gerschenkronian terms, with the persistency of different degrees of economic development in the three countries, or with low and slow economic convergence among them before the Great War, especially as far as Italy is concerned. Nevertheless, a perhaps better explanation for this divergence in investment banking patterns could be found in the peculiarities of the institutional and legal frameworks, i.e. those elements which either enhanced or limited the ability of investment banks to solve the 'liquidity dilemma' mentioned above, that is to say the ability to transform 'permanent' investments into 'liquid' assets, and to convince savers to hold them.

1 D. Landes, 'Vieille banque et banque nouvelle: la révolution financière du XIXe siècle', *Revue d'histoire moderne et contemporaine*, 3 (1956).

## II.

Though its origins can be traced back to the second quarter of the nineteenth century – when first in France and then in Belgium a number of pioneering projects were promoted in order to set up big financial institutes aimed at fostering industrial enterprises – the establishment of joint-stock investment banking in continental Europe took place successfully around the middle of the century.[2] The pioneer of this financial revolution that rapidly spread throughout the continent was the Crédit Mobilier, promoted by the Pereire brothers. They were able to gather a group of bankers, financiers and industrialists around the project of a huge joint-stock investment bank devoted to financing railways, public utilities and related industries. As is well known, the foundation of the Crédit Mobilier in 1852 was rapidly followed in the succeeding years by that of several other institutes, such as the Crédit Industriel et Commercial and the Société Générale in France, or the Darmstädter Bank and the Disconto Gesellschaft in the German states. All these new institutes were big joint-stock banks with huge amounts of share capital, whose charters – though sometimes showing some differences regarding the extent and characters of limited liability these companies could enjoy in the different countries – tended to very much resemble those of the Crédit Mobilier in terms of the kind of activities they were allowed to carry out. In fact, their statutes all provided for the widest range of financial activities such as promoting new firms and companies; investing in public securities; but also underwriting, issuing and placing new shares and bonds on behalf of both firms and governments; making loans and advances in a variety of forms; and, not least, raising capital through the collection of deposits and by issuing bonds of various kinds and maturity. Moreover, all these banks originated from the association of prominent banking houses – known in France as the *haute banque* – which the Pereire brothers had caught off-guard when they launched their bank at the beginning of the 1850s. Those bankers, indeed, quickly understood the potentialities the new banking pattern could have in solving the issue of ensuring endless and growing funding for new technologies, while assuring investors of the 'temporary' or liquid character of their commitment. They thus moved into the new business, promoting or becoming shareholders of these initiatives.[3]

The diffusion of this new pattern of investment banking throughout Europe has been widely discussed, alternatively underlining the pivotal role played by the Crédit Mobilier not only in accelerating the financial revolution in France, but also in exporting it to the Continent. It also either served as a model for new banks in the German states, or directly established new Crédit Mobilier-like banks in many countries, as in Italy for instance; or by emphasizing the presence of a class of bankers in the different national contexts, already aware of the transformations that were taking place and that simply were able to do what the Pereire and the *haute banque* were doing in France.[4] What seems to emerge from the literature, however, is the presence in continental Europe of a relevant community of 'old' merchant-bankers which occupied the high segments of finance and was often cosmopolitan in character. They collaborated in many *affaires*, such as issuing, underwriting and launching government loans and railway bonds and shares in various countries, and tended to establish and develop personal relationships with each other, often enhanced by marital strategies. They thus formed a wide financial network of bankers and financiers, to which one or the other of its branches the founders of the new investment banks often belonged to.[5]

2 R. Cameron, *France and the Economic Development of Europe, 1800-1914: Conquest of Peace and Seeds of War* (Princeton 1961).

3 Landes, 'Vieille banque et banque nouvelle'; B. Gille, 'La fondation de la Société Générale', *Histoire des entreprises*, 8 (1961).

4 R. Cameron, 'Founding the Bank of Darmstadt', *Explorations in Entrepreneurial History*, 8 (1956); Cameron, *France*; R. Tilly, *Financial Institutions and Industrialization in the German Rhineland, 1815-1870* (Madison 1966); R. Tilly, 'Germany, 1815-1870', in: R. Cameron et al. (eds.), *Banking in the Early Stages of Industrialization* (New York 1967), pp. 151-182; B. Gille, *Les investissements français en Italie* (Turin 1968); G. Luzzatto, *L'economia italiana dal 1861 al 1894* (Turin 1991).

5 B. Gille, 'Les procès-verbaux de la Réunion financière', *Histoire des entreprises*, 9 (1962); K.E. Born, *International Banking in the Nineteenth and Twentieth Centuries* (Leamington Spa 1983); Luzzatto, *L'economia italiana*; E. Bussière, *Paribas 1872-1972. L'Europe et le monde* (Antwerpen 1992).

The evolution of financial and credit systems in Europe accelerated in the following decades with the adoption of these banking features in almost all European developing countries. There is generally a certain agreement on the fact that new great banks tended to evolve towards unspecialized patterns, in particular following the German model of universal banking. However, the French case has been described as a peculiar one, in which the early disappearance of the investment banks' ancestor Crédit Mobilier, in 1867, and other shocking episodes such as the bad experience suffered by Crédit Lyonnais in the *affaire Fuchsine* and the crack of Union Générale in 1882,[6] convinced big banks such as the Société Générale and the Crédit Lyonnais itself to accelerate the realisation of a nation-wide network of branches and to rapidly specialise in safer activities, such as deposit and commercial banking. Only a few big institutions, first and foremost Paribas, devoted themselves to 'pure' investment banking. In this sense, high segments of the emerging credit systems of continental Europe can be roughly described as dominated by great unspecialised investment banks, with the partial exception of France, whose credit system from late 1880 already experienced the articulation of several layers of specialisation.[7]

This notwithstanding, a comparative approach that takes into consideration quantitative data might tell a different story. The study of great investment banks' balance sheets, in fact, offers some interesting insights on the kind of activities carried out and thus on the pattern of specialisation these banks decided to adopt. Here, comparison takes into account great investment banks from the three major continental European economies, namely those of Germany, France and Italy. Banks are chosen according to their relevance: in investment banking; in fostering industrial development; and for their significant role in the development of their respective financial systems. The following banks are therefore considered: the French Crédit Mobilier, Crédit Industriel et Commercial, Crédit Lyonnais, Société Générale, Paribas, and Crédit Commercial de France; the German Bank für Handel und Industrie (Darmstädter Bank), Disconto Gesellschaft, Deutsche Bank, Dresdner Bank, Commerz und Disconto Bank; and the Italian Credito Mobiliare Italiano, Banca Generale, Banca Commerciale Italiana, and Credito Italiano.[8]

Comparison relies upon data taken from the banks' balance sheets over a period of about 50 to 60 years. Balance sheets are often regarded as unreliable or inaccurate sources, for window dressing or the concealment of profits are indeed quite well documented practices.[9] Nevertheless, such customs, especially as far as hidden profits and reserves are concerned, were principally aimed at preserving 'the trust of the public', i.e. to 'normalise' short term fluctuations in earnings that could affect the perceived robustness of the bank, having indeed the effect of strengthening its capital structure. It has to be noted, then, that a relevant part of banks' assets and liabilities items (share capital, deposits, loans and advances) are expressed at nominal values and, as such, they cannot be easily manipulated. Generally, then, assets liable to subjective valuation (securities and participations) were given prudential estimates, in order not to show too high profits or to constitute (hidden) reserves for coping with non-performing loans and other risks. Deviation from 'normal' habits could have happened, but if they persisted in the medium to long term, they would have affected banks' soundness, eventually leading to bankruptcy. Balance sheets, giving accounts on the development of a business over time,

6 J. Bouvier, *Le krach de l'Union Générale 1878-1885* (Paris 1960), p. 308; J. Bouvier, *Le Crédit Lyonnais de 1863 a 1882: les années de formation d'une banque de dépots* (1961; reprinted Paris 1999).

7 J. Bouvier, 'Les monnaies et les banques', in: P. Leon (ed.), *Histoire économiques et sociale du monde* (Paris 1978); M. Lévy-Leboyer, 'Le crédit et la monnaie', in: F. Braudel and E. Labrousse (eds.), *Histoire économique et sociale de la France* (Paris 1976); M. Lévy-Leboyer and M. Lescure, 'France', in: R. Sylla et al. (eds.), *Patterns of European Industrialization* (London/New York 1991). See also M. Lescure, 'La banque et le financement de l'économie', in B. Dejardins et. al. (eds.), *Le Crédit Lyonnais 1863-1986* (Geneva 2003).

8 As it is well known, the Crédit Mobilier is not the first continental big joint-stock investment bank. This primacy belongs to the Société Générale de Belgique, but it has been a paradigm to all other 'new banks' in Europe and in particular to those in the three countries referred to. On the preeminence of these banks there exists a vast literature.

9 The Crédit Lyonnais, for instance, had three different profit and loss accounts: one for the general manager and his staff; one for the board of directors; and one for shareholders; see Bouvier, *Le Crédit Lyonnais*, p. 164. A. Confalonieri, *Banca e industria in Italia, 1894-1906* (Bologna 1981), found that Comit used to prepare two different profit and loss statements, too.

were also the primary form of self representation of the firm – at least in the early stages of the development of business enterprises – and a device managers have often used as an important signalling tool towards stakeholders. Indeed, even the economic press' reports on businesses' performance relied upon such public sources. Thus, although accounting records could be hazy or blurry concerning the quality of some of their items,[10] they are still able to provide reliable information regarding the choices and policies of bankers, and thus about banks' structures and patterns of specialisation.[11]

Balance sheet items from these 15 great French, German and Italian banks have been collected, reordered and standardised in a common grid. Raw figures were then used to calculate financial ratios such as assets and liabilities composition, solvency, liquidity, and so forth. Balance sheet ratios have then been used in the quantitative analysis to assess differences and similarities over the medium to long term among banks and great banks' national systems. Assuming that the adoption of the same banking patterns implies similar balance sheet structures for the banks in the sample, a multivariate analysis method – cluster analysis – has been applied to check for similarities among them. Cluster analysis permits the grouping of objects of similar kinds into respective categories, and the building of taxonomies. There are different kinds of clustering. In this work hierarchical clustering based on the single linkage method and the Euclidean distance – which adopt a 'friend to friend' clustering strategy – have been used. Thus, each bank (object) is assigned to its own cluster and then the algorithm proceeds iteratively, joining at each stage the two most similar clusters according to their characteristics (financial ratios), continuing until there is just one single cluster. Groups which result from computations represent similar banking patterns among the banks considered.[12]

The following charts show some relevant and typical examples of how banks in the sample behaved over the long period, between the 1850s and 1910s. Charts 1 and 2 show clusters for 1877 and 1885 (data on the

**Chart 1**

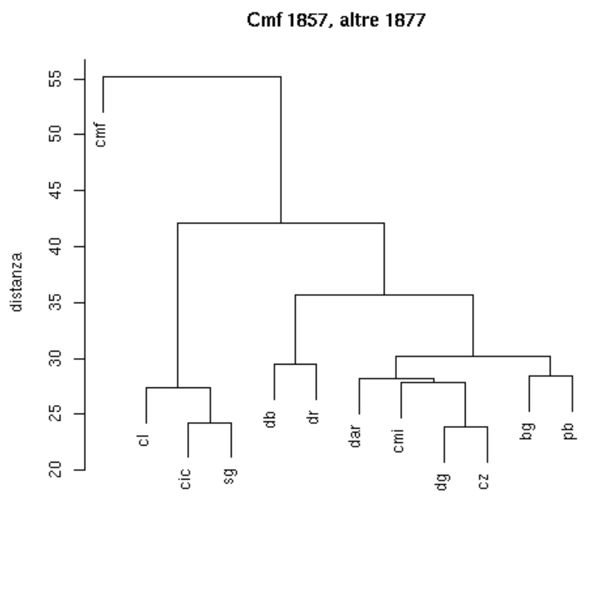
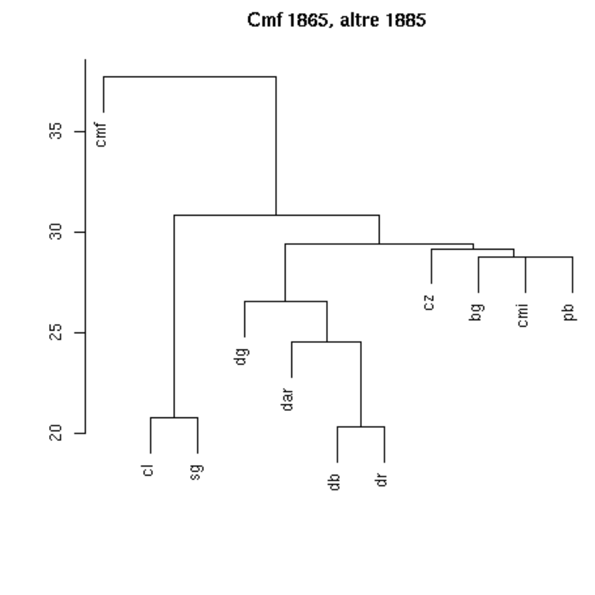



**Chart 2**




10 As emphasised for instance by P. Hertner, 'Das Vorbild deutscher Universalbanken bei der Gründung und Entwicklung italienischer Geschäftsbanken neuen Typs 1894-1914', in: F.-H. Henning (ed.), *Entwicklung und Aufgaben von Versicherungen und Banken in der Industrialisierung* (Berlin 1980).

11 Concealed profits, for instance, have an impact on performance indicators in the short term, but they tend to reappear under the form of retained earnings, reserves or even share capital in the long run.

12 Clustering was computed using the statistical package R. The single linkage method presents the advantage of being independent from the particular shape of the cluster to be found and thus of showing the natural distribution of objects in groups or categories. See on that J.A. Hartigan, *Clustering Algorithms* (New York 1975) and A. Rizzi, *Analisi dei dati. Applicazioni dell'informatica alla statistica* (Rome 1985). See also C. Brambilla, *Banche di investimento in Europa. Tipologie e strutture operative prima del 1914* (Pisa 2008), Ch. 2, for a wider discussion on sources and clustering.

Crédit Mobilier are relative to, respectively, 1857 and 1865, since the bank had already failed by the late 1860s). What seems to be clear is that the Crédit Mobilier does not group with any other bank in the sample, and moreover, that the distance between the Pereires' bank and the other great European investment banks is always very high. This suggests quite different behaviours between the former and the latter. In other words, it seems questionable that this bank – often considered a precursor and an ancestor of joint-stock investment banking on the Continent – represented a model for later experiences. Or perhaps more likely the other great banks developed different patterns of functional organisations in just a decade. Moreover, these latter seem to be quite similar to one another.

In fact, in both charts the only other clear cut cluster is that of big French banks Crédit Lyonnais and Société Générale, which soon developed a massive multi-branch and deposit collection strategy; they group together at the second iteration at most, and at very low distances. Paribas, the Italian banks Credito Mobiliare and Banca Generale, and the German banks tend to group together at various stages between the third and fifth iteration, at overall not such great distances, thus suggesting quite high degrees of similarity. Inside this cluster, a closer look at its components seems to suggest two patterns: the stronger similarity among second generation German banks, especially as Deutsche Bank and Dresdner Bank are concerned, and quite rapid convergence among the first generation German banks, the Italian ones and Paribas.

Considering these first two charts all together, therefore suggests that a differentiation in continental investment banking patterns was already emerging in the 1870s and 1880s. On the one hand, in fact, three quite well defined clusters can be observed already in the 1870s; that of the French great deposit banks, the ancestor – whose model is already abandoned by the others after a decade from its introduction – and that of all the other investment banks. On the other hand, the emergence of a cluster grouping together with the most relevant second generation German banks suggests the process of pattern differentiation likely deepened in the following decades.

Between the 1890s and the 1910s, in fact, the situation evolved even further (see Charts 3 to 5). A first glance at these clusters makes it immediately clear how Italian universal banks have developed their own pattern, which distinguishes them from any other great European bank.

Chart 3

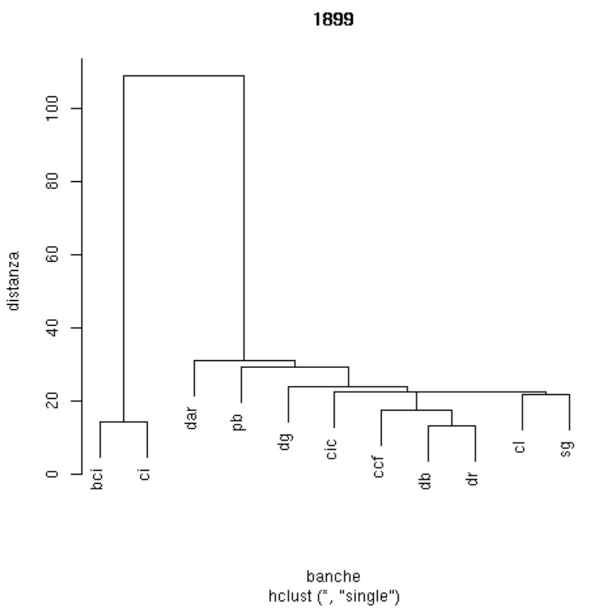


Chart 4

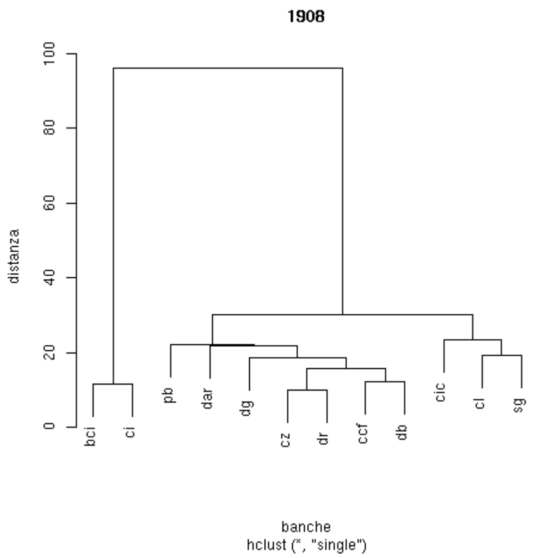
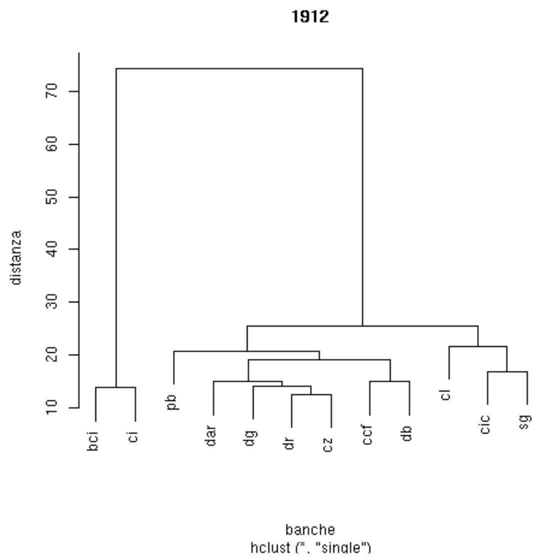



Chart 5




Banca Commerciale Italiana and Credito Italiano, in fact, group in the same cluster immediately, at very low distances in the whole sub-period. In Chart 3, Crédit Lyonnais and Société Générale, which already adopted deposit banking, show similar structures, grouping together at a certain distance from the other banks, forming the second large cluster. This tendency is confirmed and accentuated in Charts 4 and 5, where the cluster made by the former and Crédit Industriel et Commercial results even more clearly, revealing a fairly well defined model, different from that of the other European great banks.

In all three charts, a larger cluster comprehends both German and French universal or investment banks.[13] Quite interestingly, younger banks like Deutsche Bank, Dresdner Bank and Crédit Commercial de France, tend to group together at the first iterations and at short distances, a tendency that increases in the new century, suggesting a similar pattern characterising these banks. The other German banks and Paribas gather to them shortly afterwards in subsequent iterations, forming a larger and fairly cohesive cluster which in turn groups with that of French deposit banks. As already noticed, the last cluster to join the tree, and at a very high distance, is that of Italian universal banks.

What emerges over the long term then, is a process of progressive divergence in the experience of European investment banking development. Starting in the middle of the nineteenth century, this process saw great investment banks spreading through the continent initially following the example of the French Crédit Mobilier. A certain differentiation then took place during the 1870s, with the early specialisation of some great French banks in deposit banking, while other French, German and Italian banks remained in an investment banking pattern, though quite different from that of their French ancestor Crédit Mobilier. Differences in patterns became deeper in the following decades, when French deposit banking pioneers went on specialising in this business and developing a wide network of branches. Other banks went along with them as Paribas and Crédit Commercial de France remained – to a higher or lower degree – on a universal banking pattern, together with German ones. Not least, different patterns in universal banking emerged among great continental banks, as the case of Banca Commerciale Italiana and Credito Italiano clearly shows.

13 Crédit Commercial de France is clearly shaped as a universal bank, while Paribas, though usually described as a 'pure' banque d'affaires often presents a balance sheet very similar to that of universal banks. On the activities of these two banks see, respectively, J.P. Daviet and M. Germain, *Une banque dans le siècle, 1894-1994* (Paris 1994); E. Bussière, *Paribas 1872-1992* and Id., 'Entre la banque mixte et la banque d'affaires. La Banque de Paris et des Pays-Bas et sa strategie industrielle 1900-1930', *Entreprises et histoire*, 2 (1992).

## III.

These outcomes seem to question classical explanations relying upon Gerschenkronian arguments concerning degrees of economic development as determinants for the adoption of particular patterns of financial organisation. In fact, despite the fact that in those countries a process of financial modernisation took place and several kinds of financial institutions emerged along the period, universal banking was not abandoned in any of them, but continued to characterise several of their larger and most prominent banks. Moreover, this latter group clearly adopted differentiated universal banking patterns, in spite of the fact they had a common origin, occupied the same functional segment within the financial system and were connected to each other through a continental-wide network of relations. As intermediaries between borrowers and lenders, they applied delegated monitoring to solve the opposition between the preference for 'liquidity' by investors and the 'permanent' needs for capital by new industrial undertakings. To do that, they all used a wide range of financial tools: On the one hand, they collected capital through the issuance and placement of their own bonds and shares, and/or by collecting deposits. On the other hand, they launched new firms, or transformed existing ones into joint-stock companies, and they raised and allocated capital to them by issuing, underwriting, launching and placing new industrial bonds and shares. They also granted loans and advances to industrial undertakings, fulfilling in all cases an informational function that helped to fill the gap between savers and investors.[14]

As these were the functions and activities investment banks performed, the differences emerging from their balance sheet-structures and thus in their patterns can be explained by the way continental investment banks decided to make use of the variety of tools they had at their disposal. In other words, the adoption of a peculiar set of activities in which those financial tools were used in different proportions. Why was that? What are the reasons that similar financial institutions, quite interconnected to each other and working on fairly open markets, decided to diversify their activities to the extent that this resulted in the emergence of different banking patterns?

The ability by investment banks to carry out their functions and to solve the 'liquidity dilemma' is related to the existence of proper legal and institutional frameworks, such as the functioning of organised financial markets, the legal enforcement of contracts, and so forth. But taking for granted a certain minimum institutional endowment without which investment banks could not even have been created, it seems anyway that the peculiarities of the 'incentives', or constraints, investment banks found to their activities in the various institutional contexts have had effects on the sets of tools they came to work with, and thus in shaping their patterns. In this sense, for instance, the willingness by the central bank to support investment or universal banks by offering them facilities to overcome liquidity constraints, especially when tensions on their liabilities are growing, allowing banks to more easily substitute savers in their long run commitment, even when capital markets are less receptive; or to bear higher risks for their own assets. A legal system able to effectively guarantee the rights of minority shareholders is likely to enhance the willingness by these to buy 'permanent' assets and to hold them for longer periods. Larger and deeper financial markets, such as those characterised by lower volatility, will encourage small investors to hold bonds and shares, thus helping banks to channel investments to industrial companies. Therefore, the evolution of investment banking patterns in continental Europe can be considered as the more or less successful attempt by great joint-stock banks to solve the 'liquidity dilemma' through the adoption of distinct sets of activities aimed at coping with specific institutional contexts. The Italian case is in this respect a very telling one, as shown in the next section.

14 D.W. Diamond, 'Financial Intermediation as Delegated Monitoring', *Review of Economic Studies*, 51 (1984); D.W. Diamond and P.H. Dybvig, 'Bank Runs, Deposit Insurance and Liquidity', *Journal of Political Economy*, 91 (1983), No. 3; H.E. Leland and D.H. Pyle, 'Information Asymmetries, Financial Structure and Financial Intermediaries', *Journal of Finance*, 32 (1977), No. 2.

## IV.

While already in the 1850s a few pioneering experiences in joint-stock banking, following the French Crédit Mobilier's example, appeared in Piedmont and in Tuscany, at the time of reunification Italy still had a fairly underdeveloped credit and banking system.[15] In fact, the financial apparatus of the new kingdom was quite segmented, with very different situations in the various regions and almost no presence of modern banking. In Piedmont and in Tuscany a first core of new banks was developing and a certain articulation of the system was emerging especially in the former, thanks to the policy of the Banca Nazionale and roughly inspired by that of the Banque de France. Issuing banks in the southern regions dominated a backward environment where credit services were mostly granted by semi-public institutions inherited from the *ancien régime*, such as pawnbroking charity bodies and rural not-for-profit bodies offering advances on crops.[16] In the central-northern regions, there were active not-for-profit savings banks, while a community of merchant-bankers was widespread all over the country.[17] Beginning in the 1860s credit and banking saw a quite rapid development along with the first massive investments in public utilities and infrastructures (foremost in railways), the establishment of new industries, and later the first wave of industrial growth. These transformations in the financial sector and its subsequent developments until the Great War were marked by a number of crises which had a relevant role in shaping the evolution of the credit system and of the new joint-stock banks' patterns in particular. From this point of view three major sub-periods can be identified. The first one runs from the reunification of the country in 1861 to the crisis of the early 1890s, which saw the failure of the first big joint-stock investment banks. The end of the second sub-period is marked by the 1907 crisis. While the third and shorter one can be seen as a transitional period, since it covers the pre-war years and shows some of the features that characterised the 1920s.

After reunification, the commercial code of 1865 – partly inspired by the French one[18] – was aimed at giving a common administrative and legal framework to the new country, and tended to privilege the protection of entrepreneurs' rights and properties from possible speculators, while somehow sacrificing minority shareholder and creditor rights to those of the promoters.[19] Indeed, until the introduction of the new commercial code in 1882 government authorisation for establishing limited liabilities firms and companies was needed and very weak measures were set up to ensure companies' and administrators' accountability.[20] In such a context Credito Mobiliare Italiano (1863) and Banca Generale (1871) emerged from the 1870s as giants in an environment of dwarf or local banks, both having hardly any relations with cooperative and savings banks

15 I. Sachs, *L'Italie, ses finances et son développement économique depuis l'unification du royaume* (Paris 1885), pp. 699-707; A. Polsi, *Alle origini del capitalismo italiano. Stato, banche e banchieri dopo l'Unità* (Turin 1993), Ch. 1. On the influence of France in the shaping of the Italian credit and financial systems, see Luzzatto, *L'economia Italiana*; Confalonieri, *Banca e industria in Italia 1894-1906*; and Gille, *Les investissements français*.

16 Luzzatto, *L'economia Italiana*; Polsi, *Alle origini del capitalismo italiano*; S. La Francesca, *Storia del sistema bancario italiano* (Bologna 2004).

17 On the first Tuscan banks see, among others, G. Conti, 'Terra commercio e credito nella Toscana del XIX secolo', *Studi e ricerche*, Dep. of Economics (University of Pisa 1989); on the importance of savings banks in the Italian credit system see A. Cova and A.M. Galli, *La Cassa di risparmio delle provincie lombarde dalla fondazione al 1940* (Milan-Rome 1991); G. Prato and G. Fenoglio, *La Cassa di risparmio di Torino nel suo primo centenario* (Turin 1927); about the permanence of *ancien régime* banking practices and structures in Milan until the 1860s, see G. Piluso, *L'arte dei banchieri. Moneta e credito a Milano da Napoleone all'Unità* (Milan 1999); L. Segreto, 'I banchieri privati e l'industrializzazione italiana', *Imprese e storia*, 24 (2001) underlined the relevance of merchant bankers for the development of the Italian credit system during the nineteenth century.

18 In fact, it was a sort of emendation of the Piedmontese code of 1842, which, in its turn, derived from the *code Napoléon*. See Camera dei Deputati, Ricerca sulle società commerciali. *Linee evolutive della legislazione italiana e ordinamenti stranieri* (Rome 1968).

19 G. Conti, 'Finanza d'impresa e capitale di rischio in Italia, 1870-1939', *Rivista di storia economica*, n.s., 10 (1993), No. 3.

20 Even the short-lived experience of the *Sindacato governativo* (a sort of controlling commission on joint-stock companies depending on the Ministry of Agriculture, Industry and Commerce) did not improve the situation, characterised by high degrees of opacity in financial and economic information on companies. On this body see F. Belli and A. Scialoja, 'Vocazioni interventiste, miti ed ideologie del liberismo all'indomani dell'unificazione nazionale; il controllo delle società commerciali e degli istituti di credito nell'esperienze del Sindacato governativo (1866-1869)', in: C. De Cesare, *Il Sindacato governativo, le società commerciali nel Regno d'Italia* (Bologna 1979).

or with smaller joint-stock ones.[21] The segmentation of the credit system, on the one hand, and the characters of the institutional and legal framework, on the other, can explain the strong ties they established with the major note-issuing bank, Banca Nazionale nel Regno d'Italia, which sustained them whenever downturns or crises threatened their liquidity. Their primary commitment to market activities can then be explained by the attempt to solve the 'liquidity dilemma' while at the same time preserving their own stability in a still underdeveloped and poorly regulated economic context in which creditors suffered from lack of information. On one hand, they collaborated with the National Bank in placing risk-free securities, such as national and local government bonds; on the other, they underwrote and placed bonds and equities of railway companies and other public utilities, of basic industries such as metal works and mechanical engineering companies. They were basically financing projects of national interest which offered higher guarantees. In this sense, the similarities between the Italian and especially the first generation of German banks (Charts 1 and 2) are coherent with the establishment of Gerschenkronian banks during the early phases of financial development and of infrastructural modernisation in latecomer countries.[22] When great infrastructural projects were in their final phase during the 1880s, Credito Mobiliare and Banca Generale started investing heavily in the real estate boom, which was connected with the renovation of main cities like Rome and Naples and which relied upon a patrimonial concept of credit. Unfortunately, this was not sufficient to avoid bankruptcy when the real estate bubble burst, causing frozen assets that, together with accumulated non-performing assets on industrial investments and persisting economic depression, eventually caused their failure in 1892–93.[23]

The new commercial code of 1882 presented several novelties which improved the legal framework and ameliorated both the information disclosure on the part of companies and the minority shareholders' and creditors' rights as compared to the privileges of promoters and majority shareholders. It also improved corporate governance tools in joint-stock companies and in this way brought Italian institutions closer to those of the other main European countries.[24] The new code, in fact, included a few stricter rules on bookkeeping and made annual balance sheet publication as well as a statutory board of auditors (*collegio sindacale*) compulsory. However, the law only prescribed that balance sheets reported the exact amount of profits and losses, of capital and of reserves, but did not set rules on the quality and quantity of information to be given on other items, in contrast with other European legislations such as those introduced in England, Belgium and Germany. These countries' legislation provided for more precise and accurate bookkeeping practices.[25] The statutory board of auditors was elected by the same majority which had elected the board of directors. Moreover, the law was very soft about shareholding syndicates, interlocking and pyramidal shareholdings; and shareholders maintained the right to withdraw from the company at any time, a threat that can be used

21 Owing to their failure in 1893-94 and the almost complete loss of their archives, we have little information about them. The former was founded under the aegis of the Pereire brothers' Crédit Mobilier, with the participation of outstanding Italian bankers, such as Bastogi and Balduino; while the latter was constituted in Milan by a group of Italian and Central European bankers, among whom were Bischoffscheim and Goldschmidt. Luzzatto, L'economia Italiana; A.M. Galli, 'Sviluppo e crisi della Banca Generale', in: E. Decleva (ed.), *Antonio Allievi, dalle scienze civili alla pratica del credito* (Milan-Bari 1997).

22 Confalonieri, *Banca e industria in Italia 1894-1906*.

23 See M. Pantaleoni, *La caduta della Società Generale di Credito Mobiliare Italiano* (1895; reprinted Turin 1998); Luzzatto, *L'economia Italiana*; Confalonieri, *Banca e industria in Italia 1894-1906*.

24 A. Errera, *Il nuovo codice di commercio del Regno d'Italia* (Florence 1883); Conti, 'Finanza d'impresa'; R. Teti, 'Imprese, imprenditori e diritto', in: F. Amatori et al. (eds.), *Storia d'Italia, Annali 15, L'Industria* (Turin 1999).

25 L. Cellérier, *Etudes sur les sociétés en France et dans les pays voisins* (Paris 1905); G. Zappa, *Le valutazioni di bilancio con particolare riguardo ai bilanci delle società per azioni* (Milan 1910); for a wider discussion on these issues see also C. Brambilla and G. Conti, 'Informazione e regole contabili nei rapporti tra banca e industria', in: G. Conti, *Creare il credito e arginare i rischi. Il sistema finanziario tra nobiltà e miserie del capitalismo italiano* (Bologna 2007).

to oppose strategic decisions such as new capital issues, mergers and acquisitions, changes in the company objects, etc.[26]

Banca Commerciale Italiana and Credito Italiano, founded after the crisis, had swept away not only the two biggest investment banks, but also a plethora of other joint-stock banks. Most importantly, four out of six issuing banks had to cope with a framework in which the Bank of Italy was unable and unwilling to maintain the same strict, friendly relations and generous attitudes, Banca Nazionale had had with the failed great banks. The main bank of issue arose from the ashes of this latter and of two regional issuing banks, having taken charge of the liquidation of Banca Romana's frozen assets. It displayed a more thrifty behaviour in offering refinancing facilities to the banking system.[27] Comit and Credit hybridised Central European patterns and experiences as the composition of their groups of control confirms[28] and, because of their origins and their universal pattern, they are often referred to as German-style mixed banks.[29] During the two decades preceding the First World War, universal banks answered to the growing demand for investment banking and industrial financing induced by the upwards trend of the Giolittian years. They committed themselves especially to financing new sectors such as chemicals, metal works, mechanical engineering and electricity. With the new century the growth of industrial investments and profits, the slackening of public debt issues, and universal banks' market activities, the first stock exchange was created, which widened the offering of listed securities and prices.[30] Compared to their Italian ancestors they showed stronger abilities to raise funds from customers, to manage multi-branch banking, particularly from 1900 onwards, and to maintain friendly and stable relations with international financial circles. That allowed them to manage more easily demand for funding and investment banking services through the organisation of larger pools and syndicates. This helped prevent too rapid a depletion of their means and liquidity.

This notwithstanding, cluster analysis had shown how Italian universal banks' pattern was quite different from that of German ones. This suggests that they indeed developed different strategies to ensure 'permanent' investments to industrial companies. In Germany, the legal context provided several measures to discourage speculative behaviours: higher face value of stocks; a clear separation between common and privileged stocks; a balance of power between managing bodies – such as the board of directors and the executive board (*Vorstand*) – on the one hand, and controlling bodies – such as the supervisory board (*Aufsichtsrat*) and the auditors appointed by local authorities – on the other; wider information on companies' situations and deeds; and more precise provisions on managers' responsibility in case of fraud.[31] By putting their own representatives in supervisory boards, German banks had a pretty effective means of overseeing and monitoring debtors, thus strengthening their ability to solve the 'liquidity dilemma' and guaranteeing effectual intermediation between savers and investors. The new law on the stock exchange of 1896 banned future contracts for most securities and ensured stricter supervision over the stock exchange. It also brought a large

26 Conti, 'Finanza d'impresa'; A.K. Kuhn, *A Comparative Study of the Law of Corporations with Particular Reference to the Protection of Creditors and Shareholders* (New York 1912); C. Vivante, 'Per la riforma delle società anonime', *Rivista del diritto commerciale e del diritto generale delle obbligazioni*, 2 (1913), No. 2.

27 F. Bonelli, 'Introduzione', in: Id. (ed.), *La Banca d'Italia dal 1894 al 1913. Momenti della formazione di una banca centrale* (Rome-Bari 1991).

28 On the constitution of the two new banks see Confalonieri, *Banca e industria in Italia 1894-1906*, Vol. 2; P. Hertner, *Il capitale tedesco in Italia dall'Unità alla prima guerra mondiale: banche miste e sviluppo economico italiano* (Bologna 1984).

29 See for instance J.S. Cohen, 'Financing Industrialization in Italy, 1894-1914: The Partial Transformation of a Late Comer', *Journal of Economic History*, 27 (1967); G. Mori, 'L'economia italiana dagli anni ottanta alla prima guerra mondiale', in *Storia dell'industria elettrica in Italia*, Vol. 1, G. Mori (ed.), *Le origini 1882-1914* (Bari 1992); C. Fohlin, 'Relationship Banking, Liquidity and Investment in German Industrialization', *Journal of Finance*, 53 (1998), No. 5, and Ead., 'Capital Mobilization and Utilization in Latecomer Economies: Germany and Italy Compared', *European Review of Economic History*, 2 (1999).

30 G. Toniolo, *An Economic History of Liberal Italy, 1850-1918* (London/New York 1990); G. Federico and G. Toniolo, 'Italy', in: R. Sylla and G. Toniolo (eds.), *Patterns of European Industrialization: the Nineteenth Century* (London/New York 1991).

31 Kuhn, *A Comparative Study*, pp. 69-85; Vivante, 'Per la riforma'; W. Rathenau, 'Le società per azioni. Riflessioni suggerite dall'esperienza degli affari', *Rivista delle società*, 5 (1960); C. Fohlin, *Finance Capitalism and Germany's Rise to Industrial Power* (Cambridge 2007).

share of securities' trading 'inside' the banks, which fostered stricter control by banks over the market and enhanced their ability to ensure a long lasting commitment to industrial companies' financing. In Italy the legal framework shaped by the commercial code of 1882 left important issues unresolved such as that of the protection of minority shareholders' and creditors' rights, or that of full information disclosure. Moreover, the stock markets were smaller and more volatile and characterised by higher speculative behaviours which discouraged the diffusion of 'permanent' investments.[32] In such a context, Italian banks tried to cope with information asymmetries and to strengthen their position as creditors and/or minority shareholders. First and foremost, they sought to acquire enough voting rights in general meetings so as to ensure themselves one or more seats on the board of directors of the debtor companies and to obtain effective supervision over them.[33]

However, this practice implied careful tuning in order not to excessively burden banks' securities portfolios, and thus endanger their own liquidity. And indeed balance sheet data suggests that Italian great banks did not maintain significantly higher participations in industrial companies than German ones. What, on the contrary, seems to differentiate Italian banks' balance sheets from others, is the amount of contangos and, especially, of third parties' securities deposits (*conti titoli*). These were very tiny in French banks and absent in German ones. Comit and Credit securities deposits, on the contrary, amounted on average to two-thirds or even more of their total assets.[34] In most French banks contangos amounted to a small proportion of total assets, while on average German ones invested more in them. Yet this was still to a lesser extent than Comit and Credit, which on average show figures in the order of 20 per cent of assets.[35] Both contangos and securities deposits are indicators of the acquisition of proxy voting rights by Italian banks; a strategy that enabled them to maintain and extend supervision and control over companies and thus secure their position as creditors or minority shareholders at a fraction of the cost that they would have had to bear for taking stakes in them. Therefore, the variety of patterns and degrees of specialisation that cluster analysis outcomes show are likely to be explained by the different strategies each bank adopted trying to solve the 'liquidity dilemma' while coping with a peculiar institutional environment. In this sense, the ability of French banks to develop a greater division of labour and a higher degree of specialisation during the period was perhaps also due to the character of the international financial centre and of the prominent continental market enjoyed by the Paris stock exchange. This helped them to better manage the opposition between 'liquidity' preferences and 'permanent' investment needs and to rely upon wider, deeper and less volatile markets.

The international liquidity crisis of 1907 hit the Italian stock exchanges fiercely and interrupted financial markets' development, which never recovered completely nor grew broader until the last decades of the twentieth century. This left industrial capital supply entirely on banks' shoulders.[36] That had relevant consequences on the universal banks' ability to fulfil their functions while preserving their own liquidity and 'freedom of movement', since it compelled them to higher commitments towards industrial financing, and hence to eventually accept heavier portfolios of securities and illiquid loans. This would soon determine an involution in universal banks' pattern. This notwithstanding, there is no evidence of that in cluster analysis nor in balance sheet ratios before 1914. It was, in fact, after the war that universal banks saw their balance

32 Brambilla and Conti, 'Informazione e regole contabili', G. Siciliano, *Cento anni di borsa in Italia* (Bologna 2001); S. Baia Curioni, *Regolazione e competizione. Storia del mercato azionario in Italia (1808-1938)* (Bologna 1995).

33 Indeed, interlocking directorates was a practice Comit and Credit widely used. See F. Pino, 'Sui fiduciari della Comit nelle società per azioni, 1898-1918', *Rivista di storia economica*, n.s, 8 (1991); C. Fohlin, 'Fiduciari and Firm Liquidity Constraints: the Italian Experience with German-style Universal Banking', *Explorations in Economic History*, 35 (1998), No. 1; M. Vasta and A. Baccini, 'Banks and Industry in Italy, 1911-1936. New Evidence Using the Interlocking Directorates Technique', *Financial History Review*, 4 (1997).

34 In some years they even exceeded total assets (Brambilla, *Banche d'investimento*, Appendix, tables 18-32).

35 Ibid.

36 Bonelli, *La crisi del 1907 una tappa dello sviluppo industriale in Italia* (Turin 1971); Siciliano, *Cento anni di borsa*; A. Confalonieri, *Banca e industria in Italia dalla crisi del 1907 all'agosto del 1914* (Milan 1982).

sheets progressively burdened both by industrial participations and illiquid assets. Comit and Credit found it more and more difficult to renew their assets and preserve their liquidity both because of the weakness of the Italian financial market, and of the shrinking of inter-banking funding from European great banks on which they had to rely before the war. In such a situation, and while the segmentation of the credit system still prevented the development of a proper inter-banking market,[37] universal banks progressively came to hold higher and higher amounts of the shares of industrial companies and public utilities, transforming themselves into quasi-holding companies at the head of huge pyramidal financial groups.[38] When changes in monetary policy curbed the ephemeral boom of the mid-1920s and general economic conditions deteriorated at the beginning of the 1930s, they eventually failed and had to be bailed out by the government.[39]

## V.

Modern banking arose in Europe in the age of railways as a means to solve a 'liquidity dilemma', namely the opposition between the need for 'permanent' capital to finance infrastructure and industrial undertakings, and the preference for 'liquid' assets expressed by single savers and investors. The new banks were huge joint-stock companies which offered the entire range of financial services with the aim of mobilising capital and solving that dilemma by means of their own intermediation, i.e. through delegated monitoring. Though they blossomed from the same seed between the 1850s and the 1860s, fulfilled the same functions, performed the same activities, and were interconnected through a wide international network of bankers and financiers, these banks evolved quite rapidly towards different patterns as cluster analysis has shown. Already in the 1870s, a few French banks started specialising in deposit banking, while others, together with major German and Italian ones, remained on an investment banking pattern, though quite different from that of their ancestor Crédit Mobilier. Divergence became even deeper in the following decades, when French banks either further specialised in deposit banking, developing a nation-wide network of branches, or adopted to a lesser or greater extent a universal banking pattern, as German and Italian banks did. Even in universal banking, however, diverging patterns among continental banks emerged clearly as shown by the case of Comit and Credit. These differences that shaped the evolution of investment banking patterns in Europe were due to the more or less successful attempt by great joint-stock banks to solve the 'liquidity dilemma' through the adoption of distinct sets of activities, of peculiar 'crafts' aimed at coping with specific institutional and legal contexts. Under this aspect, Italian banks showed a peculiar pattern of development as compared to French and German ones by which, however, they were heavily inspired. The legal system and the institutional framework, in fact, proved unable to sustain and foster the widening of credit markets and to promote the integration of a segmented system. That prevented banks from solving the dilemma by means of specialisation, as happened in France, but also from adopting a 'classic' universal banking pattern as in Germany. In Italy, indeed, the legal system did not enhance minority shareholders' and creditors' rights – providing, for instance, stronger controlling bodies and institutions as in Germany – which limited information disclosure by companies. It also did not curb stock exchanges' speculative attitudes and price volatility. All that led to higher degrees of opacity concerning the quality of investment projects and the performance of

37 G. Conti, 'Le banche e il finanziamento industriale', in: F. Amatori et al. (eds.), *Storia d'Italia, Annali: 15, L'Industria* (Turin 1999); G. Piluso, 'Mercati settoriali e squilibri regionali nella formazione di un sistema bancario in Italia (1860-1936)', in: G. Sapelli (ed.), *Capitalismi a confronto: Italia e Spagna. Atti del secondo seminario internazionale di storia d'impresa* (Soveria Mannelli 1998).

38 A. Confalonieri, *Banche miste e grande industria in Italia, 1914-1933* (Milan 1994); P. Ciocca and G. Toniolo, 'Industry and Finance in Italy, 1918-1940', *Journal of European Economic History*, 13 (1984), No. 2; S. Battilossi, 'Banche miste, gruppi di imprese e società finanziarie(1914-1933)', in: G. Conti and S. La Francesca (eds.), *Banche e reti di banche nell'Italia postunitaria* (Bologna 2000).

39 G. Toniolo (ed.), *Industria e banca nella grande crisi 1929-1934* (Milano 1978); G. Toniolo, 'Italian Banking, 1919-1939', in: C. Feinstein (ed.), *Banking, Currency and Finance in Europe between the Wars* (Oxford 1995).

industrial undertakings, and also to higher degrees of risk connected with 'permanent' capital investments. As a consequence, Italian great banks, whose monitoring and controlling strategies implied the acquisition of larger voting rights, were more exposed to liquidity risks and to financial crises as the experience of Credito Mobiliare Italiano and Banca Generale showed. New universal banks addressed the 'liquidity dilemma' by trying to overcome the segmentation of credit markets, by developing stable relations with European great banks and bankers, and by minimising their commitments towards industry by relying upon proxy voting, which large shares of securities deposits accounts and contagos in their balance sheets shows. This lead to the development of a distinctive universal banking pattern. Though these strategies proved effective in the medium term, they tended to improve capital markets' weaknesses and instability, and after the 1907 crisis shook the system, their involvement in industrial companies grew. This led to their transformation into quasi-financial holdings during the 1920s and eventually to their failure at the end of the decade.

# Resistance through Saving: The Founding of the Bank of Cyprus.

Ersi Demetriadou

The 16 men elected on February 1899 to form the board of directors and oversee the business of the newly established Nicosia Savings Bank,[1] could not have foreseen that it would one day be the leading and oldest financial institution of the island. Known today as the Bank of Cyprus Group, it has a banking presence in Great Britain, Greece, Australia, Romania, Russia and the Ukraine.[2] Founded by members of the Cypriot Association on 1 January 1899, the Nicosia Savings Bank had very modest beginnings. It commenced its business without an initial capital investment, fashioned along the lines of a joint stock bank. Its success was dependent solely upon the loyalty of its numerous small shareholders. Shareholders, in expressing interests for the bank's shares, were committing to a five shilling deposit per share and a weekly one shilling installment per share over a five-year period. The bank, on the other hand, was charged to manage these shillings carefully, build up its capital, provide small and manageable loans to its members and pay up to an eight percent annual dividend.

By the end of February 1899, 430 of the bank's first 1,000 shares were already sold and installments promptly made at the Cypriot Association's clubhouse.[3] The Cypriot Association was a male membership and the only social, cultural and political club located across from Ayios Savvas church in the emerging commercial and residential centre of Nicosia. It soon became apparent, however, that this location was not convenient to the sizable number of women shareholders whose schedules and sensibilities needed to be accommodated.[4] By 30 June 1899, the closing date of the first shareholder registration period, 364 Cypriots, mostly Nicosia-Greek residents, had acquired at least one share,[5] valued at five pounds (£) each and the bank could now boast a capital of 1,054 pounds, five shillings and seven and a quarter copper piasters,[6] all of which were available for domestic development. Armed with little more than a vision and the motto 'through ourselves only',[7] the most the founders could now anticipate was that their bank would partake in the fate of similar institutions flourishing on the continent.

The 16 men elected to oversee the bank's business were well chosen from amongst the Cypriot Association's membership. They were all self-made men, respected members of the community, with a proven and extended public service record.[8] They were to offer their time *pro bono*, four in the managing team and twelve on the board of directors. Thirty-three year old lawyer and member of the Legislative Council Ioannis Economides was elected to be its managing director. Economides was the driving force behind the idea of founding a bank. He held this post until his untimely death in 1934. He was helped by fifty-two year old merchant George Papadopoulos, who was elected to be the deputy managing director. In 1898, Papadopoulos completed building the island's first modern theatre fashioned after those found in European capitals.[9] Fifty-two year old merchant Constantine Savvides was elected to serve as treasurer. The youngest member

1 Nicosia based Greek weekly *Foni tis Kyprou*, (henceforth FK), No. 626 (935), Feb. 8/20, 1899, 2:3.

2 Bank of Cyprus Group, *Annual Report 2008* (Nicosia 2008).

3 *FK*, No. 626 (935), Feb. 8/20, 1899, 3:5.

4 Cypriot women were, at the time, the larger land owners of the island after the Greek Orthodox Church. They also commanded full legal rights and control over their property, income and wages. In 1881, Edward Fairfield, a Colonial Office First Class Clerk, was of the opinion that 'there never was a more proper place than Cyprus for the introduction of woman suffrage. Marriage has no effect on a woman's property as a rule, nor on her capacity to contract.' Edward Fairfield to the Earl of Kimberly, Minutes, 31 Jan. 1882, PRO, CO 67/21/76:502.

5 There is a slight discrepancy in the numbers of shares and shareholders reported in the weekly press and the numbers given in official bank announcements at this time.

6 *FK*, No. 645 (953), July 19/1, 1899, 3:6.

7 *FK*, No. 624 (933), Feb. 25/6, 1899, 1:4.

8 This has been ascertained through a detail study of the weekly press, a research undertaken by the author on behalf of the Bank of Cyprus Historical Archive.

9 *FK*, No. 607 (916), Oct. 29/11, 1898, p. 1:2-5.

of this group, thirty-two year old Constantine Samuel, was elected to be the bank's secretary. Samuel, a clerk at this time, later became a teacher and in 1924, founded the first private commercial secondary school of Nicosia.

Of the twelve men elected to serve on the board of directors, two, forty year old Antonis Theodotou and thirty-seven year old Aristodemos Finieas were doctors who spent lengthy periods of time in European capitals for medical training. They both developed an extended record of serving the public in various posts, boards and committees. Antonis Theodotou was the president of the Cypriot Association in 1899. In 1906, he was elected to the Legislative Council where he served for one term. A third member of the board of directors, fifty-four year old tobacco manufacturer and merchant Constantine Dianellos is credited with founding the island's first tobacco processing factory in 1865, while a fourth member, thirty-seven year old Charalampos Maratheftis, an elementary school teacher, spent time in Athens and Geneva improving his teaching skills so that he could later teach the new didactic methods to other educators in Cyprus. The remaining eight members of the board of directors were Constantine Dragomanos, Christodoulos Georgiades, Constantine Loizides, Mattheos Loukaides, Achilleas Markides, Philippos Nicolaides and his younger brother Stylianos Nicolaides. Sixty-three year old Ioannis Zachariades was the oldest member elected to oversee the bank's affairs. In his younger days, Zachariades spent extended periods of time trading in Asia Minor and building up his business.

Accomplished, practical and down to earth, the men who took charge of the Nicosia Savings Bank had in common a commitment and a wide range of experience serving the public. They also had a wide range of mercantile and business experience, extending beyond the shores of the island. They all had come of age during the closing years of Ottoman rule over Cyprus and by 1899 had an additional twenty years' experience dealing with British colonial rule. At this time, however, they were disappointed with the British colonial administration which repeatedly displayed great indifference and failed to solve the island's economic problems. In fact, prior to the turn of the twentieth century, it was commonly believed that British colonial rule was singly responsible for the island's dire economic circumstances. These men remembered Sir Garnet Wolseley's promises delivered on the day he assumed duties as first British High Commissioner of Cyprus. On 22 July 1878, Wolseley proclaimed Queen Victoria's 'intention to order the adoption of such measures as may appear best calculated to promote and extend the commerce and agriculture of the country, and to afford to the people the blessings of freedom, justice and security.' He went on to assure Cypriots that 'no measure shall be neglected which may tend to advance the moral and material welfare of the people.'[10] Writing a few days later, Wolseley reported to the Marquis of Salisbury, that he had 'copies of the proclamation in Greek and in Turkish [...] circulated and publicly posted up throughout the different districts of the Island.'[11]

Therefore, news regarding the change in the administration of the island spread fast and regardless of whether they were in their mid-teens, twenties or thirties, whether in Nicosia, Larnaca or a village community, the bank's founders were surely among those caught up in the excitement. They believed, as many other Cypriots did at the time, that they were witnessing the dawn of a bright new era for the island and had no reason to doubt Wolseley's promises. For this reason, they gave the new administration the benefit of the doubt and waited for the desired reforms to materialise. Moreover, because the island was the first to be colonised after the Congress of Berlin, Cypriots did not know that regardless of education, standing in the community, experience or income, their opinion and knowledge of local affairs would be dismissed by their new rulers, because they were now delegated into the category of the colonised 'other'.[12]

The founders of the Nicosia Savings Bank had no reason to doubt Wolseley's promises because in 1878, Great Britain was perceived to be a friendly nation towards Cyprus; progressive, democratic and industrious – all admirable qualities, surely to be employed during the administration of the island. The abrupt substitu-

10 Sir Garnet Wolseley to the Marquis of Salisbury, Enclosure in No. 2, 28 July 1878, PRO, CO 67/1:197.

11 Sir Garnet Wolseley to the Marquis of Salisbury, No. 2, 28 July 1878, *Cyprus State Archives* (henceforth CSA), G5/1:2.

12 E. Demetriadou, 'Ugly women, handsome men and the constructing the 'other' in 19th century traveler accounts to Cyprus', Paper presented at the ASTENE Cyprus Conference, 11-12 Sept. 2004.

tion of Ottoman for British rule, accomplished through the agreement known as the Cyprus Convention, was therefore welcomed, especially by the island's Greek majority.[13] They envisioned that with the guidance of an enlightened European ruler and by virtue of being Europeans themselves, they would be allowed to assume a direct role in the administration of the island. This, they expected, would lead to all-encompassing reforms in the administration, judiciary, agriculture, commerce, education and the economy. What they were unaware of at the time, was the enormous financial burden imposed upon them in the form of a 92,799 pound, eleven shillings and three copper piasters annual 'tribute.' The 'tribute' was a responsibility undertaken by Great Britain under the terms of Article III of the Annex to the Cyprus Convention. Nevertheless, Great Britain immediately transferred this financial burden onto Cypriots. Over the next decades, Cypriots protested that this was an unjustly heavy levy which was destroying the island's economy and impoverishing the population. They also rightly ascertained that Cyprus, unlike Egypt and the Balkan principalities, was a province in the Ottoman Empire, not a tributary state and for that reason, no 'tribute' was due to be charged upon its revenues.[14] British rule over the island of Cyprus had begun with promises that could not be kept, and expectations soon shattered.

The island had no industry and no natural resources. It was primarily an agricultural land, farmed by numerous small-holders who depended on the weather for prosperity. Artisans, craftsmen, merchants and town residents also depended upon the farmers' prosperity. Even among the few large landowners and big volume merchants dealing in cereal and carobs, none could claim an annual income of more than £1,000, and only a few that of £500. In 1881, *per capita* income was calculated to be £4.9.[15] In 1901, agricultural labourers could command wages varying from two to 20 pounds per year depending on whether they were fed and clothed by their employers.[16]

Despite these economic conditions, since the mid-nineteenth century, an upper-working, lower-middle and middle class had begun to form. These classes were fluid and porous and the slightest economic setback could easily throw many into poverty. The upper-working, lower-middle and middle class individuals of this time were found in all towns and many of the larger villages of the island, squeezed between the handful of wealthy merchants and large landowners and the vast majority of the peasant population. These classes were initially ignored by the British administration, but in the closing years of the nineteenth century their voice began to be heard. Made up of men and women who still maintained a strong foothold in the countryside, they came to constitute the vast majority of the Nicosia Savings Bank's shareholders.

The British government preserved the almost intact Ottoman taxation system it inherited, abolishing only certain less profitable tithes and taxes and introducing new levies such as wharfage dues and a one per cent-addition on tithes, allocated as a locust tax. The most significant alteration was made in the area of cereal tithe collection. From 1879 to 1892, this tax was paid in money instead of in kind. Wolseley, in haste and without consulting Cypriots or the relevant provisions of Ottoman law,[17] decided to modernise the taxation system, stamp out corruption, reduce revenue loss and end the tithe-farmers' abuses of the system.[18] His decision created undue hardship on cash-strapped farmers, who often faced great difficulty in obtaining cash and credit on reasonable terms.[19] Interest rates charged by merchants and moneylenders varied, depending

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13 UK, Parliament, *Turkey No. 36*, Correspondence respecting the Convention between Great Britain and Turkey of 4 June 1878, C. 2057 (London 1878), pp. 3-4.

14 See, G. Hill, *A History of Cyprus, Vol. IV: The Ottoman Province, the British Colony, 1571-1948* (Cambridge 1952), and G.S. Georghallides, *A Political and Administrative History of Cyprus, 1918-1926: With a Survey of the Foundations of British Rule* (Nicosia 1979).

15 UK, Parliament, *Papers relating to the administration and finances of Cyprus*, C. 3661 (London 1883), p. 48.

16 J.T. Hutchinson and C.D. Cobham, *A Handbook of Cyprus* (London 1901), p. 52.

17 This was in violation of the Ottoman law provisions that required District Administration Councils to set the rates, determined according to market prices, of all levies payable in money.

18 Sir Garnet Wolseley to the Marquis of Salisbury, No. 21, 18 Aug. 1878, *CSA*, G5/1.

19 There was a 97% return on the tax when the system reverted to payment in kind. *Cyprus Annual Report for the Year 1895-6*, C. 8580 (London 1897), p. 8. Cereal tithes were finally abolished in 1926.

on the products, and repayment of loans made in cereals could demand up to 130 per cent interest.[20] Usury was and remained rampant and, once they found themselves in need, few could escape its ruinous hold, not even the town merchants themselves.

For this reason, among the first and most persistent demands made of the British government was for the establishment of an agricultural bank to provide low interest loans and credit to farmers.[21] The 'tribute' burden, however, did not permit government to assume this responsibility, as it did not allow it to reduce taxation or expend resources on public works, education and income generating projects. It could not even alleviate the plight of the population during times of severe and extended drought, when the island became one 'desolated waste'.[22] In fact, the 'tribute' often transformed many able British colonial administrators into mere tax collectors counting pennies.

A stern warning was addressed by the Marquis of Salisbury to the local administration urging extreme caution in giving Cypriots cause for complaint. Salisbury reminded the new High Commissioner, Sir Robert Biddulph, that British policy in the region aspired for the island to become a model system of government other countries could emulate.[23] But regardless of Salisbury's intentions, the colonial government's first priority never became the 'moral and material welfare of the people'.[24] The first priority became extracting and exporting the 'tribute' to the British Treasury, which applied it towards the 1855 Ottoman Crimean War Loans.

It is for these reasons that in 1905, a few months after assuming duties as High Commissioner, Sir Charles King Harman could not but express his 'apprehension and dismay' over 'the hopeless nature of the existing financial situation, that offers no prospect of realizing the prosperity and progress which, under other circumstances, might be expected to be obtained from a wise administration of the abundant resources of this interesting and fertile country'.[25] King Harman was speaking with the authority of someone who served in Cyprus during the first years of British rule and was thus able to determine based on his own observations what progress the island had made. By this time, King Harman's apprehension was shared by almost all Cypriots and with good reason. In the first twenty years of British rule, almost half of the island's annual revenue was exported as 'tribute.' This made the island one of the most heavily taxed colonies in the British Empire and in turn created impoverishment and political discontent, voluminously documented in the debates of the Legislative Council and the local press. Moreover, at regular intervals, almost always following periods of severe drought and financial strain, petitions and deputations were dispatched to London asking for reforms. None were forthcoming.

In 1898, those who were later chosen to serve as the Nicosia Savings Bank's first board of directors were already painfully aware that the island's economic plight had not substantially changed under British rule. A few roads were constructed, serving mostly the small British contingent station on the island.[26] A few government buildings were repaired and a small number of new ones built, but tangible progress could not be claimed. If it had been otherwise, King Harman would have had no reason to express his apprehension in these matters. In fact, certain changes made in the application of the Ottoman land law increased the peasants' plight. Now, when faced with foreclosures, the peasant population could be left destitute and landless. After years of petitioning, suggesting, protesting, explaining and arguing their various causes, many

20 Commissioner of Kyrenia to Chief Secretary, Confidential, 21 Aug. 1884, *CSA*, SA1/19327.

21 Sir Robert Biddulph to the Marquis of Salisbury, Enclosure No 2 in No. 80, 17 Aug. 1879, *CSA*, V11/78:140-147 and in the Larnaca based Greek weekly, *Neon Kition* (henceforth NK), No. 2, June 30/11, 1879, p. 1.

22 H.R. Lang, *Cyprus: Its History, its Present Resources, and Future Prospects* (London 1878), p. 253.

23 The Marquis of Salisbury to Sir Robert Biddulph, No. 28 Secret, 4 July 1879, *CSA*, V11/78:63.

24 Sir Garnet Wolseley to the Marquis of Salisbury, Enclosure in No. 2, 28 July 1878, PRO, CO 67/1:197.

25 Sir Charles King Harman to Mr. Lyttelton, No. 31, 25 Jan. 1905, PRO, CO 883/6, *Mediterranean*, No. 59, Confidential, Further correspondence relating to affairs in Cyprus (Colonial Office, Feb. 1906), p. 17.

26 The state of the roads is best evident in Edward R. Kenyon's description that during the winter months while travelling the Nicosia-Kyrenia road, his horse would be knee high in mud and the only way to proceed is through the fields. Commissioner of Kyrenia to Chief Secretary, 16 Mar. 1885, *CSA*, SA1/1173/1885.

Cypriots came to the conclusion that none of their demands would be met by the government and that the high expectations they and their fathers had at the beginning of British rule would not materialise. This apprehension grew stronger after 1896, following the colonial office's response to the latest in a series of Greek memorials addressed to the British government.[27] Except for some minor points, all suggestions and demands made there were dismissed.[28] For this reason, these demands, which included the establishment of an agricultural bank, increased expenditure on education, public works and agriculture, tax reduction, the abolition of the 'tribute' and a more direct input by Cypriots in the administration of the island,[29] remained a constant theme in the political landscape of the early twentieth century.

Within this historical context, all through the summer and autumn months of 1898, the founding of a bank was quietly deliberated in the Cypriot Association's clubhouse. It was there that judges, lawyers, doctors, legislative council members, civil servants, educators, journalists, clerks, small shop-keepers, artisans and many of the town's merchants gathered. They vented their frustration over British rule, discussed the international and local issues of the day, argued fervently the price of corn and carobs, the plight of viticulture and wine export, and the double levies paid on goods imported from or exported to Ottoman Turkey, a major trade partner of the island at the time.[30] Many of the men who gathered at the Association were also frustrated and argued fervently over the feasibility of getting their overseas orders on time, now that the government did not subsidise the steamship company which had included Larnaca anchorage in its weekly routes of bringing in and taking out the mail. They compared their island with what they saw during their travels abroad and found it seriously wanting.

To their overall frustration was added the strain felt by the merchant community because the Imperial Ottoman Bank,[31] established at Larnaca since 1864 and having expanded after July 1878 with branches, agencies or correspondents in all towns, and serving concurrently as the British colonial government's banker,[32] went ahead with its stated intention to scale down business and closed both its Nicosia and Limassol branches. Just one branch was left at Larnaca.[33] While the Ottoman Bank never extended loans and credits to farmers or the numerous small craftsmen, shopkeepers and merchants, its actions had a direct effect on the peasant population because of the interdependence of all financial aspects in the precarious economic conditions of the time. Writing in January 1897, High Commissioner Walter J. Sendall points out this interdependence by reporting that 'having almost discontinued its business, and pressed the collection of its money with vigour, the state of the district has become worse,[34] and the merchants, obliged to satisfy previous obligations, and not favoured with further credits, are unable, in their turn, to afford such to the peasants.'[35] Since peasants did not have the means to obtain seed-corn, government officials feared that this situation would affect the prospects of a good harvest and in turn the island's 'tribute' payment into the British treasury. Given these circumstances, it is not surprising, that by 1898, not only the government, but the people's representatives were directly blamed for the actions taken by the Imperial Ottoman Bank and newspaper editorials repeatedly called upon those in authority to take immediate, corrective measures and to resolve the problem.[36]

These were the issues bothering the men who were gathered at the Cypriot Association's clubhouse. The Association was founded in July 1879, in the aftermath of the general discontent over the heavy-handedness of the Wolseley administration. From its inception, it assumed a strong political voice on the issues of the

27 As in 1888, the Turkish Cypriot representatives withdrew their support in petitioning the British government for reform.

28 Mr. Chamberlain to Sir W.J. Sendall, No. 104, 27 July 1896, PRO, CO 883/5. *Mediterranean*, No. 45, Correspondence relating to affairs in Cyprus (Colonial Office, Dec. 1997), pp. 174-176.

29 The 'tribute' was abolished in 1927.

30 For the comparative import and export returns of this period see Cyprus, *Report for 1899-1900*, Cd. 510 (London 1901), pp. 22-25.

31 The Anglo-Egyptian bank had also established a presence on the island in 1879, but in 1890 it merged with the Imperial Ottoman Bank.

32 Sir Garnet Wolseley to the Marquis of Salisbury, No. 78, 1 Oct. 1878, *CSA*, G5/1:97-98.

33 Starting in May 1898, numerous articles in the local weekly press complain bitterly about this decision.

34 The reference is to the district of Pafos.

35 Sir Walter J. Sendall to J. Chamberlain, No. 3, 7 Jan. 1897, PRO, CO 67/104/1207:5-6.

36 See for example the editorial entitle 'We are at fault.', *FK*, No. 597 (906), Aug. 21/2, 1898, 1:1-2.

day. Nevertheless, its stated purpose was to promote education in Cyprus,[37] an education broadly defined, all-encompassing and extending beyond the classroom. The Association had accumulated an extensive library, and in 1898, it also founded the first Nicosia night school.[38]

Given the precarious economic circumstances of the island, an educational and cultural association appears to be an unusual place in which a bank could germinate, especially a bank founded without an initial capital investment but dependent solely upon small weekly deposits. Furthermore, it is evident that the founders were aware that this was a risky social and economic experiment, and that, had it failed, the Association, those elected to lead the bank, and all future local banking endeavours would had been discredited. Nevertheless, the idea went ahead because the Association's members had, by 1899, a twenty year history in promoting cultural and social change and in engaging the British colonial administration in what was often a dreary, monotonous and mostly unproductive dialogue regarding political, legislative and fiscal reform. They also had finally resigned to the idea that no help could be expected from government. Moreover, in view of the fact that the bank's founders wanted to cultivate frugality, thrift and saving, in other words, educate Cypriots to manage their financial resources, however limited these could be, the idea came within the broadly defined educational mission of the Association and was zealously supported by its rank and file. This indicated that the upper working and middle classes were now ready to address directly some of their pressing problems.

The Association's decision to found the Nicosia Savings Bank was praised in the local press and potential shareholders were rallied to the cause via editorials castigating the colonial government and indicating that no help should be expected from it. In the editors' opinion, government had repeatedly shown its indifference towards the economic plight of the people. It was not simply indifferent, but a force that stood against the island's prosperity, shrewd and innovative in finding new ways of extracting the last penny from the people, but dull and inactive when it came to finding ways of improving the islanders' dire financial state, prosperity or standard of living.[39] At the same time, the benefits derived from small weekly savings were analysed, giving examples of how these beneficially worked on the continent, even suggesting that through small weekly savings, a dowry could accumulate. The Association's rank and file and Nicosia residents in general, were urged to wholeheartedly support this effort. Concurrently, cultural associations and clubs in the other five towns of the island were urged to follow in its lead, setting up their own savings banks. This they did and over the next decade, at least nineteen other joint stock or peoples savings banks were founded in the towns and village communities around the island. Some of these, as for instance, the Nicosia-based Muslim Savings Bank founded in 1901, the Popular Savings Bank of Limassol also founded in 1901, the Cypriot Savings Bank in Nicosia founded in 1903, the Larnaca-based Omonia Savings Bank founded in 1905, the Melissa Savings Bank in Pafos founded in 1906 and Cassa Providentia Bank founded in 1906 in Nicosia by its Catholic residents, were very successful banking institutions.[40]

Fiery editorials castigating the colonial government were commonplace in the Greek weekly press. Yet, the tone and urgency of the call now made to the public to render its support for the bank, constituted a break from previous established patterns. From its inception, the Nicosia Savings Bank was not only conceived, but perceived, to be an institution founded by Cypriots for the benefit of Cypriots. It was also conceived as an institution established in defiance of an indifferent colonial government determined to benefit from keeping the population poor and in an uncertain financial state. In addition, the motto 'through ourselves only' reflected a clean break from the paternalistic milieu governing the relationship between rulers and ruled

37 *NK*, No. 38, Feb. 16/28, 1880, 4:3.

38 The first night school in Cyprus was founded in 1894, at Kyrenia, by teacher Kyrillos K. Pavlides (a Cypriot Association member and a regular speaker there) and the brothers Constantine and Nikolas V. Karatzas. *FK*, No. 945, Apr.19/1, 1905, 1:3-5.

39 *FK*, No. 624 (933), Feb. 25/6, 1899, 1:2-4.

40 Some of these Cypriot banks, reorganiszed into limited liability companies in 1924 and 1925, and beginning in 1943 merged with the Bank of Cyprus allowing it to slowly form an island-wide banking network.

and the paradigms employed up until that time to address local problems.[41] Cypriots were now told that initiative for progress and change no longer needed to emanate from or be supported by established bodies of authority, be it government, the church, a handful of wealthier Cypriots, or even foreign financiers with questionable motives. No help could be expected from anyone but themselves, using their own, often limited resources.

The founders were disillusioned with the British government's constant refusal to address the pressing economic problems of the island. They therefore set about to create a venue through which to empower and enable a section of Cypriot society to resist what was believed to be the government's intentions. Their institution would cater to the needs of the emerging middle-class, as well as the upper-working and lower-middle classes, all broadly defined. It is doubtful, however, if they expected the town's poorer inhabitants to benefit from it. This was because the poorer working classes could not spare the initial five shilling deposit and subsequent one shilling weekly instalment required of shareholders. But numerous artisans, craftsmen, clerks, domestic servants with steady wages, small and middle size merchants, even some of the wealthier peasants from the outlying villages of Nicosia would be able to do so if they planned their finances carefully. By combining the meagre weekly savings of a large number of people and applying these towards domestic development, through credit-worthy loans to shareholders, everyone would profit and a dent could be made on the impoverishment and destitution evident all around them. By the end of the first five-year period, shareholders would have accumulated a respectable sum plus dividends, while, all along, their money was put to work for the community and perhaps, even, in this way eventually break the vicious circle of dependence upon usurers.

Also disillusioned were the majority of the bank's 364 first shareholders. Consistent to their 1899 commitment, they promptly made their weekly deposits at the Association's clubhouse or at the private room of the Phaneromeni coffeehouse. In 1900, the bank thought it necessary to employ its first salaried clerk,[42] and not long after that to lease its own premises in the vicinity of the Panayia Phaneromeni Church area. By 31 December 1903, at the closing of the first five-year charter period, the bank could boast an accumulated capital of £15,547. Even though a seven and a half per cent annual dividend was returned on their investment, some shareholders withdrew their capital. These were trying times. Cyprus had just come out from under one of its worst droughts which left sections of the population starving and the island littered from one end to the other with animal carcasses.[43] The dearth affected everyone, peasant and merchant, artisan and craftsman. The bank, however, survived this crucial first five-year period and after having gained momentum, re-chartered for a second five-year period. Shareholders withdrew a quarter of their capital. Nevertheless, a second issue of shares increased the number of shareholders to 912 and by 31 December 1908, the bank's capital reached £52,455, which allowed it to offer an eight per cent dividend.

The founders' initial goal to promote the spirit of saving was achieved. Thus, the bank went ahead and quietly took in weekly deposits and extended loans to shareholders. Soon the accumulated funds of the bank were in excess of what could be used in loans and mortgages by its shareholders. For this reason, the bank expanded its services offering loans to credit-worthy non-members, as well as discounting promissory notes and other banking services within the island and abroad.[44] All this banking activity, however, was undertaken under the erroneous assumption that the Nicosia Savings Bank was a corporate body recognised under Chapter III of the Ottoman commercial code.[45] This was not the case. In December 1908, when a law

41 *FK*, No. 624 (933), Feb. 25/6, 1899, p. 1:2-4.

42 *FK*. No. 679 (988), Feb. 11/23, 1900, p. 2:5-6.

43 UK, Parliament, *Correspondence Respecting the Drought in Cyprus,* Cd. 1434 (London 1903).

44 Economides and others to Chief Secretary, 1 July 1911, *CSA*, SA1/1393/1909/1:159.

45 The Cyprus Companies Limited Liability Law was introduced in 1922. See S. Fisher, *The Statute Laws of Cyprus, 1878-1923* (London 1923), pp. 107-168.

was enacted, enabling corporate bodies[46] to acquire and register immovable property in their name,[47] the Nicosia Savings Bank and financial institutions like it found themselves in legal limbo. All Cypriot banks stood unprotected, were not recognised as corporate bodies, and shareholders could have faced unlimited liability.[48] Furthermore, the land registry department would not register mortgages and immovable property under their name. The island's banks were jeopardised because of their success.

The Nicosia Savings Bank re-charted for a third five-year period beginning 1 January 1909 and its 2,002 shareholders,[49] holding 4,340 new and old shares, were now very vulnerable. It is doubtful, however, whether the majority of shareholders knew of these problems. As soon as the board of directors realised the full implications of the new law, corrective measures were taken. Ioannis Economides, who was still working *pro bono* for the bank, was asked to resign the post he held since 1901 as District Judge at Limassol, return to Nicosia and assume full-time, paid managing director duties over the institution he created. The bank's articles of association were revised and the Nicosia District Court petitioned to register the bank as a corporate body.[50] John A. S. Bucknill, then King's Advocate to the government, however, did not agree and probably found the bank's petition arrogant, claiming as it did that this was an institution 'which is of a great destination and has to serve high financial interests of the country.'[51]

Bucknill had his reasons for rejecting the bank's petition. On the one hand, the 1908 corporate bodies law specifically excluded profit-making associations, while on the other hand, the bank's 1909 revised articles of association did not comply with the requirements set forth in the Ottoman commercial code. Moreover, the whole discussion was, at this time, taking place within the framework of legislating for the establishment of co-operative societies and banks. The Nicosia Savings Bank was not a co-operative bank. As Bucknill noted, it was an institution conducting regular banking business, taking in deposits and extending loans for profit.[52] For this reason, it took Economides four years of persistent effort to finally find the legal framework within which the bank would be recognised by government as a corporate body. In 1911, he rallied the support of the Cypriot Savings Bank and the Muslim Savings Bank in an effort to convince the government to take the necessary legislative measures. In their joint memorandum to the chief secretary, the banks' managing directors explained that their institutions were neither purely savings nor purely joint stock, and most importantly, could not be classified in any of the categories of corporate bodies enumerated in the 1908 law. They petitioned the government to enact legislation that would recognise local banks 'as legally established companies', stating that they were willing to alter their articles of association accordingly to meet whatever requirements were necessary. They also informed the government that their accumulated funds now stood at £123,000, of which £90,000 belonged to the Nicosia Savings Bank.[53]

It took another year before the Nicosia Savings Bank's draft articles of association would be in a state which was acceptable to the government. In September 1912, High Commissioner Hamilton Goold-Adams asked William A. Russell, then King's Advocate, to review the articles and in consultation with Economides, make all necessary changes in order for these to comply with the Ottoman commercial code. Goold-Adams explained to Russell that this was an unusual request to make to the highest government legal authority on the island. He clarified, however, that he was

46 Corporate bodies such as companies, associations, societies, and anonyme partnerships incorporated in the UK or formed under the Ottoman Commercial Code, and nont-for-profit charitable, philanthropic, social and athletic institution.

47 Fisher, ibid., pp. 453-456.

48 High Commissioner to King's Advocate, Minutes, 26 Sept. 1912, *CSA*, SA1/519/1913:19.

49 Bank of Cyprus Historical Archive, *Minutes to the Shareholders General Meeting* (henceforth BCHA Minutes), Feb. 26/8, 1914, TK1.1-01.0209:10.

50 Under the Cyprus Courts of Justice Order of 1882, the functions and jurisdiction previously enjoyed by the Ottoman Commercial Court, established at Larnaca in 1867, wereas taken over by the District Courts. See C.D. Cobham to Chief Secretary, 1 Feb. 1879, *CSA*, SAO3/245; and C.R. Tyser, *The Cyprus Courts of Justice Orders, 1882 & 1902* (Nicosia 1907).

51 Christodoulos Sozos to Chief Secretary, 4 July 1909, *CSA*, SA1/519/1913:21.

52 Minutes, *CSA*, SA1/1393/1909/1.

53 Ioannis Economides and others to Chief Secretary, 1 July 1911, *CSA*, SA1/1393/1901/1:160.

> 'most anxious that we should get these long established institutions on some legal footing. We can't get away from the fact that they hold a considerable accumulation of the savings of the poor classes and were anything to happen such as a compulsory liquidation it would mean ruin to many.'[54]

In remaining true to the bank's original conceptualisation and people-centeredness, the draft articles of the association given to Russell referred to a 'Peoples Bank of Cyprus'. Russell, however, crossed out the word 'Peoples', and this and numerous other changes were accepted by Economides. The Nicosia Savings Bank was incorporated under the Ottoman commercial code on 18 December 1912 as the 'Bank of Cyprus', an anonym company.[55] It was to have a fixed capital of £200,000 divided into 50,000 shares of four pounds each and shareholder liability was now limited to the number of shares he or she held. Given its modest beginning and the island's continuous trying economic circumstances, this was an outstanding achievement.

Of the 16 men elected in February 1899 to lead the bank, by 1912 two had resigned and five had died. However, shareholders continued to re-elect the old board members and to elect new ones chosen from among the most active and outstanding personalities of the period. Maintaining a balance between merchants, lawyers and doctors, in 1913, six of the new members Evelthon Dragomanos, Evangelos I. Evangelides, George E. Christodoulides, Ioannis Michaelides, Abraham Tavernaris and Zenon I. Zachariades, were Nicosia merchants. The latter replaced his father who died in 1907. Evelthon Glykys, a doctor, lecturer and prolific author was first elected to the board in 1905, while lawyer, merchant, member of the legislative council and benefactor of Greek educational institutions, Demosthenis Severis, was elected in 1910.[56] Lawyer and member of the legislative council, Theofanis Theodotou, was elected president of the bank's supervisory board in 1913, a post he held until 1932. He resigned after he was exiled from the island because of his anti-colonial activity. As a member of the legislative council, Theofanis Theodotou, together with Ioannis Economides, were instrumental in formulating the co-operative credit societies law, enacted in 1914.[57] This established a solid foundation for the co-operative society movement in Cyprus. The other four members of the bank's supervisory board were lawyers: Nikolaos Chrysafinis and George Markides, as well as merchants Sofoklis Savvides and Ioannis Nicolaides.[58]

Regardless of Hamilton Goold-Adams' and William A. Russell's assistance in incorporating the bank within the legal business framework of the period, the colonial government unequivocally failed to gain the founders' confidence. Government, as far as the founders were concerned, continued to be a force working against the best interests of the people. Speaking on 8 February 1914 during the second general shareholders' meeting of the Bank of Cyprus, Economides stressed that

> 'Government intentionally refrains from providing the legal framework within which other savings banks could operate because it does not wish the spirit of mutual help, self confidence and self reliance flourish among the people. As tyrant, it finds that it is not in its best interests for slaves to progress, but it reckons disregarding the landlord.'[59]

Economides did not mince his words. He clearly implied that despite the government's assistance, the Bank of Cyprus would continue to resist attempts to keep the islanders poor and in an uncertain financial state.

54 High Commissioner to King's Advocate, Minutes, 26 Sept. 1912, *CSA*, SA1/519/1913:21.

55 Government of Cyprus, *The Cyprus Gazette*, No. 1064, Friday, 20 Dec. 1912, p. 8001.

56 In 1911, at the age of 32, in what was to be the first of numerous large and small bequests towards the island's educational institutions, Severis built the Kyrenia boys' school. This inaugurated, as far as research to this point indicates, the golden era of philanthropic bequest for the island, with Bank of Cyprus board of director members and others, generously donating towards Cypriot educational and charitable institutions.

57 Fisher, ibid., pp. 170-180.

58 *BCHA Minutes*, June 26/8, 1913. TK1.1-01.0209:3.

59 *BCHA Minutes*, Feb. 26/8, 1914, TK1.1-01.0209:10.

Examined within a broader historical context, it can be ascertained that the bank's founders certainly did not partake in the world-weariness and despair characterising the *fin de siècle*. On the contrary, they saw clear past the island's economic realities and were determined to shape a new era. They believed that reform, be it social or economic, required focused action and agency. Having shaken off the paternalist norms in which they came of age, their conceptual and behavioural shift was directly applied to problem solving. Their world view towards what they believed needed to change in order to modernise Cypriot society is also reflected in their public sphere activities. They did not just idly serve on various boards and committees. They founded new societies and associations, lectured to the public, published books and took on an active role in politics, from inside or outside the legislative council, attempting to shape legislation to the extent that this was possible within the limitations placed upon them by the colonial government. They intervened directly to promote the work of charitable institutions, cultivated philanthropy through their own example, built schools, set up scholarship funds, meal programmes and workshops that would assist the less fortunate around them. More often than not, the founders' wives were equally active members of Cypriot society, often using income derived from their bank shares to promote charitable and philanthropic institutions, women's education and welfare.

The risky Cypriot banking experiment begun in 1899, succeeded because its founders were committed to change and to serving their community in the public sphere. They envisioned themselves as agents, who took direct steps in dealing with their community's problems, altering and transforming what, in many ways was still a backward and Oriental culture, into a modern European society. In this effort numerous, small shareholders assisted. That is, the merchants, doctors, shoemakers, judges, housewives and maidens, farmers, lawyers, policemen, seamstresses, teachers, clerks, grocers, pastry-makers, silversmiths, coppersmiths, and bakers, to list but a few, whose meagre, weekly shillings contributed to this vision.[60] Their loyalty played a critical role in the bank's success. The majority of shareholders were often unaware of the founders' broader vision but they were quick to realise the benefits of saving and utilising small, manageable loans. Crucially important to the bank's success, Ioannis Economides provided trusted, good and stable management over its first 35-year history. He tailored the bank according to the economic realities of his time in order to meet the needs of the working, lower-middle and middle-classes; that is, the small shareholders, small depositors and small loan seekers. In more than one way, this was an institution founded by Cypriots for the benefit of Cypriots in resistance to a government that benefited from keeping Cypriots poor.

60 Based on shareholders' occupations listed in various documents found at BCHA.

# The Breakthrough of Commercial Banking in Industrial Finance in Finland.

Risto Heralla

## I.

This article focuses on the competition of commercial banks with their main rival Suomen Pankki (Bank of Finland) during the first phase of commercial banking and industrialisation in Finland. At that time, the private commercial banks and Suomen Pankki, a public institution and the incumbent in the banking scene, still had significant overlap in their operations. To be able to gain customer acceptance relative to Suomen Pankki, the commercial banks had to improve on what Suomen Pankki was doing at least in some respects. This paper explores how the commercial banks managed this feat. By comparing the operations of commercial banks and Suomen Pankki, I aim to gain insight about the contribution of commercial banking to financial intermediation and early industrialisation, from the mid-nineteenth century to the start of World War I.

Previous international studies have demonstrated a remarkable variety of paths of development in the financial sector during the early industrial period. The divergent paths have generated a puzzling variety of financial systems, which Lazonic and O'Sullivan (1997) categorise under market control (UK and USA) and organisation control (Germany, Japan). They also demonstrate marked differences in institutional structure within these groups.

Wide differences have been reported across countries in the types of institutions that dominated in early industrial finance. According to Crisp (1967), the Russian system was characterised by the State Bank at the apex, with relatively undeveloped markets and private institutions. Sandberg (1978) shows that, in stark contrast to Russia, the private *enskilda* banks in Sweden thrived in the early 1800s with the help of private note issue rights. In Norway, it was the local savings banks that initially took the lead in financial development.[1]

In Finland, commercial banks changed the financial landscape by replacing Suomen Pankki, the central bank at the apex of industrial finance. A study of the financing conditions in the late 1800s and early 1900s in industrial finance suggests that commercial bank success cannot be explained by price competition. The mix of financial products they offered to the early industrialists played some role, mainly the fact that commercial banks operated interest-bearing deposit facilities. In contrast, commercial banks had a clear competitive edge over the central bank in geographical expansion. In general, success relied on their high powered incentive to succeed in corporate finance in contrast with the more inflexible Suomen Pankki that focused increasingly on its central banking role.

A study of the loan portfolios of the two institutions suggests that, initially, commercial banks did not contribute much to the broad spectrum of loan types offered to industrialists. However, we observe a gradual divergence of the roles of the two institutions in the loan market. Commercial banks gained ground in the complex field of industrial finance by increasing their supply of flexible loan products to the early industrial-

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1 W. Lazonick, M. O'Sullivan, 'Finance and Industrial Development: Evolution to Market Control. Part I: the United States and the United Kingdom', *Financial History Review*, 4, (1997), pp. 7-29; W. Lazonick, M. O'Sullivan, 'Finance and Industrial Development: Evolution to Market Control. Part II: Japan and Germany', *Financial History Review*, 4, (1997), pp. 117-38; O. Crisp, 'Russia 1860-1914', in: Cameron, Crisp, Patrick (eds.), *Banking in the Early Stages of Industrialisation. A Study of Comparative Economic History* (Tilly 1967); L. Sandberg, 'Banking and Economic Growth in Sweden before World War I', *The Journal of Economic History*, Vol. 38, No. 3 (Sep. 1978), pp. 650-80; E. Lange, 'The Norwegian banking system before and after the interwar crises', in: Teichova, Gourvish, Pogány (eds.), *Universal Banking in the Twentieth Century Finance, Industry and the State in North and Central Europe* (1994), pp. 12-21.

ists. At the same time, Suomen Pankki strengthened its focus on standardised, short term finance in line with its role in monetary policy.

A study of the dynamic interaction of these institutions in the loan market further demonstrates significant differences in the behaviour of the two institutions. One can find that commercial banks were the leaders and Suomen Pankki the follower in the loan market. Granger causality tests suggest that the reactions of Suomen Pankki to some extent lagged behind those of the commercial banks. Commercial banks were the first to contract during recessions, and the first to expand during upturns.

From the point of view of previous international research, it is interesting that the clearest visible characteristic of the winning strategy for Finnish commercial banks is geographic expansion. Crisp (1967) and Sandberg (1978) both single out geographical expansion as one key characteristic of the winning strategy in Russia and Sweden respectively around that time. Lange (1994) reports that the failure of commercial banks in Norway was in part related to the protective attitudes of local business centres, which made branching impossible. Norway's unique geographical characteristics may have contributed to the prevalence of such attitudes.

The Finnish case demonstrates that commercial banking can support industrialisation in a country that starts from a very low level of industrial development and economic welfare. The period of commercial bank expansion was also a period of decreased government involvement in industrial finance, as Suomen Pankki focused increasingly on monetary policy. It is remarkable that the pro-industrialist government was able to successfully promote this goal by minimising its involvement in industrial finance.

## II.

Until the emergence of banking in the nineteenth century, trading houses were the main domestic financiers for the, at that time, small industrial sector in Finland. Prior to commercial banks, the Finnish financial sector hosted three types of banks: Suomen Pankki, savings banks, and Suomen Hypoteekkiyhdistys (a mortgage bank). Suomen Pankki was established by the Russian emperor in 1811 to perform specific financial tasks in Finland, such as the taking of deposits and the granting of loans. Until the formation of the state treasury in the 1870s, Suomen Pankki also managed the funds of the Finnish government. In the 1860s, Suomen Pankki was granted the right to issue Finnish monetary units, a decision that further strengthened the autonomy of the Finnish financial system from that of Russia.[2]

The savings banks, first established in 1823, were by status non-profit institutions which, in line with many European forerunners, strived to promote saving by the poor. In 1860 the first private mortgage bank, Suomen Hypoteekkiyhdistys, was established. By law, it focused on agricultural loans against mortgages on land. In addition to banks, a small number of insurance institutions operated in Finland.[3]

Arguments for commercial banking were debated in the first half of the eighteenth century by the political and business elite. However, the first attempts to set up commercial banks by local groups of industrialists in the 1850s in local business centres (Oulu, Jyväskylä and Tampere) failed. The first working blueprint was found when Suomen Yhdys-Pankki was established in 1862. Other attempts followed, and the number of commercial banks rose to ten by the end of the century.[4]

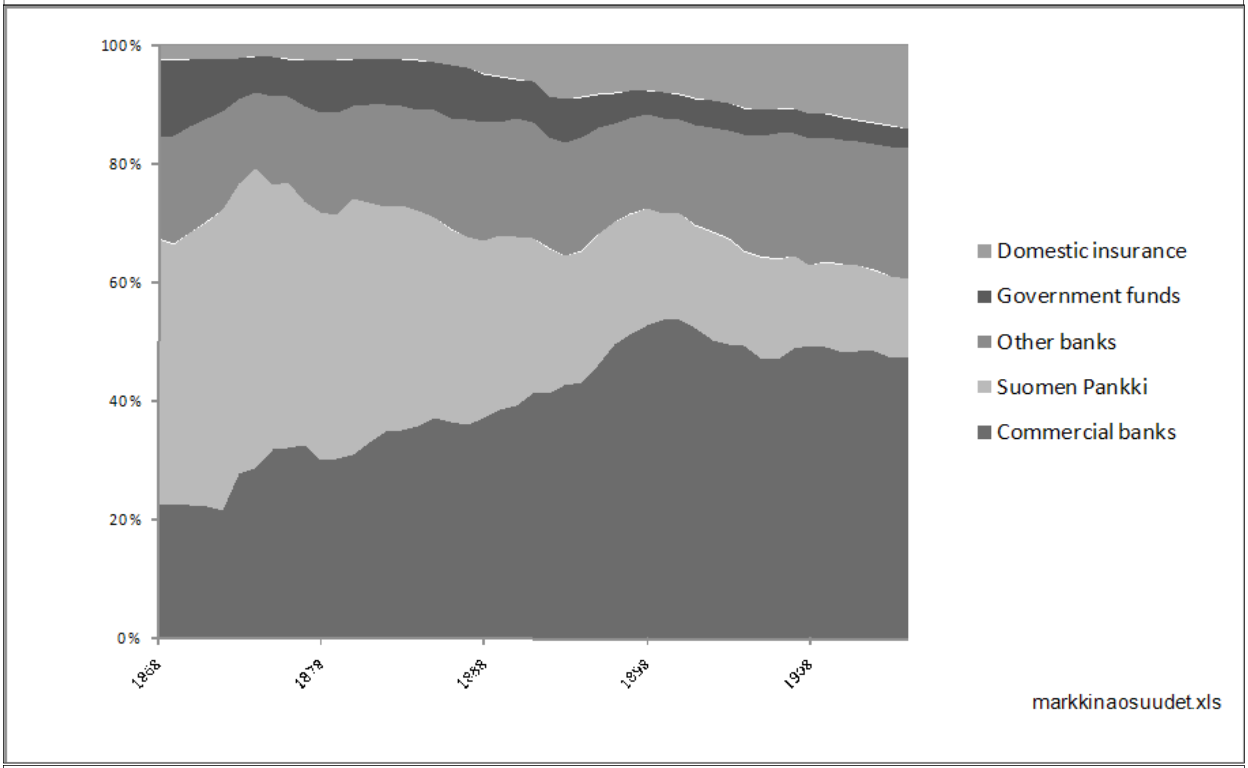
2 H. Pipping, *Paperiruplasta kultamarkkaan Suomen Pankki 1811-1877* (Helsinki 1961); H. Pipping, *Kultakannan turvissa Suomen Pankki 1878-1914* (Helsinki 1969); A. Kuusterä, 'Valtion Sijoitustoiminta Pääomamarkkinoiden Murroksessa 1859-1913', *Suomen Historiallinen Seura*, Historiallisia Tutkimuksia 149 (Helsinki 1989).

3 A. Kuusterä, *Aate ja Raha Säästöpankit Suomalaisessa Yhteiskunnassa 1822-1994* (Helsinki 1995); K. Pihkala, *Suomen Hypoteekkiyhdistys 1861-1961, 100-vuotishistoriikki* (Helsinki 1961).

4 H. Pipping, *Sata vuotta pankkitoimintaa* (Helsinki 1962).

The establishment of the first commercial bank was followed by a period of expansion in the operation of commercial banks, and in their share of lending to industry and commerce. By balance sheet size, the share of commercial banks reached 50 per cent of all domestic financial intermediaries by the turn of the century (figure 1). According to Lefgren (1975), commercial bank loans covered approximately 17 per cent of total liabilities in a sample of 28 industrial companies by the start of the First World War. At that time, commercial banks covered almost half of all industrial debt. The industrial loan stock of the central bank, the second largest source of bank loans to the industry, was only about six per cent of the industrial loan stock of commercial banks.[5]

Figure 1: Evolution of the structure of the financial services industry in Finland, 1868-1914 (balance sheet shares).




Sources: E. Aaku, 'Suomen Liikepankit 1862–1955', unpublished manuscript (1956); V. Ikonen, 'Suomen Pankin tase vuosina 1868-1991 Kuukausisarjat', Bank of Finland Discussion Paper 19/98, (1998); Statistics Finland, 'Official statistics' (Finland 1892-) ; A. Kuusterä ' 'Aate ja Raha'. K. Pihkala, 'Suomen Hypoteekkiyhdistys'; own calculations.

The laws and commitments that governed the operation of these financial intermediaries shaped the competitive environment in industrial finance in the 1800s. In particular, the focus of Suomen Hypoteekkiyhdistys on agricultural loans, and savings banks on the poor, made them in practice non-competitors on the industrial credit market. There are few examples of loans by Suomen Hypoteekkiyhdistys and the saving banks to major industrialists, but the market for loans to industry and trade in the late 1800s was mainly split between commercial banks and Suomen Pankki.[6]

## III.

In elementary models of price competition, the battle for market share is won by the contestant with the lowest price. In the context of banking, both deposit and loan rates are relevant variables in price competi-

5 J.C. Lefgren, *Banking in the Early Industrialization in Finland, 1860-1914* (Utah 1975).

6 P. Schybergson, *Juuret Metsässä Schauman 1883–1983* (osat 1 ja 2) (Helsinki 1983), pp. 41-5; P. Schybergson, *Työt ja päivät Ahlströmin historia 1851–1981* (Vammalan kirjapaino 1992), pp. 80-1; Kuusterä, *Aate ja Raha*, pp. 192-7; Pipping, *Sata vuotta*, pp. 170-2.

tion. The industrial organisation approach to banking predicts that the competition is won by the most efficient contestant who can apply the tightest margins between loan and deposit rates.[7] Under this paradigm, one could imagine commercial banks as efficient financial intermediaries, who managed to win the pricing competition in loan and deposit markets against Suomen Pankki.

The applicability of the price competition paradigm is in question here, due to the interest rate regulation of loans. The law restricted the loan pricing behaviour of both commercial banks and Suomen Pankki by imposing a six per cent interest rate ceiling on all loans until 1892, and on short term loans until 1920. Autio (1996) reports, however, that lending rates were typically clear of this upper bound.[8] Since regulation did not, *de facto*, bind loan rates, they remained an important variable for commercial banks in competition for the loan market.

In price competition one advantage for Suomen Pankki was its public note issuer status, which, in practice, enabled funding at a low cost. Indeed, Suomen Pankki terminated its interest bearing deposit facility altogether in 1875 and relied in large part on note issuance as a funding source. Commercial banks also had, until 1886, a right to issue notes , but in practice the issued amounts remained insignificant.[9] This means, that under the price competition paradigm commercial banks would need to apply narrower margins than Suomen Pankki to be competitive in loan markets.

However, previous research has established that the price competition paradigm cannot explain commercial bank success in industrial finance. It is well documented that commercial banks seldom undercut the loan rates of Suomen Pankki. Korpisaari (1920) states that commercial banks, as a rule, charged loan rates that were slightly above Suomen Pankki's rates in the late 1800s. Autio (1996) shows, by studying the micro data of loan contracts of different financial institutions, that commercial bank loan rates were not generally below central bank rates during the period under study. Something else besides loan pricing must have driven industrialists towards commercial banks.[10]

An alternative explanation to commercial bank success is offered by the theory of spatial competition, which relates market share to geographical vicinity. By law, commercial banks were free to expand geographically within the national borders and, indeed, they expanded rapidly to compete for the idle savings across the country. By the turn of the century, commercial banks had over 100 offices (Aaku), about ten times more than Suomen Pankki, whose geographical expansion was therefore significantly slower than that of commercial banks. This is in contrast to Russia, where the State Bank acquired a large branch network and it dominated banking in small villages and towns. In this respect, the development of the Finnish banking system followed the lead of Sweden.[11]

Market share gains by commercial banks could also, in principle, be related to the mix of financial products offered. Previous research has not provided a clear consensus about the extent to which this played a role in practice. With regard to the critical international debate of bank classification,[12] Finnish commercial banks conformed closest with the universal banking model. In addition to granting loans and taking deposits,

7 J. Tirole, *The Theory of Industrial Organization* (London 1998), pp. 209-38; X. Freixas, J.C. Rochet, *Microeconomics of Banking* (London 1997), pp. 51-90.

8 J. Autio, 'Korot Suomessa', Bank of Finland Discussion Papers 7/96 (1996).

9 Pipping, *Sata Vuotta*, pp. 84-5.

10 P. Korpisaari, *Suomen pankit*, *Kansantaloudellinen yhdistys, taloustieteellisiä tutkimuksia XXV* (Helsinki 1920), pp. 244; J. Autio, *Korot Suomessa*.

11 Pipping, *Kultakannan turvissa*, pp. 341-50; Sandberg, *Banking and Economic Growth*, pp 650-80; Crisp, *Russia 1860-1914*, p. 199.

12 M. Collins, and M. Baker, 'English Bank Business Loans, 1920-1968: Transaction Bank Characteristics and Small Firm Discrimination', *Financial History Review* 12, 2 (2005), pp. 135-71; L. Quennouelle-Corre, 'The State, Banks and Financing of Investments in France from World War II to the 1970's', *Financial History Review* 12, I (2005), pp. 63-86; M. Collins, 'English Bank Development within a European Context, 1870-1939', *Economic History Review*, LI (1998), pp. 1-24.

commercial banks offered, among other things, payment services, foreign exchange and investment banking services related to issue of stocks and bonds. Industrial credit was comprised of discounted bills, credit accounts and loans, mostly short term and typically rolled over on demand. Various types of collateral were routinely accepted, and some of the credit was uncollateralised. The most significant restrictions imposed by law on the industrial financing of commercial banks was that commercial banks were not allowed to own company stock (under normal circumstances) or, in general, do other business than banking.[13]

Suomen Pankki also offered a wide variety of financial services to the early industrialists. In its spectrum of financial services, a notable omission was the interest bearing deposit facility. Regulations that governed the allocation and pricing of lending by Suomen Pankki were dismantled so that the renewed charter in 1875 made security and economic gain the main principles in lending. Pipping (1962) shows that Suomen Pankki offered a spectrum of loan types that was comparable to that of the commercial banks.[14]

The commercial banks, then, had a larger geographical base than Suomen Pankki, and they operated an interest-bearing deposit facility which Suomen Pankki did not. On the face of it, these differences in the operation of Suomen Pankki and commercial banks may not appear sufficient to explain the huge gains in market share of commercial banks *vis-a-vis* Suomen Pankki. A deeper issue is whether one can really take pricing decisions, geographical expansion and product mix as given parameters in this context. Perhaps they should rather be viewed as tell tale signs in the operation of these institutions that reveal deeper differences in their approach to banking. While commercial banks viewed retail banking as a core operation, the focus of Suomen Pankki was increasingly on its role as a central bank.

Indeed, modern banking theory, based on the incomplete contracting paradigm, suggests that the key success factor of institutions may lie beneath the easily observable surface of pricing and product choice, in non-contractible aspects of the operation which are driven by the incentive structure of decision making. The differences observed in geographical expansion and product variety may only be the ‘tip of the iceberg’ of more profound differences between the approach of commercial banks and Suomen Pankki *vis-a-vis* their clients as regards marketing, the criteria for granting credits, flexibility in re-negotiation and the process of liquidation.[15]

Previous studies support the claim that incentives played a significant role in the competition for loan clients. Korpisaari (1920), in his history of banking in Finland, gives a vivid description of the role of commercial banks in the various steps needed in financing an industrial enterprise, from the establishment of an initial loan to buy the land, a mortgage to finance the building of the factory, possibly supplemented by smaller liquidity loans, and then finally the credit needed to commence the actual operation of the factory before profits start to accumulate. Commercial banks were in many cases involved ‘from cradle to grave’, not only in founding industrial companies, but also in terminating them. The financing decisions were often made with relatively poor information and imperfect ability to monitor the company in question. Korpisaari’s description suggests that many aspects of commercial banking were not easily contractible *ex ante*, and the fate of the loan customer relied on the motivation of the bank to be flexible with industrialists.[16]

Suomen Pankki, on the other hand, was viewed as a public bureaucracy, with primary focus on monetary policy. Such key operational parameters as the opening of new branches and loan pricing by Suomen Pankki had to be approved by the Banking Supervisory Committee. The discontinuation of the interest-bearing deposit facility would not have made much sense for an institution that had been eager to expand in indus-

13 Korpisaari, *Suomen Pankit*, pp. 194-274.

14 Pipping, *Kultakanna turvissa*, pp. 106-42.

15 Freixas and Rochet, *Microeconomics of Banking*; D. Diamond and R. Rajan, ‘Liquidity Risk, Liquidity Creation and Financial Fragility: a Theory of Banking’, *Journal of Political Economy*, Vol. 109, No. 2 (2001), pp 287-327.

16 Korpisaari, *Suomen Pankit*, p. 239-40.

trial finance. Neither the board of Suomen Pankki, nor the banking supervisors showed much interest in expanding the office network, and turned down many applications by local business centres. Pipping (1969) quotes the head of the banking supervisory board, Robert Montgomery, in the 1880s saying that competition with commercial banks was not in line with the role of Suomen Pankki.[17]

The sluggishness and bureaucratic nature of Suomen Pankki did not exist due to adverse political views about industrialisation. On the contrary, the prevailing economic policy was liberal and favourable to industrial growth. A better hypothesis is that the bureaucratic nature of Suomen Pankki existed, because public governance imposed other priorities. One can speculate, in line with Montgomery's comments, that neither the board of Suomen Pankki nor the banking supervisors were too eager to risk the resources of Suomen Pankki needed to fulfil its monetary policy duties, in competition with commercial banks.[18]

All in all, then, previous studies indicate that commercial banks did not succeed in industrial finance by pricing below Suomen Pankki. Geographical accessibility and, possibly, product mix contributed to commercial bank success. Ownership and other links between industrialists and commercial bankers may have played an indirect role. An important part of the success of commercial banks was related to their strong incentives to succeed in the complex and non-transparent business environment. Compared with commercial banks, Suomen Pankki was a reluctant competitor for industrial clients.

## IV.

A study of the development of commercial banks' and Suomen Pankki's credit portfolios sheds further light on the issue of whether product mix was an important factor in commercial bank success in the industrial credit market. An overview of the development of commercial bank loan portfolios is given in figure 2, and that of Suomen Pankki in figure 3.

Korpisaari (1920) characterises the different credit types in his essay.[19] 'Bills of exchange' were very traditional instruments for lending and making payments. If a firm purchased supplies without sufficient cash balances, it could use the bill of exchange to pay for the goods. They were usually uncollateralised but possibly guaranteed by name. The bill of exchange was then 'discounted' by a bank, i.e. the bill stayed with the bank and the deposit account of the supplier of goods was credited with the named amount. The credit was typically granted for a period of three to six months, and often rolled over.

The other types of lending, correspondents, cash creditives, and loans were, in Korpisaari's view, similar to each other in many respects. They were typically short term in Finland in the late 1800s due to the fact that the interest rates of credit of longer maturity were regulated by law. A notable difference in comparison of these other credit types from bills of exchange was that the other credit types provided more room for adjustment for both banker and client during the duration of the contract. The collateral arrangements varied widely case by case. Banks had the right to ask for additional collateral during the duration of the contract if deemed necessary, and cash in any collateral without timely or costly procedures if instalments were not on time. The customer had the right to early repayment. The correspondents were the most flexible ones. They were two-sided accounts which allowed the client to freely adjust the account position within the bounds set by the credit limit.

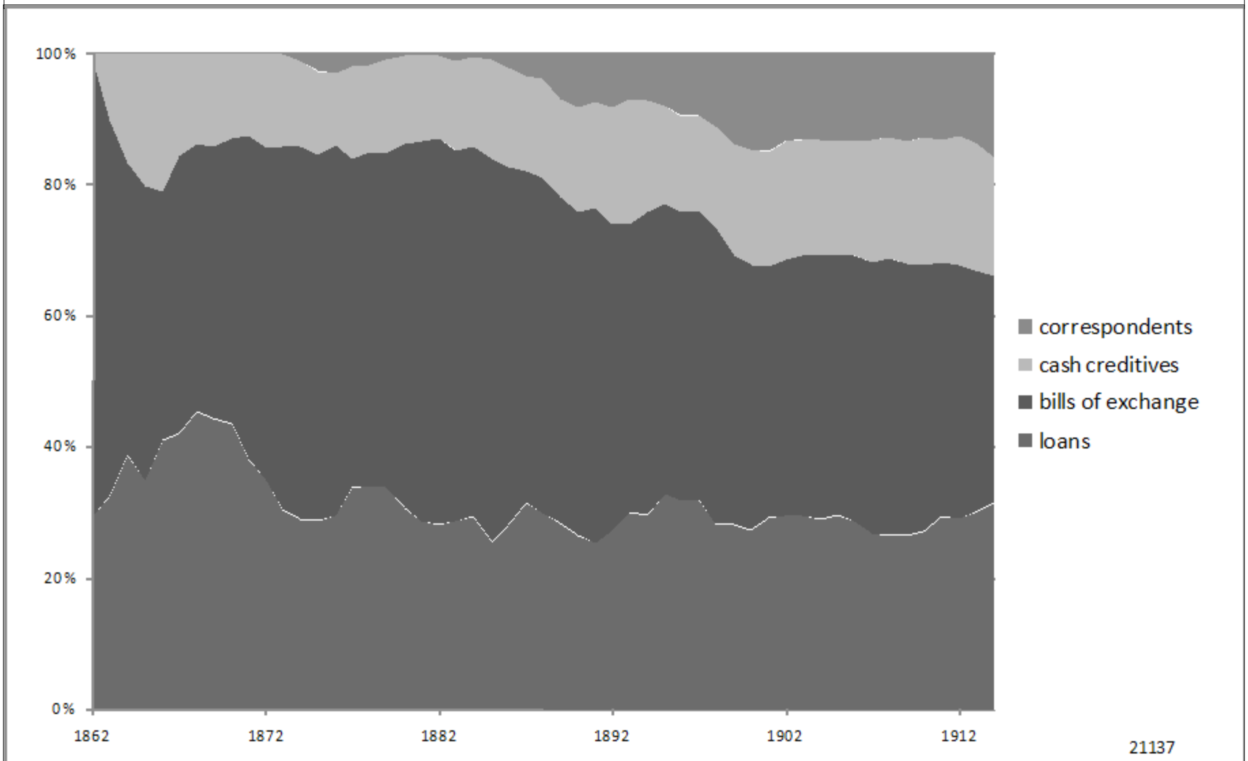
A comparison of figures 2 and 3 suggests that, in broad terms, commercial bank success was not initially related to the mix of credit types offered. Figure 2 shows that, in the late 1870s and 1880s, about 30–40 per

17 Pipping, *Kultakannan turvissa*, p. 343.

18 O. Hart, A. Schleifer, R. Vishny, 'The Proper Scope of Government: Theory and Application to Prisons', *Quarterly Journal of Economics*, Vol. 112 (4), (1997), pp. 1127-61; A. Schleifer, 'State Versus Private Ownership', *National Bureau of Economic Research*, Working paper No. 6665 (1998).

19 Korpisaari, *Suomen Pankit*, pp. 226-36.

Figure 2: Evolution of the structure of commercial banks' loan portfolio.




Source: Aaku, 'Suomen Liikepankit'.

cent of commercial banks' credit portfolios consisted of loans, 50–60 per cent of bills of exchange, while the rest were cash creditives. Suomen Pankki's portfolio achieved these proportions after the long term industrial loans granted during the period of heavy regulation (before 1875) were gradually replaced in the loan stock. The fact that the loan stocks converged towards a similar structure in the 1880s suggests that the structure of lending had been about the same during the previous years.

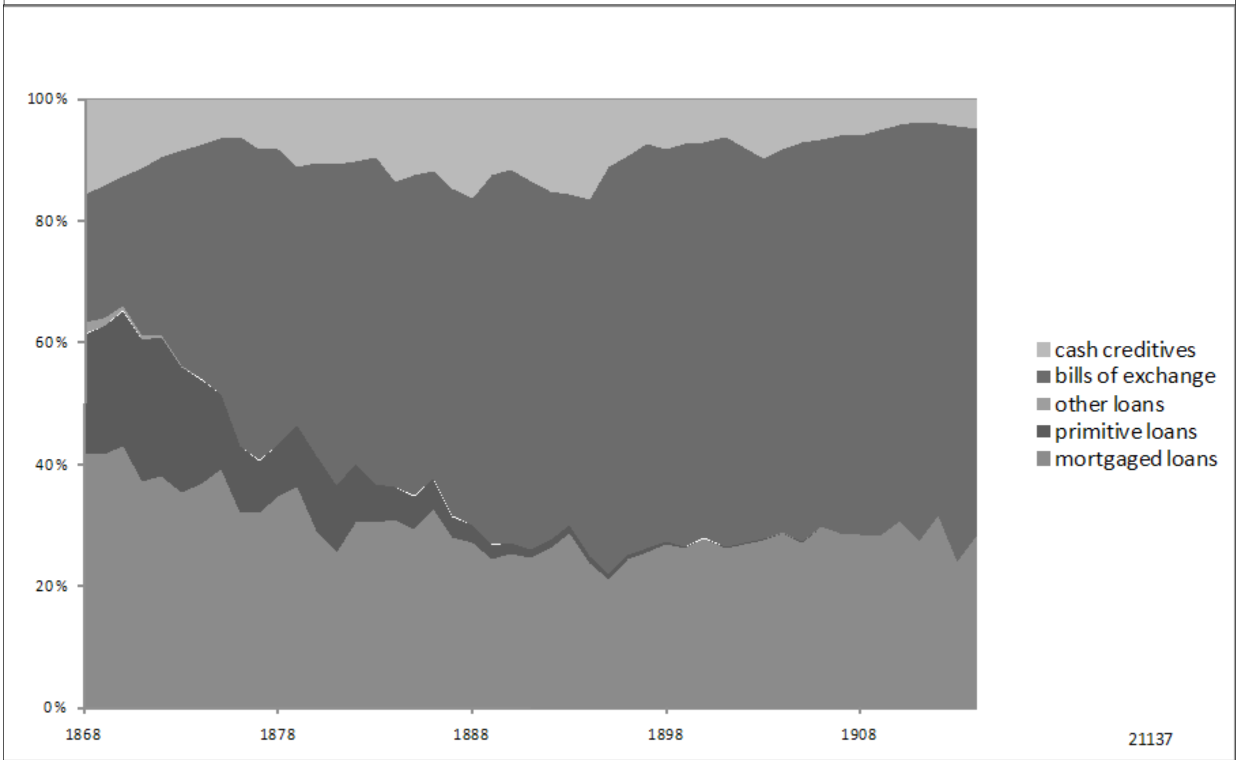
That said, the charts also reveal a divergence in the portfolios of the two types of institutions during the latter part of the sample. The prevailing trend in the loan portfolio of commercial banks during the late 1800s was a decrease in the share of bills of exchange, and an increase in the share of correspondents. In contrast, in the loan portfolio of Suomen Pankki, the share of bills of exchange increased from close to 20 per cent to over 60 per cent during the observation period. According to Korpisaari (1920), the composition of the portfolio of bills of exchange in Suomen Pankki's portfolio changed during this period so that the security of the bills increased and their duration decreased.[20]

The evolution of the loan portfolios suggests a gradual divergence in the strategies of the two institutions. Suomen Pankki increasingly favoured short maturity and low risk, in line with its role as a central bank. For Suomen Pankki, the liquid and standardised bills of exchange became the equivalent of modern market instruments at this time, when the inter-bank market was still undeveloped. Based on balance sheet data, commercial banks increased the flexibility of their loan portfolio to meet the needs of early industry and commerce.

The balance sheets of industrial companies show the divergence of the loan portfolios of Suomen Pankki and the commercial banks from another perspective. The source of information of industrial balance sheets

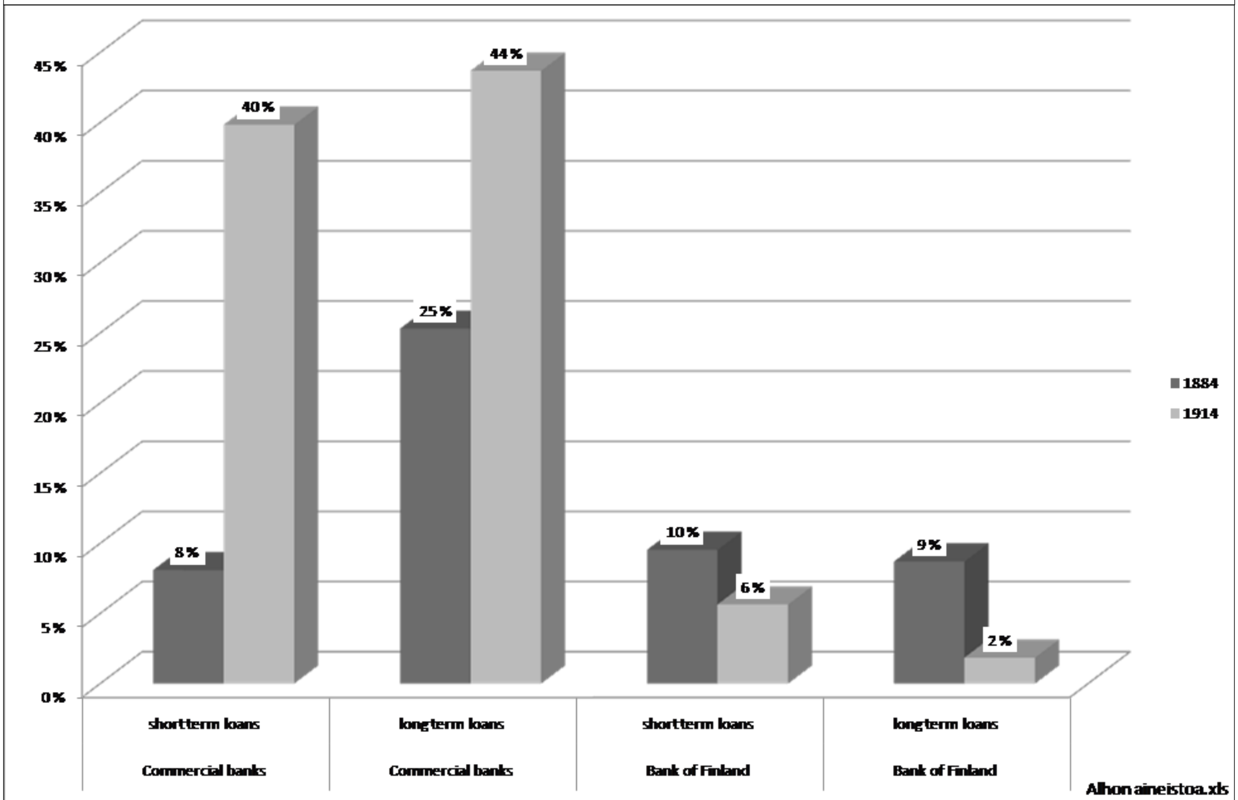
20 Korpisaari, *Suomen Pankit*, pp. 74-5.

Figure 3: Evolution of the structure of the loan portfolio of Suomen Pankki.




Sources: *Finlands Banks Årsberättelser*. The Bank of Finland Annual Reports.

Figure 4: Share of commercial banks and Suomen Pankki in long- and short-term borrowing of industrial companies in 1884 and 1914.




Sources: Keijo Alho, 'Teollisuuden rahoitustutkimusta koskevia yhdistelmätaulukoita' (*Bank of Finland Archives*, unpublished, exact compilation date unknown).

during this period is the 'Alho data' in the archives of Suomen Pankki. This has been used previously by Lefgren (1975). For this study, I have utilised the compiled tables of Keijo Alho.[21]

It can be observed from figure 4 that commercial banks increased their share in long and short term industrial borrowing markedly between 1884 and 1914. Throughout the period, commercial banks' market share in long term finance exceeded that in short term finance. The market share of Suomen Pankki declined in both long- and short term financing, but the fall was most dramatic in long term loans.

## V.

Throughout the history of banking, an important issue of debate has been the cyclicality of loan supply conditions. In particular, a classical debate in economics is the banking vs. currency school debate about the role of banks and central banks in different phases of the business cycle. It has been argued that central banks should act as lenders of last resort for banks during economic downturns.

In Finland, the flavour of the debate was affected by the fact that in the early decades of industrialisation Suomen Pankki still lent directly to the early industrialists. Entrepreneurs regularly complained about the unavailability of credit ('unavailability of money') during recessions from both banks and Suomen Pankki. Korpisaari (1920) discusses the business cycle behaviour of commercial banks and Suomen Pankki in his essay. He suggests that credit supply was adversely affected during recessions, and that there were marked differences in the lending behaviour of commercial banks and Suomen Pankki when credit conditions tightened during economic downturns. When the ability of commercial banks to finance the firms weakened, they tended to turn to Suomen Pankki for help. The ability and willingness of Suomen Pankki to help depended crucially on various parameters related to its lending policy, among them its financial position, the collateral requirements imposed on its loans, and crucially the reserve regulation which constrained its ability to increase the circulation of money.[22]

The evidence, then, hints that lending by both commercial banks and Suomen Pankki tended to be pro-cyclical: availability of credit was weakest during depressions. Indeed, a visual of changes in GDP and lending by commercial banks and Suomen Pankki (figure 5) suggest that lending by both commercial banks and Suomen Pankki tended to develop pro-cyclically. During the 1870s, 1880s, and 1890s the slowdown in GDP growth was associated with a slowdown in lending by both commercial banks and Suomen Pankki. Similarly, lending growth typically accelerated during peak periods of economic growth.

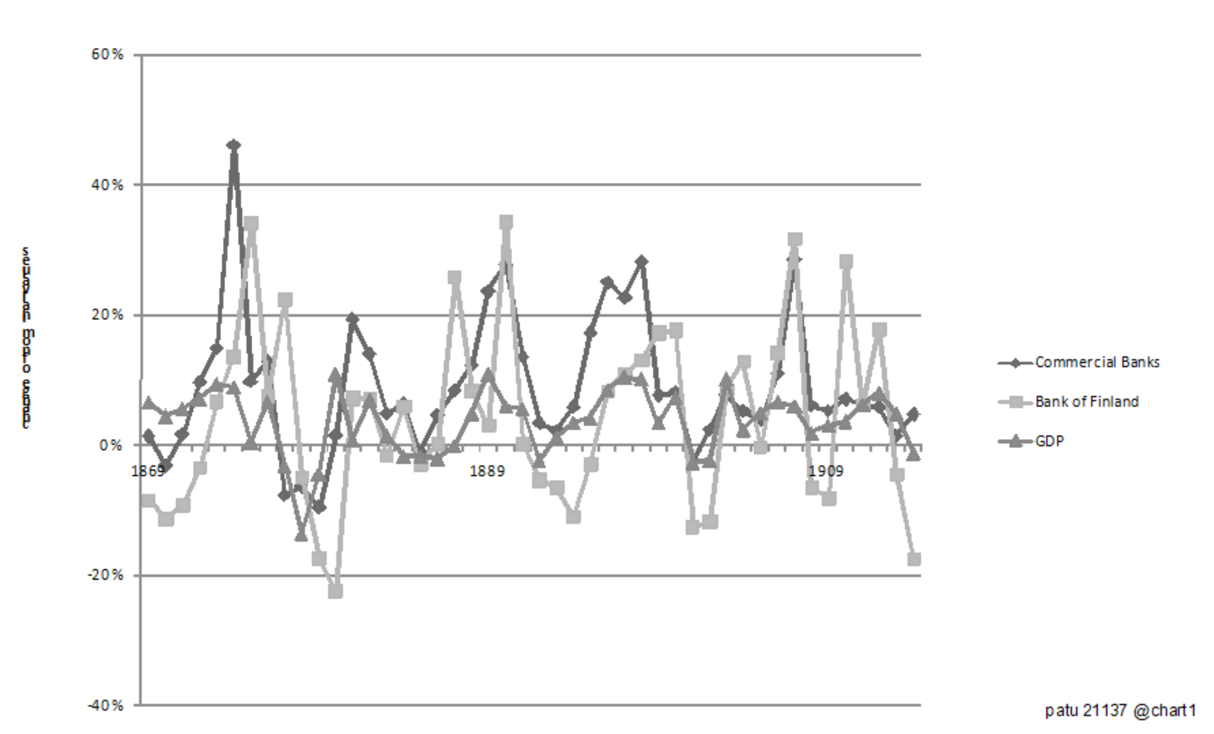
By visual impression alone, it is difficult to assess whether there were differences in the extent of co-movement of lending by commercial banks and Suomen Pankki relative to macroeconomic developments. Some insight into this issue may be gained by studying the correlations of the relevant series. The correlation of commercial bank lending growth with GDP growth was 0.6, and the correlation between lending growth of Suomen Pankki and GDP growth was 0.2 in 1868–1914. This observation is not proof, but it is in line with the view that Suomen Pankki may have been able to uphold its supply of credit to early industrialists better than commercial banks during downturns. Its lending policy may have been less dependent on cyclical conditions than that of commercial banks.

Granger causality tests can shed some light on the temporal relationship between the loan supply of commercial banks and Suomen Pankki. Table 1 shows the results of one series of tests. The tests have been performed with a VAR model that has four lags of both commercial bank lending and Suomen Pankki's

21 Sources: Keijo Alho, 'Teollisuuden rahoitustutkimusta koskevia yhdistelmätaulukoita' (*Bank of Finland Archives*, unpublished, exact compilation date unknown); Lefgren, *Banking in the Early Industrialization*.

22 Korpisaari, *Suomen Pankit*, p.82.

Figure 5: Lending by commercial banks and Suomen Pankki, and GDP.




Sources: Aaku, 'Suomen Liikepankit', *Finlands Banks Årsberättelser*; R. Hjerppe, 'The Finnish Economy 1860-1980 Growth and Structural Change', *Studies of Finland's Economic Growth XIII* (Helsinki 1989), own calculations.

lending. Both series are nominal, and in natural logarithms. Lag length was selected by standard statistical tests. A VAR with two lags gives broadly similar results except that in this case significant differences in the behaviour of the two institutions is only found in the latter part of the sample.

In table 1, the test about whether Suomen Pankki's lending Granger affects the lending of commercial banks, establishes whether changes in Suomen Pankki's lending were followed after a lag by a change in the lending of commercial banks. In a similar vein, the test about whether commercial banks' lending Granger affects the lending of Suomen Pankki, establishes whether changes in commercial bank lending are followed after a lag by changes in Suomen Pankki's lending.

It can be observed from table 1 that the result of the causality test is in line with the view that Suomen Pankki was, in general, more of a follower, while commercial banks were the leaders in the credit market. The impulse responses of the VAR suggest that a shock in the lending of commercial banks was followed by a change in the same direction in Suomen Pankki's lending.

The result suggests that when credit conditions deteriorated during recessions, Suomen Pankki was able to maintain its loan supply somewhat longer than the commercial banks. This is in line with Korpisaari's interpretation that it was the lender of last resort for early industrialists. Commercial banks were the first ones to expand their lending during recessions.

Table 1: Probabilities associated with two Granger causality tests on the loan stock of Suomen Pankki and commercial banks.

| Hypothesis | 1869-1914 |
|---|---|
| Suomen Pankki lending does not Granger cause commercial bank lending | 11% |
| Commercial bank lending does not Granger cause Suomen Pankki lending | 0% |

## VI.

The focus above is on comparing the behaviour of commercial banks and their main rival, Suomen Pankki, in Finland during the first phase of industrialisation. The comparison aims to underline the factors that made commercial banks the preferred source of finance for the early industrialists. The analysis thus contributes to our understanding of commercial banking and its role in promoting economic development during this first phase of industrialisation of the Finnish economy.

Commercial banks quickly overtook the lead in industrial lending from Suomen Pankki in the late 1800s. A study of the competitive conditions suggest that commercial bank success over its main rival Suomen Pankki was, perhaps surprisingly, not based on aggressive pricing. Rather, commercial banks appear to have been relatively expensive sources of funding for the early industrialist. Commercial banks had an edge over Suomen Pankki in spatial competition (they expanded more rapidly) and they may have offered a more diverse product portfolio than Suomen Pankki. Importantly, commercial banks excelled in non-contractible aspects of operation, flexibility and effort over the bureaucratic Suomen Pankki.

In the early days of commercial banking, the spectrum of loan types offered by commercial banks and Suomen Pankki were in broad terms relatively similar. However, towards the end of the century, commercial banks' loan portfolios changed toward loan types that offered more flexibility to both commercial banks and their clients. The loan portfolio of Suomen Pankki, in contrast, became shorter, more standardised and secure.

The loan supply of both commercial banks and Suomen Pankki was pro-cyclical. By studying the dynamics of loan supply we find that commercial banks reacted faster to external shocks than Suomen Pankki. When credit conditions deteriorated during economic recessions, Suomen Pankki was able to maintain its lending longer, suggesting that it was, in the context of restricted liquidity, a lender of last resort for the early industrialists.

# Size Matters – Does It? Two very Different Episodes of the Eastward Expansion of Austrian Banks

Aurel Schubert & Gerhard Kaltenbeck

## I.

In banking, size matters. It matters in several different respects: e.g. the size of the respective markets, the size of the respective economies, the size of the institutions. It is the goal of this study to compare two episodes of the eastward expansion of the Austrian banks under very different political and economic circumstances during the twentieth century. In both cases, sudden large political changes, tectonic shifts, had revolutionary consequences for the political as well as economic borders surrounding Austria and the Austrian banks.

We attempt to show that political boundaries do not have to be economic boundaries, but they pose special challenges for cross-border business or the success of direct investments, especially in the area of banking and finance. In a liberalised world, banks tend to seek new markets beyond the borders of their home country, especially so if the customs, laws, habits etc. are very similar. As the banking business builds on knowledge and trust, a special knowledge about the business, the institutions and the people beyond the borders is a very important asset.

This drive of financial institutions beyond geographical and political borders can be based on push factors, i.e. forces that push the banks from the home country to expand beyond the traditional borders; or on pull factors, i.e. factors in the potential host countries that pull the banks into new territories; or on a combination of both. Therefore, dramatic changes in the political and/or economic set up of the neighbouring countries have strong repercussions on the business models of banks, especially those of larger banks.[1]

The twentieth century brought two such large tectonic shifts in the immediate geographic neighbourhood of Austria, namely in 1918 and in 1989. After both 'political earthquakes' (large) Austrian banks had to and did react to these shifts with changes in their business policies. In the first episode, the aftermath of WWI and the dissolution of the Austro-Hungarian Empire, the Austrian banks were suddenly confronted with new borders, both political as well as commercial. An integrated political and economic area of more than 50 million inhabitants suddenly fell apart. A large part of their territories of activity was suddenly foreign territory, subject to new rules and to protectionist measures. They had to decide whether to attempt to stay in those areas where they had been active but were suddenly 'abroad' and—to a certain extent—hostile, or to recede to the (very small) home territory with about six million inhabitants. Could transnational banking successfully replace banking in a multinational empire? This was the challenge.

Given the size of their operations and staff a concentration of their business activities within Austria would have meant a major and painful restructuring and laying off of staff, a sharp downsizing. They decided that size – both of their institutions as well as of the markets – mattered and that they would want to stay enganged in the so-called successor states, although in different forms than previously. Nationalisation rules forced them to sell off their branches and offices but they could stay engaged in the new local institutions and they still had possibilities to extend credit and participate in local industries directly from their headquarters

1 Even smaller banks often expand into neighbouring countries, however, only in a geographically limited area (immediate neighbourhood) using their special regional expertise.

in Austria. So to speak: cross-border business instead of local business, transnational business instead of multinational business.

Thus, they stayed but accepted the new rules of the game. The new competition by the local banks made their business environment more challenging – partly because they had to accept the less-than-prime borrowers (a kind of Akerlof's lemons). As the world wide economic depression hit, the Austrian banks had to take large losses and had to merge to survive. In the end, the state also had to get financially involved to rescue the banking system. A considerable part – but by no means all – of their problems came from their continued engagement in the successor states. Size mattered also here.

The second episode of eastward expansion covers the same geographical area and partly even the same banks, but the economic and political circumstances are diametrally different. The fall of the Berlin Wall and of the Iron Curtain completely changed the geographical, political and economic landscape of Europe. Europe had been divided in two for more than 40 years and Austria was right at the division line. But it was not just a line, it was a barbed-wire fence, not to be penetrated, neither physically nor commercially. The country was faced with a dead-end situation. Suddenly, in late 1989, the fence was cut and came down. The continent became politically reunited. The process of economic reunification started.

Banking or the supply of financial services had to play a crucial role for the economic catching up of the East. These countries did not have commercial banking but a model where the central bank was the only relevant financial institution. The result was a complete lack of even the most basic banking services which are the blood-circulation of modern industrialised and service-based economies. The introduction and distribution of modern banking services and a banking infrastructure was (and is) a precondition for a serious catching-up process.

As building up modern commercial banks would have taken many years and could not have occured without large scale foreign assistance, direct involvement of foreign, i.e. Western banks was the only realistic option for the establishment of a modern banking sector. Mergers and acquisitions by Western banks was the recipe. This was a once-in-a-life-time opportunity for the banks in the neighbouring countries. They were really pulled into this new market. The major neighbouring countries were Germany, Italy, Austria for Central- and Eastern Europe, and Sweden for the Baltics. With Germany and the German banks mainly occupied with unification, an over-proportional share of the new market was available for (and required the involvement of) Austrian and Italian banks. Several Austrian banks accepted the challenge. They recognised immediately that this was a unique opportunity to extend and vastly enlarge their market to a region that was not only geographically very close but also historically and culturally. It was the old home market from the turn of the last century, from the days of the Austro-Hungarian monarchy. Thus, they recognised that size matters for success and the extended size of their potential market created opportunities and challenges. They were ready to take up those challenges.

The prospect of an eventual membership of these countries in the European Union added to the attractiveness of this region. And by 2004 eight of these countries actually became members of the EU and in 2007 two more. By 2009 two of these countries, Slovenia and Slovakia, are already members of the Euro area. i.e. full members of the European Monetary Union and therefore of the euro.

First, we describe the role of the Austrian banks in Eastern Europe before WWI and show how they reacted to the dissolution of the Austro-Hungarian empire. Using the analytical framework of push and pull factors we discuss the relative determining influences for their policy choices. Then we contrast this with the experience after the fall of the Iron Curtain. Again we show the – step-wise – expansion of the Austrian banks into the East before we use the same analytical framework as applied to the post-WWI period. We point to the similarities and especially the large differences between the two episodes before we outline some conclusions.

Table 1: Number of banks in Austria (joint-stock banks on the territory of Austria).

| | |
|---|---|
| 1913 | 27 |
| 1923 | 76 |
| 1930 | 31 |
| 1935 | 19 |

Source: Stiefel (1989), p. 95.

## II.

Vienna was the financial centre of the empire. Before WWI the Viennese banks – together with the Austro-Hungarian Bank, the central bank – covered the money and credit needs of the Austrian part of the dual monarchy but also partly the needs of the Hungarian part.[2] Viennese banks played an important role for the rapid development of Austria. Although they performed all banking duties they were especially strong in credit to industries. They financed long-term investment projects and floated the shares of newly founded joint stock companies of which they often retained a controlling majority.[3] The scarcity of capital and small savings which made industrial investment impossible explains the important part played by the banks in the industrial life of Austria.[4] This created a very tight relationship between banking and industry in pre-war Austria. This way, Austian banks were very different from British deposit banks and the French crèdit-mobilier.

The Viennese banks were also represented throughout the Austrian part of the monarchy with their branches and subsidiaries. Most of their subsidiaries were situated in Hungary, Czechoslovakia and Upper Italy. In 1913 the ten largest Viennese banks operated 149 branches outside Vienna, of which 114 were located in towns later belonging to the successor states.[5] Among these banks the Wiener Bankverein had the widest network of branches throughout the Eastern part of the monarchy. Next to its 30 branches on the territory of the (later) new Austria it had 27 branches throughout the territory that became in 1918/19 the successor states. But they had local competitors, too.

In the Czech part of the monarchy, for instance, the Czech banks managed to have a considerable share of the local market comparable to the share of the branches of the Viennese banks. The leading Czech bank, the Zivnostenska banka, for instance, represented about 35 per cent of the share capital of all Czech banks and held about 43 per cent of all local deposits.[6]

During the war, the financing of the enormous financial needs of the government became the principal business of the banks. After the war—due to the bad economic situation and the problems of industry—this link between banking and industry became even stronger than before the war.

2 Mitteleuropa-Institut, *Das mitteleuropäische Bankwesen* (Berlin/Vienna 1929), p. 9

3 H. Kernbauer and F. Weber, 'Multinational banking in the Danube basin: the business strategy of the Viennese banks after the collapse of the Habsburg monarchy', in: Teichova, et al. (eds.), *Multinational Enterprise in Historical Perspective* (Cambridge 1987), p. 185.

4 W.F. Layton and C. Rist, 'The Economic Situation of Austria', Report presented to Council of the League of Nations (Geneva 1925).

5 Kernbauer and Weber, p.185.

6 E. März, *Österreichische Bankpolitik in der Zeit der großen Wende 1913-1923* (Vienna 1981), p. 55.

| Table 2: Banks in Vienna (1913). | | |
|---|---|---|
| **Institutions** | **Year of establishment** | **Balance sheet total** (in million Crowns) |
| Oesterr. Credit-Anstalt für Handel und Gewerbe | 1856 | 1181.17 |
| Anglo-Oesterreichische Bank | 1864 | 750.70 |
| Allg. Österr. Boden-Credit-Anstalt | 1864 | 920.11 |
| Allgemeine Verkehrsbank | 1864 | 306.78 |
| Union-Bank | 1870 | 374.52 |
| Wiener Bank-Verein | 1869 | 918.57 |
| Niederösterr. Escompte-Gesellschaft | 1853 | 432.38 |
| Österreichische Länderbank | 1880 | 821.42 |
| ‘Mercur’ | 1887 | 283.05 |
| Wiener Giro- und Cassen-Verein | 1872 | 50.93 |
| Oesterr. Credit-Institut | 1896 | 122.84 |
| Oesterr. Hypothekenbank | 1868 | 117.02 |
| Wiener Baukreditbank | 1910 | 24.72 |
| Allg. Depositenbank | 1871 | 194.58 |
| Oesterr. Central-Boden-Credit-Bank | 1871 | 117.92 |
| Wiener Lombard- und Escompte-Bank | 1873 | 46.78 |
| Oesterr. Industrie- und Handels-Bank | 1910 | 39.33 |
| Allg. Kreditvereinsbank | 1907 | 5.27 |
| I. Österr. Beamten-Kredit-Anstalt | 1908 | 32.35 |
| Wiener Gewerbliches Kredit-Institut | 1894 | 4.68 |
| Oesterr. Immobilarbank A.-G. | 1912 | 11.22 |
| ‘Kompaß’ Allg. Oesterr. Kreditversicherungsbank | 1912 | 2.86 |
| | | **6759.20** |

| Table 3: Austrian Banks in the year 1913. | |
|---|---|
| **Regions** | **Balance sheet total** in Million Crowns |
| Vienna | 6759.20 |
| Austrian Province | 189.84 |
| **Austria** | **6949.04** |
| Czech Republic | 2296.77 |
| Yugoslavia | 56.72 |
| Italy | 134.48 |
| Poland | 446.87 |
| **Austria 1913** | **9883.88** |

## Austrian Banks after WWI

The Czech revolution on 20 October 1918 was the signal for the disintegration of the Austro-Hungarian monarchy. In January 1919 the currency union started to collapse with the exit of Yugoslavia, followed in March by Czechoslovakia.[7] The end of WWI brought not only large political changes but also a very difficult economic situation in Austria. In 1919/20 Austria suffered a very severe production crisis. All the new states issued export prohibitions. Traffic in central Europe came to a standstill. To enable a single train-load of coal to pass through Czechoslovak territory, for example, five separate diplomatic communications had to be exchanged with the government of that country.[8] But the industrial region of Vienna had always obtained

7 See A. Schubert, ‘The Emergence of National Central Banks in Central Europe after the Break-up of the Austro-Hungarian Monarchy’, in: J. Reis (ed.), *The Emergence of Modern Central Banking from 1918 to the Present* (Aldershot 1999).

8 J. Van Walré de Bordes, *The Austrian Crown, Its Depreciation and Stabilization* (London 1924), p. 9.

its coal from Bohemia and Upper Silesia. This supply was now cut off by the closing of the Czechoslovak frontier, and a terrible coal famine ensued.[9]

During the 1920s, Austrian economic development was very limited. GDP growth was very moderate even in times when the US and world economies were booming. With this economic situation, banks' possibilities to earn money domestically were very limited. Staying and even expanding in the successor states was thought to be the right strategy for earning money and for maintaining the pre-war status and apparatus. This way, some argue, they indirectly hurt the Austrian economy by creating and supporting competitors and directly by – at the end – requiring financial help from tax payers.

1919 also marked the start of an inflationary process leading to hyperinflation in 1922. This hyperinflation brought about a complete destruction not only of the value of money but of all nominal values and especially balance sheets, also of the banking sector. The parallel flight from the Austrian crown, however, brought large increases in foreign exchange turnover and therefore had a positive effect on the earnings of the banks. This led together with the strong rise in share issues to a boom in the establishment of new banks, creating competition for the established institutions.

The short-term external debt of Austria was rising rather dramatically and Austria's credit rating suffered accordingly. By 1927, Austria was rated below Hungary and on a level with Romania and Bulgaria – but the Viennese banks had no problems to raise capital in London and the other Western financial centres.[10] The Western banks earned a lot by lending to Vienna as the spreads were rather large. No sound statistical information was available to the central bank to evaluate the short-term foreign debt of the Austrian economy and the banks did not cooperate. In 1927, the foreign advisor of the OeNB tried to estimate the short-term debt of Austria. According to his estimates, it amounted to about 1,050 million schilling, of which 700 million was due to the large Viennese banks, especially the Boden-Credit-Anstalt and the Credit-Anstalt.[11] In 1930, the OeNB estimated the short-term debt at about 1,750 million schilling.[12]

The banks used those foreign short-term loans for foreign exchange loans to Austrian as well as Eastern European industrial firms. It appears that only a small part was used to finance Austria's persistent current account deficits. How the largest part of the deficits was financed is not really known as statistical information on these transactions was very sketchy. It was only after the outbreak of the 1931 crisis that the full extent of these cross-border assets and liabilities became transparent.

The dissolution of the empire, the peace treaties and the separation of the currencies had to have important repercussions on the Austrian banks. Although they still had a strong capital base, they were confronted with rising taxes, rising expenditures for personnel – especially for their extensive networks of branches – and with rising non-performing loan portfolios. As the state was no longer able to pay its debts to industry, banks had to grant reschedulings, rebates or even write downs to their industrial customers. At the same time, the true value of the extensive holdings of government debt obligations became increasingly uncertain.

## The Austrian Banks in the Successor States

Contemporary analysts observed in 1929: '[o]wing to the endeavors of the Succession States to free themselves of the economic influence of Vienna, the Austrian banks lost ground here and there, while in other places they were able to maintain and even extend their hold... The Vienna banks also continue to hold a

9 Walré de Bordes, p. 10.

10 Oesterreichische Nationalbank (henceforth OeNB), *Währungspolitik in der Zwischenkriegszeit* (Vienna 1991), p. 194.

11 OeNB, p. 198.

12 OeNB, p. 212.

| Table 4: Branches of Viennese Banks in 1913. | | |
|---|---|---|
| **1913** | **Branches of Austrian Banks in Austria** | **Branches of Austrian Banks in (later) Successor States** |
| Anglo-Bank | 21 | 27 |
| Wiener Bank-Verein | 30 | 27 |
| Credit-Anstalt | 5 | 16 |
| Depositenbank | 7 | 3 |
| Oesterreichische Länderbank | 16 | 3 |
| | 4 | 8 |
| Mercurbank | 16 | 16 |
| Unionbank | 4 | 1 |
| Verkehrsbank | 19 | 11 |
| Source: Rutkowski, p. 23. | | |

considerable influence in various credit institutions of the Succession States, and through them, in a large number of financial and industrial enterprises'.[13]

## The New Business Strategy

The close links between the Viennese banks and industry was especially dangerous as the war and its consequences created a totally new situation. Not only did the state became a torso but so did the economy as well as the banks. The Viennese banks had to give up their branches in the successor states and they lost the deposits they used to gather in Vienna from the different regions in order to distribute them as credits to industry throughout Austria and Hungary. With that the banks lost control of industry in the successor states and the large profits, especially from industry in the Sudetenländer and in Triest. Initially, the expectation was to maintain their positions as creditors to the successor states. To a certain degree this was also achieved but it entailed large risks for the Viennese banks, especially since the banks did not have enough capital to lend to these industries.[14]

The political changes after the war, therefore, hit the Viennese banks very hard. Before the war they financed the industry on a territory of 25 to 30 million inhabitants. In addition, they also played an important role in the Hungarian part of the empire. Now, with the new borders, the Viennese banks were suddenly separated from the largest part of their former area of commercial activities. Their special role in these geographic areas was not the result of hegemonic ambitions but rather the result of the geographic location of Vienna and of their special expertise in the economies of the Danube region and the Balkans.[15]

Nationalisation/nostrification of foreign assets in the successor states followed; by law in Czechoslovakia where share companies had to transfer their headquarters to Czechoslovakia and had to have a supervisory board with a Czech majority and a Czech president. This way, Austrian (but also German) shareholders had to sell to local interests. As there was not enough local capital available, foreign Western investors had to

13 M. Sokal and O. Rosenberg, 'The Banking System of Austria', in: H. Parker Willis and B.H. Beckhart (eds.), *Foreign Banking Systems* (New York 1929), p. 173.

14 W. Federn, *Der Zusammenbruch der Österreichischen Kreditanstalt*, Archiv für Sozialwissenschaft und Sozialpolitik, Bd. 67 (Federn 1932), p. 404.

15 Creditanstalt-Bankverein, *Ein Jahrhundert Creditanstalt-Bankverein* (Vienna 1957), p. 161.

be actively attracted (e.g. from France). In addition, the supply of loans to Czech industry was basically a privilege of the local banking institutions.

The branches of Viennese banks in Czechoslovakia were separated from their mother institutions and either merged with local institutions or they became independent local institutions on their own.[16] Similar developments happened in Poland and in Yugoslavia.

Already during the first year, the Austrian banks had to sell off a considerable part of their industrial holdings and other assets in the successor states. Shipping companies, railway companies, heavy industry, or oil industry had to be sold. Austrian investors were replaced – at least partly – by Western, often French investors. This way, Austrian banks lost their most prosperous clients.[17]

All Viennese banks had to search for a new strategy and they followed different paths. But what united them was there decision to remain in an active role in the successor states. They did not want to restrict their area of operations to the small 'new' Austria. They had to transform their subsidiaries into independent national institutions with local controlling interests. Some decided to become junior partners in these newly established local financial institutions while others started to intermediate Western deposits to Eastern debtors.

The Credit-Anstalt, for instance, the largest Viennese bank, started immediately after the war to reorder its relationship with its foreign branches and industrial holdings. The branches and other offices of the Credit-Anstalt in Czechoslovakia (e.g. in Prague, Brno, Karlsbad, Teplitz) were transferred to the Böhmische Escompte-Bank, Prague, which was renamed into Böhmische Escompte-Bank und Credit-Anstalt. This institution was partly owned by the Niederösterreichische Escompte-Gesellschaft, another large Austrian bank, and the Credit-Anstalt remained represented in the management team of this institution.

A similar arrangement was concluded in Poland, with the Warschauer Disconto-Bank, which took over the branch in Lemberg. Three years later, the shares of this bank were brought by the Credit-Anstalt to the Viennese stock exchange. In a joint venture these two institutions also created a bank in Bielitz. The Italian branches were transferred to a group of Italian banks while for the branch in Ljubljana a new bank was created, with active participation of the Credit-Anstalt. Similar ventures were concluded with banks in Serbia and in Croatia. As far as influence in the former industrial holdings is concerned, some influence could be maintained via seats on the boards of those institutions after their nationalisation.

The Wiener Bank-Verein (WBV) had the largest network of branches and offices throughout the monarchy and therefore had to accept large sacrifices in the successor states. It had to transfer most of the branches to local banks but kept participations in many of them. The branches in Poland were taken over by 'Polnischer Bankverein Warschau', established in 1921. In turn, the WBV became a sizeable shareholder in this new Polish bank. Following the same model, the Czech branches were taken over by the 'Allgemeiner Böhmischer Bankverein', so that by 1932 only three of the original 27 branches were left to the Bankverein, in Budapest, Czernowitz and Merano. A very similar development happened with the Merkurbank and its 16 branches.[18] It transferred its branches to local banks in Poland, Czechoslovakia and Czernovitz in return for shares of those institutions, thus maintaining a permanent cooperation.

Based on a contract with a few French banks, the Österreichische Länderbank changed its name to Banque des Pays de l' Europe-Centrale and transferred its headquarters to Paris. The Anglo-Österreichische Bank transferred all its assets and changed its name to Anglo-Austrian Bank-Limited, Vienna branch.

16 Mitteleuropa-Institut, *Das mitteleuropäische Bankwesen* (Berlin/Vienna 1929), p. 13.

17 Kernbauer and Weber, p. 187.

18 H. Rutkowski, *Der Zusammenbruch der Oesterreichischen Credit-Anstalt für Handel und Gewerbe und ihre Rekonstruktion* (Bottrop 1934), p. 22.

This first wave of adjustment of the Austrian banking sector to the new political and economic realities in central Europe was finished by 1923. All in all, with the loss of the branches the Viennese banks lost the very profitable business with their – mainly industrial – customers. Those steady income streams were only partly replaced by volatile profits from their newly acquired participations in the new local banks. In light of their large banking organizations (and their costs), the Viennese banks had to look for additional business in the successor states or had to restructure their operations to fit the (small) size of their new home market, the 'new geography' of Central Europe. The new Austria had only about a fifth of the population of the 'old Austria'. Size mattered. But this necessary restructuring was, however, largely postponed by the speculative boom of the inflationary period that brought vast speculative activity in the foreign exchange business of the banks.

This speculative frenzy led to a mushrooming of new banks in Austria. After the stabilization of the currency and the collapse of the speculation against the French franc and the end of the stock market boom, a (first) wave of banking losses and collapses ensued. Many enterprises that had been established during the inflationary boom did not survive the following recessionary period. Banks had to take over large share holdings and suffered large losses themselves. Many had to be liquidated.

The most prominent victim was the Allgemeine Depositenbank, an institution with a history of more than 50 years. The Wiener Lombard- und Escompte-Bank and the Central-Boden-Credit-Bank also had to close. The Länderbank became – as mentioned above – a French bank as the foreign claims were swapped for equity (debt-equity swaps) and its headquarters transferred to Paris while the Anglo-Oesterreichische Bank became a British bank with its headquarters in London. In 1926, the Austrian business of this bank was then sold to the Credit-Anstalt. In 1927, two other large Viennese banks, the Union-Bank and the Verkehrsbank, were acquired by the Boden-Credit-Anstalt. In this way, these two banks became dominant in Vienna and almost regained their dominant pre-war position.[19] In addition to the loss of branches and markets, the hyperinflation of the early 1920s in Austria deprived the banks of assets, causing large losses. And they had to come to the rescue of the state, the provinces and the municipalities.

Already during the pre-war period some of the Viennese banks managed to forge strong ties with Western financial centres and institutions. Now, these links were very useful in order to create investor interest and to generate deposits or other funds. This Western capital was used for both investments in Austria but also for investments in the successor states. In this way, Viennese banks became intermediaries between the West and the East – taking all the risks. The Credit-Anstalt, for instance, had established ties to National Provincial and Union Bank of England and to Lazard Brothers & Co. in 1923. On the occasion of a capital increase, these institutions transferred sizeable amounts of CA shares to their portfolios.[20] The Boden-Credit-Anstalt had ties to the Solvay group in Brussels or with the Schweizerische Bankgesellschaft.[21] The Niederösterreichische Escompte-Gesellschaft had – for instance – the Banque de Bruxelles as one of its shareholders. The Wiener Bank-Verein had the Belgium Socièté Générale de Belgique and the Banque Belge as shareholders.

In 1925 the aggregate balance sheet of the seven largest Viennese banks was – at the time of their first 'gold balance sheets' after the hyperinflation – about 70 per cent below the level of 1913. Their equity had even shrunk by more than 76 per cent below the 1913-level. But their field of activity had not been reduced by this amount as they did not restrict their business to the new Austria but stayed very active in the new

19 The expectation of analysts – like the Mitteleuropa-Institut – that the process of rationalisation in the Austrian banking system had been finished with these mergers proved to be utterly wrong (see e.g. Mitteleuropa-Institut, p. 14).

20 Mitteleuropa-Institut, p. 14.

21 Mitteleuropa-Institut, p. 15.

successor states. Therefore, their capital base was rather small – and sometimes even overestimated as some of their securities holdings were valued very optimistically.[22]

After the collapse of the Austro-Hungarian empire the Austrian banks became financial intermediaries between the West and Eastern Europe. Short term deposits by Western banks were transformed into long term loans to Eastern European companies – mainly in the successor states. This way, Austrian banks could maintain their sphere of influence in this region despite the new political realities. However, they also became very vulnerable, depending on the investment policies of their Western creditors as well as on the commercial success of their Eastern debtors. In both areas, their direct influence was limited, making them subject to influences beyond their immediate control. A large scale international economic and financial crisis was bound to hit Austrian banks from both sides, drying off their supplies of capital as well as endangering the value of their assets. The idea was to combine foreign – i.e. Western – capital with the long-established knowledge of market conditions in the successor states by the Austrian institutions; Austrian know-how with Western capital was considered to be the winning combination. März speaks in this context of a 'missionary role' of the banking sector – maintaining a policy despite the very different conditions of the postwar period.[23]

Actually, the Viennese banks supported the catching up of the Eastern countries and their industries and so created additional competition for Austrian industial firms. Without the intermediation of the Viennese banks many of the Eastern and Balkan industries would not have received direct credit from Western financial markets. By taking the intermediation risks – serving as a risk buffer – the Viennese banks opened up the flow of Western capital to the Eastern industries. In order to save the 'too large' Viennese banking organizations, they promoted the industrial development of the successor states and neglected the financial needs of the domestic industrial sector.The resulting losses had, however, to be borne by domestic tax payers.

The Austrian banks had bad debtors but excellent creditors. Among the debtors were those industrial enterprises that did not receive loans from the newly established local banks. But among their creditors were the most prestigious banking houses of the US and the UK. The short-term loans from the West were very volatile while the long-term loans to the East were very immobile. The price for staying in the successor states was a very asymmetrical business strategy.

In October 1929, the Boden-Credit-Anstalt became a victim of this policy. It had committed grave management errors and had to be taken over by the Credit-Anstalt. The management of the bank had not managed to adapt the bank and its large apparatus to the new and limited political and economic realities in Austria. Especially its large industrial complex created many problems and losses. Nevertheless, the BCA paid the highest dividends of all Viennese banks.

The policy of the CA after the collapse of the empire was rather defensive.[24] It withdrew from its Eastern branches and sold off many of its holdings in the successor states. It accepted a severe shrinking of its current business, especially so in Bohemia and Moravia. In April 1919, it started with the sale of its first branches to local interests, like in Trieste to the Banca Commerciale Triestina. A few months later, the branches in Bohemia, Moravia and Silesia were sold off to the Bohemian Escompte Bank, and the CA became a minority shareholder in this bank.[25] With the sale of a large proportion of the branches, the number of personnel of the CA shrank from 2,185 in 1918 to 1,645 in 1919. Over time it managed to find new profitable business

22 OeNB 1991, p. 174.

23 März 1981, p. 543.

24 März 1981, p. 359.

25 März 1981, p. 349

opportunities in the successor states. One of those business areas – which started in 1919 – was the participation in issue syndicates for new shares both in Austria as well as throughout Eastern Europe.

By about 1920 the management of the bank turned optimistic as far as the future business opportunities of the bank were concerned. This optimism might have been based on the newly developed strong ties with Western financial partners as well as the rather satisfactory resolution of the issue of the assets in Czechoslovakia.[26]

Already in mid-1920, after prolongued negotiations, the CA managed to get US American banking houses – Warburg, Kuhn, Loeb & Co. and Guaranty Trust Co. – to participate in the augmentation of its share capital. A year later, Dutch capital joined the CA – bringing its foreign participation to about 14 per cent.[27] The strategy was pursued by the Viennese banks until 1931. The collapse of the Credit-Anstalt in May 1931 was, therefore, the 'tragic climax' of the necessary restructuring and redimensioning of the Austrian banking sector which had started in 1924 with the liquidation of the Depositenbank.[28]

Table 5: The (incredible) shrinking of the Credit-Anstalt.

| | | 1913* | 1925* |
|---|---|---|---|
| **Assets** | Cash | 44,4 | 6,7 |
| | Securities | 67,1 | 35,7 |
| | Bills of exchange | 291,5 | 25,0 |
| | Participations | 122,1 | 26,3 |
| | Advances for securities | 72,6 | -- |
| | Real estate | 16,1 | 7,5 |
| | Loans | 1086,2 | 370,1 |
| | Inventory | 1,0 | 0,9 |
| | | 1701,0 | 472,2 |
| | | | |
| **Liabilities** | Shares | 216,0 | 50,0 |
| | Reserves | 134,8 | 20,0 |
| | Acceptances | 72,5 | 1,5 |
| | Special Deposits | 115,6 | 19,6 |
| | Deposit liabilities | 1162,1 | 381,1 |

* figures in million schillings

Source: Rutkowski, p. 29.

## The Costly Outcome

With the advent of the Great Depression starting in 1929 the difficult situation of the Austrian banks in the successor states became even dangerous. After the problems of the Boden-Credit-Anstalt in October 1929 and its merger into the Credit-Anstalt (CA), the latter had 'inherited' the Eastern portfolio of a large part of the Austrian banking sector. When it announced its problems in May 1931, a considerable part of its difficulties resulted from impaired assets in the successor states.

The business policy of the CA – partly due to the inherited portfolio of the Boden-Credit-Anstalt – was by no means prudent. It had very large loans to individual companies. 'In Austria, the Credit-Anstalt could not have lost that much. The expansionary policy of the CA was the particular source of its losses.'[29] The CA

26 März 1981, p. 361.

27 März 1981, p. 353.

28 März 1981, p. 543.

29 See D. Stiefel, *Finanzdiplomatie und Weltwirtschaftskrise* (Frankfurt 1989), p. 99.

suffered heavy losses especially in the textiles industry and in the metallics industry of the successor states.[30] These were the more difficult industries which were not or only partly served by the local banks. The price for staying in business in the successor states was obviously to accept the high(er) risk enterprises as customers.

In 1931, about 40 per cent of the business of the Credit-Anstalt was foreign business. At the time of its collapse the CA had claims against the successor states of about 500 million schillings, about the same sum as it had debts outstanding in the West.[31] These claims against industry in the successor states amounted to 35 per cent of its loan portfolio.[32] Therefore, one way of solving the problems after the collapse of the CA could have been to transfer all assets in the East to Western creditors. But this avenue was not pursued. Rutkowski calls it 'grotesque' that the weak Austria had to bear – due to the policy of the Credit-Anstalt and the unfortunate rescue policies of the government – parts of the losses that Czechoslovaks, Romanians, Yugoslavs and Poles would normally have had to bear.[33]

As the foreign assets of the CA were of about the same size as its foreign liabilities, a limitation to Austria would have made foreign credit unnecessary for the bank, thus reducing its dependence on foreign financial markets. The profit opportunities might have been larger in the successor states but so were the risks. Finally, foreign assets had to be devalued by more than 60 per cent and among the ten largest debtors of the CA five were foreign firms.[34]

But there were differences among the Viennese banks. The other (four) large banks – apart from the Boden-Credit-Anstalt and the Credit-Anstalt – followed a much more cautious business model.[35] They limited their exposures to individual loans and did not let them rise above prudent limits. They were also very cautious with their foreign participations. For instance, they tried to lead credit syndicates in order to be able to limit the risks taken. The Niederösterreichische Escompte-Gesellschaft controlled banks in Poland, Romania and Southslavia.

The Viennese banks never managed – or maybe they did not even try hard enough – to transfer the risks from their Eastern debtors to Western creditors. As one consequence, the collapse of the CA had important repercussions on some of the debtors in the successor states as their link to Western capital was thus broken. But there were some opposing voices, arguing for a change in strategy. The Styrian economic programme of 1925, for instance, a programme of the Christian-social party in Styria, concluded that even after seven years the Austrian banks did not want to accept that the separation of the countries as stated in the Treaty of St. Germain would be permanent. And that they still hoped for a reunification and an elimination of the commercial and financial barriers. The program argued forcefully for a withdrawal from the successor states and a concentration of all capital resources in Austria in order to reduce interest rates in Austria, to strengthen the Austrian economy and to reduce dependence on foreign powers.[36]

Adjustment to a territory with only one fifth of the inhabitants of the former empire would have been necessary. Spitzmüller – then Governor of the Austro-Hungarian Bank – requested that the Viennese banks should give up their ambition to hold on to their positions in Central Europe. He suggested that the banks get rid of their assets in Czechoslovakia, Poland, Yugoslavia and also in Hungary. This way a vast amount of foreign exchange could have come into Austria, generating a solid base for the Austrian economy. However, in this case a reduction of the large banking apparatus would have been necessary. His ideas were not well

30 Federn, p. 411.
31 Federn, p. 414.
32 Rutkowski, p. 55.
33 Rutkowski, p. 113.
34 Stiefel 1989, p. 98.
35 Federn, p. 413.
36 OeNB 1991, p. 249.

received in the ministry of finance. Quite to the contrary, he was accused of not understanding the mission of the Viennese banks in Central Europe.[37] (Actually, some of the Viennese banks attempted to enlarge their sphere of influence in Central Europe, especially the Boden-Credit-Anstalt.)

## Evaluation of the Interwar Episode

In evaluating the interwar episode, we can use a framework of 'push' and 'pull' factors. First, the push factors:

**Too large to be profitable.** Due to the large apparatus that was inherited from before and during the war and the hyperinflationary boom as well as high taxes and social contributions, the Viennese banks were very unprofitable. In 1924 the Austrian newspaper, Reichspost, complained about the 'mammoth dimension' of the Viennese banking apparatus with its army of civil servants, which does not fit with the small state of Austria.[38] Therefore, the domestic business only generated losses. Nevertheless, dividends were paid, largely from hidden reserves.[39] The bad macroeconomic situation of Austria—low GDP-growth or even recessionary tendencies – did not help the banks either.

**Staying the course.** There was a strong inclination by many of the bank managers to try to remain in the traditional markets despite all the political changes. But it was only after the end of the hyperinflation and the stabilization of the currency that the Viennese banks managed to reestablish their ties to the successor states in a sizeable volume. But the character of the role of the Viennese banks had changed. They were not needed for regular current loans – those were supplied by the newly established local banks which also funded themselves locally. The Viennese banks became the creditors of those industries and enterprises that did not prosper (the 'lemons') – a negative selection occured. These were mainly in the textiles and in the metalls industries. That is also where the Credit-Anstalt ended up making its largest losses.

**Maintaining the status of Vienna as a regional financial centre.** Viennese banks – poor in funds – borrowed money on the capital markets of Western Europe – mainly short-term funds – and lent them to industry in the successor states. In such a way, Vienna served as an intermediary between the West and the East. Due to their good reputation they managed to raise funds at very favourable rates in the West and then to pass them on to the East with a sizeable profit margin. This was initially a lucrative business. But with the deteriorating economic development these loans started to be frozen just at the time their domstic business got rough. They were caught from two sides simultaneously.

**Ambitions of the bank managers.** '[...] with a restriction to the Austrian economic area we would not have found an adequate field of operations for an institution like ours [the Credit-Anstalt]'.[40] The bank managers of the Viennese banks would not want to accept a redimensioning of their fields of operations to the small Austrian territory and they held on to the dream of Vienna as the financial capital of the Danube states. Rutkowski calls that 'the tragedy of the Viennese bank managers'.

**Preserve existing relationships.** Viennese banks had established over many years an intensive knowledge of their Eastern European customers. After the collapse of the monarchy, they wanted to take advantage of their expertise and therefore maintain their existing relationships to the largest extent possible.

**Availability of central bank credit.** There was the repeated claim – e.g. in 1923 – that the Viennese banks used credit from the central bank to finance their industrial holdings in the successor states. In addition, the banks were accused of keeping, via this export of capital, the interst rate level in Austria unnecessarily

37 A. Spitzmüller, '*...und hat auch Ursach, es zu lieben.*' (Wien 1955), p. 332.

38 Reichspost, 10.2.1924.

39 Federn, p. 412.

40 Citation from the Annual Report 1930 of the Credit-Anstalt, see Rutkowski, p. 58.

high.[41] Some even argued for a special on-site inspection of the banks' records by the central bank in order to monitor the use of central bank loans. The management of the central bank implicitly welcomed the activities of the Viennese banks in the successor states. In light of the large debt relative to the Western financial centres they welcomed the existence and growth of balancing assets in the East. But there were also warning voices. In 1924, the central bank started to offer foreign exchange forward transactions as well as repos to the banks in order to reduce or even eliminate the foreign exchange risks of the foreign loans they raised in Western markets.[42]

A number of pull factors should also be considered:

**Large capital needs of the successor states promise high rates of return.** The successor states needed large amounts of capital in order to build up their industries after WWI and local savings were not sufficient to cover those needs. The scarcity of capital promised high rates of return.

**Existing presence in the region (branches).** The sale of the existing branches of the Viennese banks to (partly newly established) local banks resulted in the participations of the Austrian banks in the region.

**Existing relationships to enterprises and managers.** Over the many years of presence and business in the region, Viennese banks had built up a network of business contacts from all over the countries of Central and Eastern Europe. There was a strong pull from those institutions and firms.

**High reputation of the Viennese banks.** After the war the Austrian banks were quick to re-establish these relationships which, prior to 1914, had united Vienna with the large financial centres of the world. The traditions of the Viennese credit institutions and the manner in which they acquitted themselves, under peculiarly difficult conditions, of their pre-war obligations towards ex-enemy countries, inspired confidence abroad and materially assisted in re-linking Austria again to international finance.[43] Therefore, they managed to raise funds in Western markets for very favourable rates. And they had a good professional reputation in many of the successor states.

**'Lemons' needed capital, too**. Industries with lower profitability were not served adequately by the local banks – they were a chance for the Viennese banks looking for new customers in these now very competitive markets. But the increased risks were – in the end – not adequately covered by the margins charged.

## III.

From the end of WWII up to about 1970 the external activities of Austrian credit institutions were essentially limited to handling cross-border payments, while their main focus was on rebuilding local business after the disruptions of the war, and on expanding business in the home market. In the early 1990s, Austrian businesses started to reach out to international markets and to intensify their export activities. In due time, the growing external activities of Austrian enterprises required credit institutions to follow their customers abroad and to internationalise their business as well. As a result, they started to establish representative offices in the new markets. The international significance of Austrian credit institutions remained low, however. For instance, in terms of total assets, Austria's biggest bank at the time, Creditanstalt-Bankverein,[44] ranked ninety-eighth amid the top 200, and the largest savings bank, Zentralsparkasse und Kommerzialbank Wien, ranked one

41 OeNB 1991, p. 125.

42 OeNB, 1991, p. 148.

43 Sokal et al., p. 172.

44 In 1997, the Creditanstalt was taken over by Bank Austria, itself the product of a merger between Länderbank and Zentralsparkasse (from 1991). In 2000, the Bank Austria merged with the German HypoVereinsbank. Both institutions became part of the UniCredit Group in 2005. The name of the Bank Austria was then changed in 2008 to 'UniCredit Bank Austria AG'.

hundred ninety-eighth. Building international banking know-how was a gradual process, and the number of representative offices and subsidiaries abroad was slow to grow.

Initially, establishing business relations with so-called correspondence banks was the avenue of choice for Austrian banks tapping external markets. Correspondence banking involved running mutual accounts, exchanging information at regular informal meetings, and – once confidence was firmly anchored – granting each other autonomous decision-making power to issue letters of credit and settle foreign exchange transactions. Creditanstalt alone established a network of approximately 6,500 foreign bank correspondents at the time, for instance, and the Girozentrale und Bank der österreichischen Sparkassen AG had a network of some 3,700 correspondent banks.

When Austrian banks started to acquire stakes in foreign banks in the mid-1980s, such transactions were still subject to a number of constraints. In most cases, they could buy only minority interests (usually below five per cent) in foreign credit institutions, as the banking supervisors of most states would not permit the sale of interests other than minority interests. There was widespread concern that foreign investors controlling domestic interests might gain too much power and usurp the decision-making process. Some countries went so far as to prevent any acquisition of interests by foreigners. By the mid-1980s, Creditanstalt held the highest number of minority stakes (13) among all Austrian banks, whereas the other large banks – Länderbank, Girozentrale and Genossenschaftliche Zentralbank (Raiffeisen) – held only four each.

At the same time, banks established more representative offices. Between them, the five major Austrian banks had approximately 25 such representative offices in the mid-1980s. Geographically speaking, those representative offices were concentrated in the big international financial centres, namely Frankfurt, London, Milan and New York. By the mid-1970s, the first direct banking contacts to Eastern Europe had been established. The geographical closeness, the business ties across the Iron Curtain and the political neutrality of Austria helped to start this process. The Creditanstalt was the first Western bank to reach out to Eastern Europe by opening a representative office in 1975 in Budapest. It remained alone for more than eleven years until Raiffeisen followed to Hungary by founding Unicbank (what is today Raiffeisen Bank Hungary), the first Western bank in the region. In 1987, still before the opening of the East, Creditanstalt established other representative offices in Prague as well as Moscow, while the Länderbank opened such an office in East Berlin.

Table 6: Chronology of Austrian Banks Moving Abroad 1985-2008.

| | **1985** | **1990** | **2000** | **2008** |
|---|---|---|---|---|
| **Representative offices** | 25 (2) | 29 (5) | 60 (21) | 52 (3) |
| **Subsidiaries** | 6 | 8 | 24 (3) | 121 (-) |
| **Majority interests** | - | 13 (1) | 67 (38) | 98 (30) |

The figures in parenthesis indicate the number of banking offices in CESEE & CIS countries.

## III.1

The autumn of 1989 completely changed the face of Europe. The post-war division of the continent by an Iron Curtain suddenly and rather unexpectedly ended. In November the Berlin Wall came down. The Austrian banks were also surprised by these developments. Suddenly, the Eastern part of Europe was potentially open for business – a unique chance to expand into territories where the Viennese banks had been before. History gave them a new chance.

However, for the moment the main focus continued to be on the world's major financial centres as well as on a number of Asian countries (Hong Kong, Singapore, Tokyo, Beijing). It took some time to readjust the business strategies towards the potentially newly extended home markets east of Vienna. Over time, however, Austria's major banks recognised that their earnings prospects were limited in the Western and Asian markets and at the same time subject to comparatively high risks, given that they were after all small banks by international standards. They lacked the financial strength to compete with the big players in international financial markets, so that they refocused their activities on the domestic market but – at the same time – started to a limited extent to expand to the east.

Hungary and Budapest were the first targets. In 1990, the Zentralsparkasse started with its first operational subsidiary in Budapest, the Europai Kereskedelmi Bank (EBK) while the Creditanstalt also established a bank, Creditanstalt RT, there. The following year, 1991, the Creditanstalt opened in Prague and in Warsaw (as the first foreign bank in Poland), while the Länderbank opened the first foreign bank in the former Yugoslavia in Ljubljana and the Volksbank established a subsidiary in Bratislava.

While this first wave of expansion after the fall of the Iron Curtain was in the form of newly established institutions ('green field investments'), 1992 brought the acquisition of a Slovenian bank, Nova Banka, by the Creditanstalt. In the following years, especially after 2000, such acquisitions would become the major avenue of eastward expansion of the Austrian banks.

The year 2000 marked a paradigm shift in the business strategies of Austrian banks. Since the domestic banking market was more or less saturated, and since the conditions of doing business in Eastern Europe had changed dramatically after some ten years of transition after the collapse of the communist regimes, Austrian banks entered the Eastern European market by buying major interests (often 100 per cent) in local banks in ever bigger numbers. In 2000 alone, ERSTE Group, Raiffeisen Zentralbank and UniCredit Bank Austria acquired stakes in a total of 16 foreign banks in Eastern Europe.

The strategic decision to go east in such a big way was not only motivated by the low levels of banking services in those countries and the opportunities offered by privatisations but also by the fact that a number of Eastern European countries had already applied for EU membership in the mid-1990s: Hungary and Poland in 1994, Bulgaria, Romania and the Slovak Republic in 1995, and the Czech Republic and Slovenia in 1996. The prospect of EU membership and of participation in the single market for those countries, too, encouraged above all the big players in the Austrian banking sector to increase and speed up their engagement in Eastern Europe.

ERSTE Group, for instance, started its eastward expansion as a late comer in 1997 with the acquisition of the Mezöbank in Hungary. Its business policy was from the start to acquire retail banks and to aim for a market share of at least ten per cent in each market. In the year 2000, the bank expanded to the Czech Republic (by acquiring the Česká Spořitelna) and in 2001 to Slovakia (by buying the Slovenská Sporiteľňa). With the purchase of the largest Romanian bank, the Banca Comerciala Romana in 2005 another such major acquisition in the retail banking area followed. In 2007, the next wave brought the ERSTE Group to Ukraine and then in 2008 to Russia.

Under the policy of seeking to buy shares in foreign banks over the years, ERSTE Group, Raiffeisen Zentralbank and UniCredit Bank Austria had acquired in several waves interests in around 45 foreign banks by 2008, mostly in Eastern Europe. These foreign subsidiaries now surpass their mother institutions in many respects. In 2008, the consolidated total assets of banking groups resident in Austria totaled close to EUR 1,000 billion. The foreign subsidiaries of Austrian banks in the Central Eastern Europe(CEE)-area and in Central Asia accounted for approximately 32 per cent of this volume and their share of claims on nonbanks came to around 38 per cent. At the same time, the foreign subsidiaries contributed almost 69 per cent of the consolidated profits of Austrian banking groups, and more than half of their fee-based income. Even more striking is the contribution of CEE and Central Asian subsidiaries to the consolidated profit for the

| Table 7: Subsidiaries of Austrian banks by host countries, 2008. | |
|---|---|
| **Country** | **Total** |
| Croatia | 8 |
| Hungary | 8 |
| Bosnia and Herzegovina | 7 |
| Malta | 6 |
| Serbia | 6 |
| Slovenia | 6 |
| Czech Republic | 5 |
| Romania | 5 |
| Slovak Republic | 5 |
| Russian Federation | 4 |
| Ukraine | 4 |
| Liechtenstein | 3 |
| Switzerland | 3 |
| Bulgaria | 2 |
| Germany | 2 |
| Poland | 2 |
| Albania | 1 |
| Antigua and Barbuda | 1 |
| Belarus | 1 |
| France | 1 |
| Italy | 1 |
| Kazakhstan | 1 |
| Kyrgyz Republic | 1 |
| Latvia | 1 |
| Montenegro | 1 |
| Macedonia | 1 |
| Cyprus | 1 |
| Cayman Island | 0 |
| Tajikistan | 0 |
| Total | 87 |

year: 91.5 per cent.[45] This implies that the economic success of Austrian banking groups in Austria itself is fundamentally dependent on the profitability of their holdings in CEE and Central Asia.

Last but not least, Austrian banks are major employers. The home-market headcount of Austria-based banks has been rising for years and totaled almost 80,000 on 31 December 2008, whereas Austrian banks' foreign subsidiaries had close to 140,000 people on their payrolls on that date.

## III.2

An assessment of how the international orientation of the Austrian banking sector evolved after the end of communism and the fall of the Iron Curtain shows again that there were essentially two kinds of driving forces at work: push factors and pull factors. But it is also relevant to see that the business strategies followed

45 'CEE and Central Asia' includes 31 countries: Albania, Belarus, Bosnia-Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Macedonia, Montenegro, Moldavia, Poland, Romania, Russia, Serbia-Montenegro, Slovak Republic, Slovenia, Turkey, Ukraine, Afghanistan, Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Mongolia, Tajikistan, Turkmenistan, Uzbekistan.

by the different Austrian banks were quite diverse. The Erste Group, for instance, started its venture to the east relatively late, in 1997, but with a very clear strategy focused solely on the retail business. It only felt 'pulled' into the region once the economic transition had reached the stage where a large scale demand for retail banking services had developed. In addition, it waited until the European Union prospect had become concrete enough. It then made major acquisitions ('mergers and acquisitions'–strategy). On the other hand, Raiffeisen had a strategy to enter the new markets early as a pioneer and ahead of the competition and then to expand locally. Until 2000, its expansion was pursued organically, exclusively by founding banks ('green field investment'). The business strategy was aimed at corporate banking and investment banking services, however, not only servicing international corporations but also the local business community. Only from 2000 on did it start to acquire leading local banks and to expand into the retail segment. A very decisive event for the role of the Austrian banks in Central and Eastern Europe was the Russian financial crisis of 1998. While many other Western banks withdrew after their losses from that region, the Austrian banks stayed and showed this way their long-term commitment to the region. Again, evaluation can be considered by looking at first, pull and second, push factors:

**In the slipstream of Austrian businesses.** In the early years banks went abroad in the slipstream of Austrian businesses in order to assist them in doing business in the post-communist states – they were pulled into the new markets by their customers. It is, however, a fact that banks have been more successful in establishing a foothold abroad when they did so at their own initiative rather than driven by demand from Austrian companies. The high profit share that foreign subsidiaries contributed to the consolidated results of Austria-based banking groups in 2008 is strong evidence to this effect.

**Undersupply of banking services.** After 40 years of a socialist economic system, the countries of Eastern Europe suffered from an almost total lack of (modern) basic banking services. The share of loans relative to GDP, for instance, was and still is far below the shares in Western Europe, offering a considerable growth potential for efficient banks. Therefore, there was a demand and a market for Western banking services and technology and the Austrian banks were ready to supply those services to businesses and private entities.

**The lure of high margins.** Strong demand for modern financial services and still limited competition have enabled higher margins – at least for a few years – than in the saturated markets of the West.

**The European growth region of the future.** The process of catching up with the West will generate economic growth rates in Eastern Europe in excess of those in the Western markets for many years. Even short-term transition problems will not alter this long-term trend. Parallel with this stronger growth financial services will also expand above average.

**Privatisation of banks.** Many of the existing banks in transformation countries were privatised by the respective governments and Austrian banks used those opportunities to buy into the market. In this way they were pulled into the countries.

**European Union membership prospect.** From the mid-1990s on, it became clear that the countries of Eastern Europe aimed for an eventual membership of the European Union and of the single market. This prospect of legal as well as economic convergence with European standards made them an even more attractive market for Austrian banks.

The push factors are overwhelmingly domestic in nature:

**Overbanked and low-margin home market.** The domestic banking market of the Austrian banks has been characterised by a very large number of institutions and a rather fragmented market. With more than 850 banks in the country Austria is usually classified as 'overbanked'. Competition is very fierce and therefore gaining additional market shares is very hard and costly. The sudden opening of the East and new markets in the close neighbourhood made the banks move abroad on their own initiative in an effort to conquer these new markets. The size of the respective market, they realised, matters after all. Expanding to the Eastern neighbours was therefore a golden opportunity to escape from this highly competitive and relatively low margin environment.

**High savings rate and rising current account surpluses in Austria.** Austria has been characterised by relatively high savings rates in excess of ten per cent. In addition, the Austrian economy managed a transition from a current account deficit towards a continuous surplus in the early years of the twenty-first century. Thus, the country turned into a net capital exporter. Central and Eastern Europe was one of the regions receiving a large part of those capital exports.

**Economies of scale – similar financial products for similar economies.** The Austrian banks' financial products are geared to the needs of the Austrian economy. With the economic transition in Eastern Europe moving ahead fast the economic structures approach Western European standards. Therefore, the demand for financial products will be rather similar, allowing for the export of tried products. The large scale export of low interest rate foreign currency loans for housing finance to the different countries of Central and Eastern Europe is a case in point.

**Shareholders' pressure.** There are many reports of shareholders of Austrian banks putting pressure on the respective managements to generate higher income and consequently to accept higher risks. The Central and Eastern European markets with their comparatively large margins were the 'natural' field of operations to generate these higher returns. This 'no risk, no fun attitude' resulted in the accumulation of portfolios with high risk assets.

## IV.

The two episodes of eastward expansion of the Austrian banks show some similarities. First of all, the geographical region was almost the same, although during the second episode the expansion went further to the east, for instance to Kazakhstan. In addition, both episodes were characterised by a plethora of push as well as pull factors.

There are special challenges if a bank enters a foreign jurisdiction. Banking is a politically sensitive area of the economy. Government decisions concerning the financial sector might not always be based solely on economic reasons. There is a latent danger of unexpected heterodox policy measures by the respective national authorities, especially in times of economic and financial stress. Foreign (owned) banks are an easy scapegoat in such periods. Therefore, going foreign for financial institutions requires very professional risk management, including political risks. Austrian banks had to encounter that in both episodes – albeit to different degrees.

Banking expertise can be easily exported but needs to be adjusted to the specificities of local markets. While the basic product might be the same, adaptation to local customs and more might be needed. Going abroad or banking across borders is always combined with a transfer of knowledge and know how. The success of banking is intimately linked to the developments in the host economy—it cannot be separated from the overall economic success. There was in both episodes an understanding of the respective needs of the region and an adaptation of the business policies to those local needs. The origin from a small, open economy might have helped Austrian banks in their ability to adapt to different local specificities.

There are always push factors and pull factors, although they might differ in strength and in relevance from period to period and from country to country, and from institution to institution. But the two episodes of eastward expansion show many more crucial differences.

After the collapse of the Austro-Hungarian monarchy the goal of the Austrian banks was to maintain their commercial presence in a new – somewhat hostile – environment. It was a defensive strategy trying to defend a field of operation. After the collapse of the Iron Curtain there was a strategic decision to enter a new market, an offensive approach of conquering new commercial territories. The opening of Eastern Europe meant the opening of an area of up to 300 million people who did not yet enjoy any meaningful banking services – an underdeveloped area in terms of financial services. Enormous potential for a catching-up process was created with the need for a long-term commitment to the region – something the Austrian banks were ready to commit themselves to.

The level, intensity and style of competition were very different during the two episodes. While after WWI the Austrian banks were crowded out by newly emerging local banks, in the 1990s well established and capitalised Austrian banks with a high reputation entered markets that did not have commercial banks and were thus pioneers bringing modern banking services to countries unused to and therefore in need of such services. While in the 1920s the Viennese banks had to be content with serving the so called 'lemons', i.e. those firms and individuals who were not served by the local banks due to their risk profiles, they learned to cater for the best risks in the respective markets under the circumstances. While the loans to the industry in the successor states were refinanced by borrowings from Western financial institutions and markets, the loans of the subsidiaries of Austrian banks during the second wave are mainly refinanced by local deposits. More than 80 per cent of the loans are financed locally.

The business models were very different. After the dissolution of the Austro-Hungarian empire the Viennese banks tried to stay in business by converting their branches into local banks where they held some minority shares and by financing (some) foreign firms directly from Vienna. Now, they are present in the countries with their (fully owned) subsidiaries. Those subsidaries perform all segments of banking services to the local customers, households, businesses as well as governments. They offer the 'bread-and-butter business' of banking which was the domain of the local banks during the 1920s' episode. In addition, there is also a growing business of cross-border loans from headquarters in Austria.

Another important difference between the first and the second episode is the level of transparency. While the 1920s were characterised by an almost complete lack of reliable information about the size and the risks of the business (until it was too late), now a lot of reliable statistics exist on the size and the types of banking business in which the Austrian banks engage in Central and Eastern Europe.[46] Based on this level of information banking supervision is well established now, supported by a web of memoranda of understanding between the home and host supervisors. In the 1920s, in contrast, no meaningful banking supervision existed. The authorities limited themselves to ex-post crisis management.

The first episode is already history, the second is just developing and we do not yet know its end. It is being tested right now due to the financial crisis that the United States exported to Europe and also to Central and Eastern Europe. This crisis hits those transition economies very hard and throws them back somewhat on their path of catching up. But there is still an enormous potential for a catching up process and it will continue after the worst of the current crisis is over. Austrian banks play an important role in shielding these countries – at least partly – from the consequences of the crisis, e.g. by supplying their subsidiary companies in Eastern and South Eastern Europe with additional capital and liquidity. This shield of protection is strengthened by international initiatives and coordination, like the so called 'Vienna Initiative'.[47]

In sharp contrast to the interwar years of disintegration, the region of Central and Eastern Europe in the current period is integrating very fast. Ten of the countries have already joined the European Union (and two of them are even part of the euro area). Most of the other ones are in various stages of the EU accession process. The European Union prospect is a uniting factor and the benchmark to aim for. During the last few

46 This is, however, not a guarantee against the possibility to hide certain risks outside the balance sheet and so outside the view of the (home) supervisors.

47 See European Bank for Reconstruction and Development, *Transition Report 2009: Transition in Crisis?* (London 2009), p. 18.

years, these countries have been catching up fast in their level of economic development. After WWI, in contrast, the so called successor states were leaving the common monetary and economic zone – driven by nationalism, nostrification, protectionism and disintegration instead of advanced integration.

In addition, the exposure of the Austrian banks to the region is strongly diversified. Currently, there are 69 subsidiaries in 19 different countries. The International Monetary Fund – after comparing the role of foreign banks in the region of Central and Eastern Europe – concludes that '[t]here is a concentration of claims by individual home countries. For almost all creditor countries, 50 percent or more of their total claims on CESE are attributable to three host countries (this ratio rises to 80 percent in the case of Greece, Japan, and Sweden). Austria – the most prominent creditor to CESE – has the most diversified loan portfolio among the major home countries, with its three biggest CESE borrowers accounting for less than half of its total claims on the region'.[48] This way, there is a risk diversification across countries and across industries. During the first episode, Austrian banks were much more concentrated in a few countries and in a few industries. In addition, their current business model is based much more on 'bread-and-butter' banking than on participation in and lending to specific sectors of industry.[49] They maintain a very extensive network of branches throughout the region supplying retail services to the population and commercial customers. In addition, there is also cross-border lending from the home market to host markets.

After all, after twenty years of transition the countries of Eastern Europe are very diverse. They are no longer a homogenous region in terms of their economic development and their respective risk profiles. In the meantime, twelve of these countries are already part of the European Union, two of them even part of the euro area.

Finally, the economic situation of the home country, Austria, could not be more different. While during the interwar years Austria was a very poor country, tumbling from one economic crisis into the next with anemic growth, present day Austria is one of the richest countries in the European Union and even in the world, with high per capita GDP, low unemployment and even a comparatively low level of government debt – and with a strong international competitive position. In sharp contrast to that, in 1929 Austrian GDP per capita did not amount to more than 50 per cent of the US value and it had high unemployment and a protracted current account deficit.

## V.

Banking is always the management of risks. Reckless banking might sometimes exist but riskless banking never exists. Multinational banking entails more risks than purely domestic banking, but it also entails more opportunities. Banking in a geographical area close to the home market is potentially a natural extension of the domestic market. Political borders do not have to be banking borders – they can be overcome. However, the level of additional risks depends on the degree of political, legal and economic differences between the markets. Being in an economic – and even in a monetary – union with the host country reduces risks considerably while a break up of such an economic and political entity – like in the 1918/19-episode increases those risks considerably.

In the course of the twentieth century Austrian banks have experienced two fundamentally different episodes of expansion to the neighbouring countries to the east and south east. Trying to stay a major financial

48 A.M. Maechler and Li Lian Ong, 'Foreign Banks in the CESE Countries: In for a Penny, in for a Pound?', *IMF Working Paper*, WP/09/54, International Monetary Fund (Washington 2009), p. 17.

49 The Achilles' heel is, however, the high proportion of lending in foreign currency – mainly euros and Swiss francs, adding to the credit also a foreign exchange risk in some of these countries.

actor in the politically as well as economically very challenging or even hostile environment of post-WWI Central Europe proved to be a very costly adventure, both for the banks as well as for the Austrian tax payers.

Being a major financial actor in present day Central Europe, with the continent of Europe slowly growing together, both politically and economically, is a very challenging enterprise, but the longer-term chances far outweigh the risks. There might be temporary setbacks,[50] for instance due to negative external influences or due to inadequate risk control procedures that slow down the catching up process. But we observe very clearly that the framework of membership in the European Union or even in the euro area or a well-advanced membership prospect are crucial stabilising factors.

The current challenges appear to be manageable – in sharp contrast to the challenges during the interwar years. After all, the Austrian banks are in the main long-term growth-region of Europe and they are there to stay.[51] It is a long-term commitment based on the potential of a win-win situation for both, the banks as well as the host countries. This time the driving forces are based on an offensive, forward-looking strategy and not a defensive one. History will be the judge but, in any case, we see that the size of the market matters in banking – but the political framework matters just as much.

50 See, for instance, the large losses of the majority German owned Hypo Alpe Adria Bank and following rescue and take-over by the Austrian government in December 2009.

51 The growth projections of the European Commission of fall 2009 expect a speedy return to higher growth rates in the new EU member countries compared with the 'old' ones.

# The National Bank of Romania during World War I: The Influence of the Political and Military Context on its Operation.

Nadia Manea & Mihaela Tone

## Introduction

By 1914, the National Bank of Romania (NBR) had been running for almost three and a half decades, becoming during this period the axis of the Romanian banking system and deeply involved in the process of modernising Romanian society. By extending its network of branches to 32 at the outbreak of war, the NBR offered substantial support to the Romanian economy, but this situation began to change once the war started, as it was forced by circumstances to serve public finances. Many central banks of the European states involved in the war experienced similar pressures.[1]

## I.

The National Bank of Romania was set up pursuant to the law published on 17 April 1880,[2] a short while after Romania became independent (1877–1878). According to this statutory act, the National Bank of Romania was a joint-stock company with Romanian registered share capital of lei 30m (60,000 shares) and enjoyed the exclusive privilege of being able to issue bearer bank notes. The state owned a third of its shares, and two thirds belonged to private persons. The issuance power was granted for 20 years.[3]

In May 1880 a new act was published, called the 'NBR Statute',[4] which strictly regulated the operations the NBR was able to carry out. Although the content of this statute was successively amended, the list of the operations of the central bank remained unchanged. Thus, in 1913, just one year before the outbreak of World War I, the National Bank of Romania was able to carry out the following operations: discounting bills of exchange; promissory notes; treasury bills (in this case, limited to 20 per cent of the paid up capital); of vouchers and warrants; trade in gold and silver; collection of promissory notes; granting fund advances against gold or silver; cash advances in the current account or for short terms; deposits of national public drafts, land deeds or other securities guaranteed by the state; and receiving the amounts, titles, precious metals as well as gold and silver currency in the current account and on deposit. At the same time, the following operations were forbidden: loans against mortgages, industrial or trading shares or NBR shares; the direct or indirect share in industrial or trading enterprises; the possession of other real estates other than those strictly necessary for its services, as well as any other operations that were not mentioned in the two fundamental acts mentioned above. Thus, the National Bank of Romania was forbidden from granting loans to the state.[5]

The executive management of the National Bank of Romania comprised: the governor, the Board of Directors, the Censors Council and the General Council. The Board of Directors consisted of six directors and the governor. The governor had to be Romanian and was appointed by the government for a five year mandate. During his mandate as governor of the NBR, he could not hold any other public function; he could

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1 V. Slăvescu, *Istoricul Băncii Naționale a României (1880-1924)* (Bucharest 1925), p. 208.

2 'Legea pentru înființarea unei bănci de scompt și circulațiune.'

3 M. Tone and C. Păunescu, *Istoria Băncii Naționale a României în date, I (1880-1914)* (Bucharest 2006), pp. 12-3; 'Legea pentru înființarea unei bănci de scompt și circulațiune', in: G.C. Marinescu, *Banca Națională a României. Legi, Statute, Dispozițiuni monetare, Convențiuni financiare etc.* (Bucharest 1939), p. 328.

4 'Statutele Băncii Naționale a României'.

5 Legea și Statutele Băncei Naționale a României (Bucharest 1913), pp. 5-6, 18-20, 29.

not be a member of Parliament; he could not be involved in any trading activity; and he could not participate in the management of a trading company.[6] The six directors and the seven censors had to be Romanian. Four of the directors were elected by the General Assembly of Shareholders, and the other two were appointed by the government, all for a four year mandate. Of the elected directors, one had to retire at the end of each year, and of the appointed ones, each one had to retire every two years; the retirees were restricted from further appointment or election. In the absence of the governor, one of the directors was appointed by the government to the position of vice-governor for a one-year mandate. Four censors were elected by the General Assembly of Shareholders and the other three were appointed by the government for a four-year, respectively three-year mandate. Every year an appointed and an elected censor retired, but they were permitted to be elected or appointed again. The directors and censors appointed by the government could not be civil servants nor members of Parliament. The Board of Directors appointed the general secretary and cashier of the bank. The General Council appointed the Discount Committee.[7]

In addition to the demise of the governor Anton Carp in February 1914, the first year of World War I also marked a change in the management of the National Bank of Romania. During 1914–16, the government appointed only a vice-governor, namely the director Ioan G. Bibicescu (1849–1924). Only a few months after Romania entered the war, Bibicescu was appointed governor of the Central Bank in December 1916. He held this position until 1921 when he became honorary governor for the rest of his life (1922–4), a unique situation in the history of the NBR. Bibicescu studied law and economics in Bucharest and Paris, and practiced journalism for several years. He was member of the National Liberal Party, became member of the Romanian Parliament (in 1883) and finally councillor of the Bucharest mayor (1886–95). In 1895, Bibicescu was elected director of the National Bank of Romania; therefore by 1914 he had been working for this institution for almost two decades.[8]

As regards the relations between the NBR and the government, after the negotiations from 1900–1, the Romanian state withdrew as a shareholder of the bank. In consideration of the amount of lei 14.8m, the Society of Bank Shareholders took over the assets, liabilities and the rights of the state in the latter's capacity as holder of a third of the bank's shares. The privilege of issuance of the NBR was extended until 31 December 1930. Thus, in the first years of World War I, the NBR was a private bank, a status that it managed to preserve until 1925 when the Romanian state again became a shareholder. Even in these circumstances, the law stipulated the following: 'the government has the right to control all the operations of the bank. It has the right to oppose the implementation of any measure contrary to the law, the statute (of the bank) or interest of the state'. In this respect, the government was represented by a special commissary 'in charge with monitoring all the operations of the bank and especially the discount and bank notes issue, having the right to acknowledge the standing of businesses and to check the records and all the cashiers'. The commissary had the right to a consulting vote and could attend all the meetings of the bank's executive councils, but usually he attended only the meetings of the General Council. The balance between the bank's autonomy and state control was expressed in the provisions of article 100 in the 'NBR Statute': any modification of the status of the bank could be made only by the NBR General Assembly of Shareholders, specially convened to this effect; the content of these modifications should be previously published; in order to be valid, the shareholders' resolutions should be approved by two-thirds of the attendees; the number of the attending shareholders should represent at

6 Ibid., pp. 36-7.

7 Ibid., p. 28.

8 M. Isărescu, S. Rosentuler and S. Marițiu, 'Ioan G. Bibicescu. Viața și opera', in *Restitutio*, 5 (2005); C. Păunescu, M. Tone and N. Manea, *Istoria Băncii Naționale a României în date*, II (Bucharest 2009), pp. 366-7.

least a half of the issued NBR shares; at the same time, 'no modification of statute could be admitted without the approval of the government'.[9]

The modern national monetary system of Romania was created between 22 April and 4 May 1867 and was based initially on the two precious metals. Even Romania was not a member of the Latin Union yet, according to the 'Law on creating a new monetary system and on producing national coins'.[10] The metric decimal monetary system of the Latin Monetary Union was adopted and the leu became the monetary unit of Romania. A leu was defined as being five silver grams in weight, of the standard of 0.835 and having the following sub-multiple of banul: one leu = 100 bani. At the same time, the law set the value ratio between gold and silver at 1:14.38. Upon its creation, the National Bank of Romania was empowered to issue notes of lei 20, 100, 500 and 1,000. The General Council of NBR had the competence to establish their form, the manner of their issue and the quantity for every category.[11]

Pursuant to the laws adopted during 1890–92, the bimetallic system was replaced by the gold monometallic system. Since this time the monetary unit of Romania has remained the golden leu: 0.3226 grams in weight and having the standard 900/1000.[12] Article 35 of the 'NBR Statute' sets forth the content and size of the metallic reserve covering the notes issued by the bank:

> […] The bank shall have to possess a gold metallic reserve of at least 40 per cent of the amount of notes it issues. This limit could be reduced down to 33 per cent in exceptional circumstances and for a limited period of time, based on the request of the General Council of the Bank, approved by the Council of Ministers […]. Thirty per cent of the metallic stock of the National Bank could consist of first-rank bills of exchange on the English, German, French and Belgian markets […].[13]

Initially, in 1892, the bills of exchange were valid only on the English and German markets.

## II.

At the beginning of World War I, Romania was a parliamentary constitutional monarchy, ruled by King Carol I (1866-1914) and a government formed by the National Liberal Party. The prime-minister was Ion I.C. Bratianu. The old Kingdom of Romania was 138,000.00 square kilometres in area and had 7,160,682 inhabitants.[14] The territories along its borders were also inhabited by Romanians. These territories belonged to the neighbouring empires: Transylvania and Bucovina to Austro-Hungary and Bessarabia to Russia. In 1883, Romania signed a secret treaty whereby it joined the political-military block of the Central Powers (the Triple Alliance). The geopolitical status of Romania at the beginning of World War I was very complicated due to the fact that the territories inhabited by Romanians outside the borders of Romania belonged to both political-military groups. After the criminal attempt in Sarajevo, King Carol I convened the Crown Council in Sinaia, where, contrary to the King's opinion, the neutrality of Romania was decided. King Carol I requested Romania to enter the war together with Austro-Hungary and Germany. This opinion had only one

9 C. Păunescu, M. Tone and N. Manea, *Istoria Băncii Naţionale a României*, pp. 22-3.

10 'Legea pentru înfiinţarea unui nou sistem monetar şi pentru fabricarea monedelor naţionale.'

11 C.C Kiriţescu, *Sistemul bănesc al leului şi precursorii lui*, I (Bucharest 1967, reprinted 1997), p. 311; Legea şi Statutele Băncei Naţionale, pp. 8, 23.

12 C.C Kiriţescu, *Sistemul bănesc al leului*, I, p. 337.

13 Legea şi Statutele Băncei Naţionale, p. 22-3.

14 G. Iacob, 'Societatea şi economia. Procesul de modernizare', in: G. Platon (ed.), *Istoria românilor*, VII, II (Bucharest 2003), p. 56; I. Agrigoroaiei and I. Scurtu, 'Teritoriul, populaţia, starea de spirit', in: I. Scurtu and Gh. Ottu (eds.), *Istoria românilor*, VIII (Bucharest 2003), p. 31.

supporter, but the other members of the Crown Council were opposed. In his capacity as the constitutional king, Carol I accepted the decision of the Crown Council, although this conflicted with his feelings and opinions on the issue.

The same year in September, King Carol I died and his successor, King Ferdinand (1914–27) chose to extend neutrality. Gradually, it became obvious that neutrality was a temporary political solution: King Ferdinand and the prime-minister I.I.C. Bratianu promoted the idea that the country should enter into closer relations with the Triple Entente. This alliance had the advantage that it recognised Romania's rights with regard to both Transylvania and Bucovina. According to the plans of the political decision-makers in Bucharest, the neutrality period was considered a time interval that should be used for drilling and equipping the Romanian Army, in order to join the war when the time was right.[15]

In this context, the Romanian government needed substantial financial aid, which was difficult to obtain, given that the offer of loans on the international market decreased dramatically. Domestically, capital owners amassed currency and withdrew their money from banks. The solution consisted of appealing to the credit of the National Bank. However, legally the central bank was forbidden from granting loans to the state. Therefore, the management of the National Bank of Romania was under great pressure: on the one hand, according to the restrictions imposed by law; on the other hand, the necessity to support the state in achieving national unity. Under this pressure, in September 1914, the bank first adopted a temporary solution and lent lei 100 million with four per cent interest via the Deposit, Savings and Loans House to the government. Therefore the state was treated as any individual requesting credit from the bank, depositing as a collateral public securities, although no individual could benefit from such a preferential interest and such a large loan.[16]

After reviewing the possible solutions to this dilemma, the NBR management considered not only the illicit character of the operation but also the risks involved with the financial support of the state. Namely: one issue concerned exceeding the needs of the monetary circulation of the state; the other dealt with the adoption of a monetary issue policy, which in the new political and military situation could mean compromising the national currency. After serious debates and several negotiations with Emil Costinescu, the minister of Finance, the NBR General Council reached a compromise solution in their attempt to support the government but also preserve the monetary positions of the bank. This was expressed in the Convention on 20 December 1914/2 January 1915,[17] and concluded between the National Bank of Romania and the Ministry of Finance of Bucharest. This convention represented the new legal framework of the relations between the government and the bank, and was enacted by King Ferdinand I on 18/31 March 1915. Between the forced exchange rate of the leu, which would have reduced trust in the national currency, and the consolidation of the stock covering the gold, the second version was chosen. Therefore the compromise between the government and the bank was set out as follows: the loan granted to the government was included in the NBR operations, by a flexible interpretation of article 12 in the 'Law on setting up the NBR'; according to this article, the volume of issue was subject to the observance of the legal metallic covering; the government deposited as security gold bonds, which were to be released to the bank for an amount equivalent to the loan; the government undertook to deposit to the bank a metallic covering amounting to 33 per cent of the value of issue, which the bank was obliged to accept with a view to granting the loan; the government sold to the bank all the gold that it still had and prohibited an export of the gold until the loan was fully reimbursed;

15 A. Iordache, 'România în anii Primului Război Mondial', in: Gh. Platon (ed.), *Istoria românilor*, pp. 400-8.

16 L. Ionescu, *Relațiunile dintre Banca Națională a României și stat: 1880-1935* (Bucharest 1935), p. 122.

17 The reason for the two different dates given here (and in future references) is the difference between the Julian and the Gregorian calender. Until 1924, Romania still used the Julian calender. Whenever there are two dates given and marked with a slash in this paper, the first one refers to the Julian date, the second one to the Gregorian.

the bank was authorised to introduce in its metallic stock the bills of exchange and its liquidities abroad.[18] Forbidding the gold export, the NBR board manifested its intention to strengthen the Bank's gold stock, 'the sole covering which is ready to sell out anytime and accepted everywhere'. Thus, governor I.G. Bibicescu noticed: 'at the end of this war, there will follow a bloodless one, but of the same wilderness, for the attainment and possession of gold. Everybody will seek the gold, inasmuch as everybody will need it'.[19] For the same reason, the NBR governor insisted that the government accept the exportation of corn against the gold exclusively. However, for reasons of foreign affairs and efforts to cope with the neutrality requirements, the Brătianu government did not yet acquiesce to the proposal. At the same time, the introduction of the bills of exchange in the Bank's metallic stock meant the admission of a weak element to the very 'foundation' of the institution. In times of peace the usage of bills of exchange in the markets of London, Paris, Berlin or Brussels would be fully justified. In autumn of 1914, however, England, France, Germany and Belgium were engaged in war and, moreover, they had implemented restrictions to the exchange of foreign bills and blocked gold transactions. Even though hypothetically the bills of exchange were still assimilated to the gold, practically they were no longer able to fulfil the key condition described under article 34 of the 'NBR Statute', namely: 'the amount of circulatory notes has to be covered by easily feasible values'.[20]

Nevertheless, based on this solution, during August 1914 to August 1916, the National Bank of Romania granted four loans to the Romanian government, a total of lei 400 million.

Table 1: The loans National Bank of Romania gave to the government during the neutrality years (1914-16).

| No. | Convention date | Amount (in Lei) | Interest |
|---|---|---|---|
| 1. | 11/24 Sept. 1914 | 100,000,000.00 | 4 % |
| 2. | 20 Dec. 1914/2 Jan. 1915 | 100,000,000.00 | 4 % |
| 3. | 15/28 June 1915 | 100,000,000.00 | 3 % |
| 4. | 19 Dec. 1915/1 Jan. 1916 | 100,000,000.00 | 2,5 % |

Source: C. Păunescu, M. Tone and N. Manea, 'Istoria Băncii Naționale', pp. 27, 30, 38, 41.

Besides financing the military preparation of the country, from July 1914 to August 1916, the activity of the National Bank of Romania also included other actions determined by the new economic, political and military standing of the country: the intermediation of a loan to the Romanian government from the Bank of Italy; the intermediation of a loan to the Romanian government from the Bank of England; the intermediation of the sale of grains by the Romanian government to the German-Austrian-Hungarian consortium and to the English government; the management of the national loan of five per cent in April 1916; and the granting of some special loans to support agriculture.

## III.

The similar positions of Romania and Italy regarding international relations resulted in the conclusion of two secret agreements between the two governments concerning their attitude to the war (September 1914, January 1915). At the same time, the Romanian government ordered war materials from Italy. In order to

18 NBR Archive, Procese-verbale ale consiliilor de conducere ale BNR, file 145/1912-5, pp. 288-9v.

19 NBR Archive, Secretariat, file 3/1913-28, p. 55.

20 L. Ionescu, *Relațiunile*, p. 122.

pay for these military orders, it appealed to the NBR, which bought in the name of the government from the German market one million Italian liras at the exchange rate of lira 100 to 87 mark (November 1914). At the same time, the NBR negotiated a loan of ten million Italian liras granted by the Bank of Italy to the Romanian government, 'against treasury bills', for a year, with an interest of 6.5 per cent. The bills were valued at 75 per cent (1/14 December 1914) of the value of the loan. The NBR carried out these operations for free, requesting only the defraying of the expenses effectively made.[21]

On 8/21 January 1915, the Romanian government signed a loan agreement for five million pounds with the Bank of England. The granting of this loan underscored Romania's new foreign affairs orientation, while the National Bank was involved in the talks as a beneficiary as well. The first favourable signals arrived in Bucharest on 24 August 1914, when the British government sent a credit offer to the Romanian finance minister, through George Barclay, British ambassador to Romania. Later on, a delegation of two Romanian representatives – one of them director of the National Bank of Romania – went to London where they held talks with Lloyd George, British Finance Minister, and with Bank of England officials. Due to wire transmission difficulties from London to Bucharest, the negotiations advanced slowly, yet they managed to agree an accord. In accordance with this agreement, the loan was secured against treasury bills issued by the Romanian government, which were discounted at the Bank of England with an interest rate of five per cent for twelve months, with the possibility to extend it for a year and falling due within a year after the announcement of peace. Great Britain never asked the Romanian government to produce a formal declaration of involvement on the side of the Allies, but made a prerequisite for granting the loan that the money cannot be employed to buy weaponry and ammunition to be used against the Allies. The Romanian government used this money to fulfil its obligation under the terms of the convention signed with the NBR in December 1914. This convention stipulated the government's commitment to ensure that the metallic stock was within legal limits required for the issue of banknotes and covered the loan the government had with the NBR. Therefore, the five million sterling pounds never left the Bank of England treasury, but they were deposited in the NBR's account. According to the April 1915 encoded telegram exchanged by I.G. Nairne,[22] chief cashier with the Bank of England, and the governor I.G. Bibicescu, the first instalment in the amount of £500,000 in gold was effectively deposited in the NBR account. The Bank of England took one eighth per cent per year for this service.[23]

## IV.

The outbreak of war and the involvement of Turkey and Bulgaria on the side of the Central Powers determined the economic isolation of Romania, which could no longer export its agricultural products through the two traditional means: neither along the Danube nor by crossing the Bosphorus and the Dardanelles straits. Thus, after obtaining very large crops of wheat and corn both in 1914 and in 1915, Romania was under threat of economic suffocation, especially given that it lacked the infrastructure required both for storing these grains and for transporting them by land.[24] That was the reason why Romania became the scene where a different type of war was fought, the economic one, in which the representatives of the Central Powers bought grain and other raw materials for very low prices within the country. By the end of 1914, the NBR proposed to the

21 NBR Archive, *Consiliile de conducere*, file 145/1912-15, pp. 184-4v; A. Iordache, *România*, p. 407.

22 NBR Archive, *Consiliile de conducere*, file 145/1912-1915, pp. 228v-9v.

23 I. Mamina and I. Bulei, *Guverne și guvernanți 1866-1916* (Bucharest 1994), pp. 151-2; Gh.M. Dobrovici, *Istoricul desvoltării economice și financiare a României și împrumuturile contractate 1823-1933* (Bucharest 1934), p. 293; C. Păunescu, M. Tone and N. Manea, *Istoria Băncii Naționale*, pp. 118-22.

24 C.I. Băicoianu, *Istoria politicei noastre monetare și a Băncii Naționale a României*, III (Bucharest 1933), p. 63.

Romanian government the regulation of the export of agricultural products, possibly to impose payment in gold for grain. This solution was initially rejected by the government, which did not wish to raise the suspicions of Germany and Austro-Hungary. Gradually the attitude of the Romanian government changed and a law whereby foreign importers were obliged to pay a fee in gold for agricultural products bought in Romania was adopted in February 1915. The organisation of the German-Austro-Hungarian consortium comprised three organisations that acted as a unit in the names of the states forming the Central Powers: Zentraleinkaufsgesellschaft in Berlin, Kriegs-Getreide-Verkehrsanstalt in Vienna and the Kriegs-Produkten-Aktiengesellschaft in Budapest. These organisations acted as a sole purchaser of Romanian products, for the purpose of imposing low prices, as well as for avoiding the payment of the fee in gold. This was the consequence of speculation in the border area which led the Romanian government to impose a monopoly over the sale of agricultural products by forming a Central Commission led by the Minister of Agriculture. It included a representative of the NBR. Thus, the monopoly of the Central Powers over purchases was opposed by the Romanian state monopoly over sales of the Romanian. The contracts between the German-Austro-Hungarian consortium and the central commission in Bucharest also included some provisions involving the National Bank of Romania. Firstly, with regard to the mediation of payments, the consortium accepted to pay in lei but in order to acquire the NBR notes, the National Bank of Romania undertook to sell them in marks, at the exchange rate of lei 120 for 100 marks. These marks were to be sold at the same exchange rate and for a commission of two per cent to the Romanian government, which needed them for paying its annuities. Secondly, the export fee that had to be paid by the importer in gold coins had to be deposited, half of it to the Reichsbank into the NBR account and another half to the National Bank of Romania. If the value of this fee exceeded lei 25 million, this was to be deposited in material gold in Bucharest. We should mention that the gold that entered the covering reserve of NBR in this way was paid by the bank to the Romanian state.[25]

**Table 2:** NBR covering stock evolution between 31 December 1913 and 31 December 1916 (in lei)

| Date | Metallic stock | Gold bills of exchange and available cash | Total stock |
|---|---|---|---|
| **31 Dec. 1913** | 151,510,764.2 | 56,534,181.0 | 208,044,945.2 |
| **30 Jun. 1914** | 154,223,015.8 | 56,598,388.9 | 210,821,404.7 |
| **31 Dec. 1914** | 153,956,720.0 | 62,941,120.4 | 216,897,840.4 |
| **30 Jun. 1915** | 187,968,411.0 | 71,036,292.0 | 259,004,703.0 |
| **31 Dec. 1915** | 218,987,258.0 | 80,980,132.0 | 299,967,390.0 |
| **30 Jun. 1916** | 433,542,887.0 | 80,980,160.0 | 514,523,047.0 |
| **31 Dec. 1916** | 491,831,744.0 | 80,980,160.0 | 572,811,904.0 |

Source: G.V. Stoenescu, E. Blejan, B. Costache and A. Iarovici, 'The National Bank of Romania and its issue of banknotes between necessity and possibility, 1880-1914', in: *SEEMHN* (Bank of Greece 2008); *NBR Archive*, Consiliile de conducere, file 154/1915, pp.174; C. Păunescu, M. Tone and N. Manea, 'Istoria Băncii Naționale', pp. 593-4.

At the same time, the NBR mediated the payment of 80,000 wheat wagons bought by the English government from Romania in January 1916. Thus, the NBR paid for wheat which was bought by the English government and stored on the territory of Romania. In return, the English government opened a deposit for the NBR at the Bank of England containing ten million pounds, a third of which was in material gold.[26] The suspension

25 ABNR, *Consiliile de conducere*, file 152/1915-18, pp. 28-41; C.I. Băicoianu, *Istoria politicei*, pp. 108-12; I.G. Bibicescu, *Opt ani în Banca Națională a României* (Bucharest 1921), pp. 14-8; C. Păunescu, M. Tone and N. Manea, *Istoria Băncii Naționale*, pp. 158-61, 162-6.

26 C. Păunescu, M. Tone and N. Manea, *Istoria Băncii Naționale*, pp.146-7.

of the gold free exchange and the gold taxation for the exportation of grains permitted the NBR to triple its own gold stock.[27]

In the years when Romania maintained its neutrality, the National Bank of Romania also granted several special loans meant to support Romanian agriculture in consideration of the direct relationship between grains export and its metallic stock. Thus, the credit used for this economic sector were as follows: September 1914 – lei 20 million in the form of loans granted to trading banks, which undertook to lend to farmers with an interest rate that could not exceed the NBR discount fee by more than a maximum two per cent and without any commission; January 1915 – lei five million weekly for the warrant discount; May 1915 – lei 30 million granted by means of the Loan Against Pledge Office for Farmers and Industrialists, set up in March 1915; 1915 – lei ten million for the construction of grains storage buildings in railways stations.[28]

All those actions had a certain degree of efficiency and contributed to the gold covering stock augmentation. Yet the national currency could not evade depreciation. This translated into an increase in internal prices, a gold premium exchange, which reached 57 per cent by the end of 1916. The rates of foreign currencies continued to climb.[29] Since its establishment as the national currency, this was the first sizeable inflation of the leu.

## V.

The NBR's concern about withdrawing from circulation a portion of the cash in excess, growing military expenses and the government's intention to reduce the floating debt with the central bank led to the launch in 1916 of a national loan of five per cent. The loan was launched by the Romanian government with the law on 6/19 April 1916. It had been an initiative of the NBR. Pursuant to the law, the government was authorised to borrow from the domestic market a minimum of lei 150 million of which the NBR undertook to subscribe lei 52 million.

The idea to support the government's national objectives, and the favourable conditions offered by the government, received unexpected enthusiasm from the population. The loan terms were: the price of the issue was lei 84 for the value of lei 100 in nominal capital; the interest offered was 6.04 per cent a year; four terms were set forth for making the payments; the depreciation was to take place over 40 years; bearer bonds were issued in small nominal values, a fact that enabled persons with more modest financial means to invest their savings. Considering the advantageous conditions under this loan, in over a week lei 400 million had been subscribed and lei 310 million had been paid. The amount borrowed in this way by the Romanian state was paid by covering the loan with the NBR. Thus, a significant amount of notes were withdrawn from circulation and a part of the debt of the state to the National Bank of Romania was replaced by the consolidated debt of the state to individuals, a fact that contributed for a while to the stability of the currency.[30]

## VI.

After negotiations, Romania signed two secret conventions with the Triple Entente (a political and a military one) on 4/17 August 1916. While the Entente powers recognised the independence of Romania and its rights to incorporate the territories inhabited by Romanians in Austro-Hungary, Romania undertook to declare war

27 L. Ionescu, *Relațiunile*, p. 127.

28 C. Păunescu, M. Tone and N. Manea, *Istoria Băncii Naționale*, pp. 37-8.

29 N.C. Angelescu, 'Politica monetară', in: *Enciclopedia României*, IV (Bucharest 1943), p. 686.

30 NBR Archive, *Consiliile de conducere*, file 145/1912-5, pp. 46-56; C.I. Băicoianu, *Istoria politicei*, pp. 121-2; Gh.M. Dobrovici, *Istoricul desvoltării*, pp. 306-8.

| Table 3: The loans National Bank of Romania gave to the government during the war (1916–18). | | | |
|---|---|---|---|
| No. | Date | Amount (in Lei) | Interest |
| 1. | 21 Oct. / 3 Nov. 1916 | 300,000,000.00 | 2½ % |
| 2. | 12 / 25 Apr. 1917 | 300,000,000.00 | 2½ % |
| 3. | 19 Dec.1917 / 1 Jan. 1918 | 300,000,000.00 | 2½ % |
| 4. | 16 / 29 May 1918 | 300,000,000.00 | 1½ % |
| Source: C. Păunescu, M. Tone and N. Manea, 'Istoria Băncii Naţionale', pp. 48, 52, 61, 74. | | | |

on Austro-Hungary. On 14/27 August 1916, King Ferdinand convened a crown council at Cotroceni, which was informed about the content of the two conventions, and on 15/28 August 1916, the Romanian minister in Vienna presented the declaration of war of Romania to the Ministry of External Affairs of Austro-Hungary. The following day, on 16/29 August 1916, Germany declared war on Romania, and sent to Transylvania five infantry divisions and one cavalry division. In the following days, first Turkey (17/30 August 1916), then Bulgaria (19 August/1 September 1916) declared war on Romania. Thus, Romania was obliged to fight on two fronts with an insufficiently equipped and trained army. At the same time, the allies of Romania did not fulfil their commitments: the offensive of the general Sarrail from Salonika to the Danube did not take place and the operations of the Russian Army in Dobrogea were limited. The Romanian army was defeated on the Danube, at Turtucaia, and forced to retreat from Transylvania as well. After the last attempt to defend Bucharest failed, in November 1916 the Romanian army retreated along the Siret River, and the Romanian authorities left Bucharest. Parliament, government and the royal family relocated to Iasi.[31]

The consequences of war were felt immediately and fully by the National Bank of Romania. Its operations were seriously affected. Firstly, the NBR's assets (accounts included) held with banks in Germany and Austro-Hungary were frozen. Then, the 21 branches were evacuated in the autumn of 1916. The NBR treasury (amounting to gold lei 314,580,456.00) was moved to Iasi (September 1916) and then to the State Bank in Moscow (December 1916). The NBR central administration moved to Iasi (14/27 November 1916) and NBR headquarters in Bucharest remained a simple delegation with limited powers, comprised of two directors and two censors. Some clerks of the bank were mobilised to the front, where 21 of them died.[32]

In the two years after the retreat to Moldavia the National Bank of Romania faced a difficult situation. In order to stop the progress of the German and Austro-Hungarian armies along the axis of Focsani to Galati, the Romanian government continued to request new and substantial loans from the central bank. It took four more loans, each one to the amount of 300 million lei.

In April 1917, when the loans granted to the government reached lei 1,000 million, it was decided that leu convertibility should be suspended until the full repayment of these loans to the National Bank. On the occasion of negotiations for the sixth loan convention, the Minister of Finance, Victor Antonescu, declared that during the period October 1916–April 1917 the Romanian government could not comply with the agreement to deposit the necessary metallic covering for the previous loan of October 1916. Moreover, with regard to the new loan, the government affirmed its commitment to constitute provisions at London in favour of NBR, using no-interest British government bonds. Taking into account that 'the government has great restraints facing the country's needs and requests understanding from NBR', the governor I.G. Bibicescu 'accepted in principle the situation', but asked the government to undertake the obligation to replace the

31 A. Iordache, *România în anii*, pp. 420-1.

32 C. Păunescu, M. Tone and N. Manea, *Istoria Băncii Naţionale*, pp. 184-7, 188, 190-3, 205-6, 218, 222, 224.

British bonds, within a period of ten months, commencing upon the conclusion of the war and peace settlement. It was to take place via a transfer to London in pounds sterling, calculated at the rate of lei 25.22 to one pound sterling. Furthermore, 'estimating as a sacrifice NBR is offering to support the State in these difficult moments', I.G. Bibicescu agreed to 'the loss of the interest he should receive from London, had the government made his promised deposits according to the convention'. The main concern governor Bibicescu had was that the National Bank of Romania might not arrive at the limit or stay within its issuing limits 'because after the war the national bank may be placed in a complicated position, for itself and for the country, of being in the situation to help very little, if at all, the revival of national economic, commercial and industrial life, and this would be really terrible'. In the face of these warnings, Victor Antonescu communicated that 'both he and the government took into account these questions, and they recognise the strength of the advanced notices and promise to find the fastest possible way to alleviate the national bank's situation'.[33]

In the spring of 1917, the Central bank of Romania, now in refuge at Iasi, found itself in an untold hardship, but the following events brought consequences with them that were even more serious for the NBR. So, even the Romanian army recuperated with the help of the French mission led by General Henri Mathias Berthelot and in the summer of 1917 the Romanian army was victorious at Marasti, Marasesti and Oituz, stopping the German offensive at the gates of Moldavia. However, the events on the Eastern front had developed badly for Romania. In the autumn of 1917, the situation on the Eastern front became more complicated, following the outbreak of the Bolshevik revolution in Russia. More serious, in Moldavia fights took place between Romanian troops and troops of Bolshevik soldiers, and in January 1918 Soviet Russia broke diplomatic ties with Romania. The Romanian ambassador in Petrograd was arrested. In January 1918 Russia concluded an armistice with the Central Powers at Brest-Litowsk. Remaining alone on the Eastern Front, Romania also concluded an armistice and then the treaty of Bucharest (24 April/7 May 1918), but King Ferdinand never promulgated it.[34]

This situation seriously affected not only National Bank operations, but also brought serious harm to its assets. In July 1917, all banking transactions were suspended, the last agencies that still worked in the unoccupied territory were closed and the Board took into discussion the possibility of evacuating the central administration of the bank outside the country, namely to Russia. While the bank and its officials remained in Romania, its treasury was evacuated and transported to Russia in August 1917. The value of the second freight of NBR treasure sent to Moscow was lei 1,594,257,083.72, of which lei 574,523 was gold. From that time onward NBR activity was restrained to its central administration in Iasi, where the sole function became that of granting loans to the state. Gradually, under the impact of events on the front, government pressure had increased. In December 1917, the minister of Finance, Nicolae Titulescu, came to the bank and asked the NBR general council for a new loan of lei 300 million, while promising to deposit the reserve coverage when Romania received financial support from Britain, France and the USA. The general gouncil agreed to approve the loan, because they knew that two days later, on 18 November/1 December 1917, representatives of France, Britain and the USA were to meet in Paris to discuss a loan for the Romanian government. Indeed, the outcome of this meeting was to open a credit line for the Romanian government, totalling 20 million US dollars. It was to be provided in equal parts in US dollars, pounds sterling and French francs by each country. But the loan covered just a small portion of the debt accumulated by the Romanian government at the central bank. After half a year, in May 1918, the new conservative prime minister, Alexandru Marghiloman, came in person to the NBR. In the morning the general council was set to discuss the approval of a new loan of lei 150 million. The prime minister asked for nothing else but the double of that amount, i.e. lei 300 million,

33 NBR Archive, *Consiliile de conducere*, file 145/1912-5, pp. 146-51v.

34 A. Iordache, *România în anii*, pp. 437, 441-52.

promising government support for the interests of the National Bank at the financial conference in Berlin, whose organisation was planned in the treaty with the Central Powers and signed by the new government in Bucharest in May 1918.[35] By the end of the war, the total amount of the loans granted to the government by the NBR reached approximately lei 1,600 million (lei 1,596,101,555).

At the same time, in the occupied territory of Romania, the issuance power and the assets of the NBR suffered. Starting in January 1917, the German military administration in the occupied territory of Romania issued the occupation currency, also called the leu. The Romanian General Bank in Bucharest which had German capital was invested with the power of issuing these notes, based on a deposit in marks formed at the Reichsbank. The new currency represented the sole legal means of payment in the occupied territory, from where the German military administration withdrew marks but also the NBR lei. According to the resolution of the financial conference held in Berlin in October 1916, the issue of these notes was unlimited subject to the 'demand for notes'. The total value of this issue was approximately lei 2,144,727,958. In March 1917, NBR headquarters in Bucharest was seized by the occupational German authorities, which imposed a coercive administration on the NBR branch in Bucharest. This administration used NBR liquidities from the Reichsbank in operations, breaking the 'NBR Statute'.[36]

In June–July 1918, the financial conference in Berlin took place, where several provisions were adopted regarding the NBR, among which: any claim from the NBR to be compensated for the operations engaged in by the German coercive administration was to be rejected; the occupation notes issued by the Romanian General Bank were to be withdrawn and replaced by NBR notes within six months after signing the peace accord; the NBR was to be controlled by German military headquarters which were involved both in the management of the bank and in establishing the issue and making of payments.[37]

In the context of Germany being defeated by the Entente States on 10 November 1918, Romania declared war on Germany again. Following the collapse of the Russian empire, on 27 March/8 April 1918, Bessarabia decided to unite with Romania. After signing the armistice, Bucovina (15/28 November) and Transylvania (18 November/1 December 1918) also decided to unite with Romania. On 1/14 December 1918, the Romanian authorities and the management of the National Bank of Romania moved back to Bucharest.[38]

## VII.

Although the war took its toll as evidenced by both the number of the dead and wounded, and the extent of material damage, Romania obtained more than it meant to upon entering the war. However, the expenses and the total loss were huge. Thus in World War I the Romanian state spent almost lei 5,000 million of which 32.2 per cent in loans was granted by the NBR.

For these loans the Romanian government should have deposited with the NBR lei 499 million so as to cover the reserve required for the issue, but it could only deposit lei 179 million. The volume of circulation of NBR notes reached, on 31 December 1918, lei 2,489,145,311, namely 5.9 times more than on 30 June 1914, when it was lei 418,938,320. Of the approximate lei 2,500 million issued by the NBR at the end of 1918, lei 1,600 million had been absorbed by the debt the government had with the bank. To this volume of cash, lei 2,100

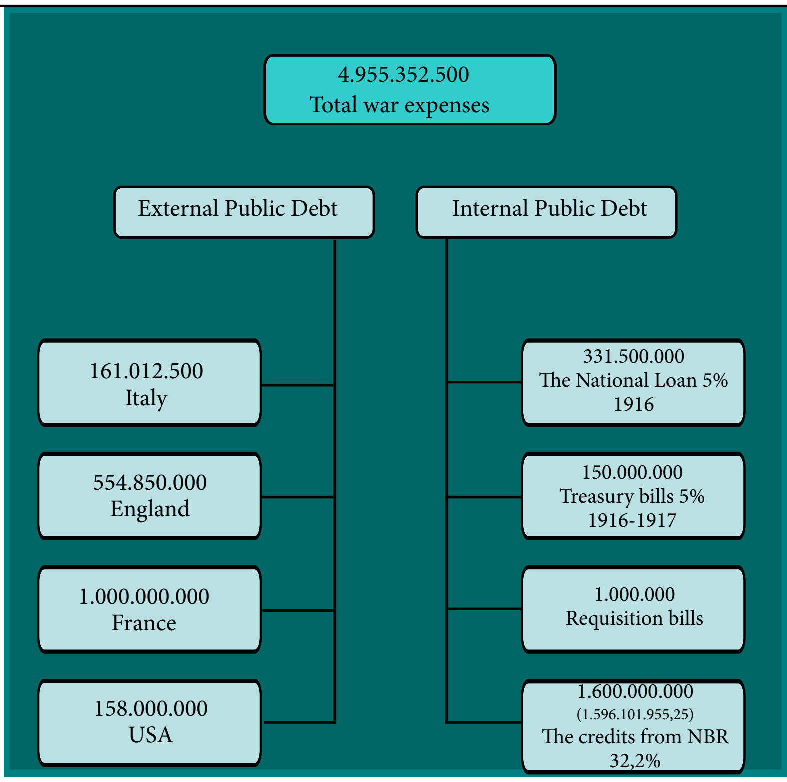
35 C. Păunescu, M. Tone and N. Manea, *Istoria Băncii Naționale*, pp. 58, 60-1, 272.

36 C. Kirițescu, *Istoria războiului pentru întregirea României (1916-1918)*, II (Bucharest 1922; reprinted 1989), pp. 294-5; C.I. Băicoianu, *Istoria politicei*, pp. 254-5; G.C. Marinescu, *Banca Națională a României*, p. 377.

37 C.I. Băicoianu, *Istoria politicei*, p. 371.

38 I. Agrigoroaiei, 'Marea unire', in: G. Platon (ed.), *Istoria românilor*, pp. 480, 498, 507.

**Figure 1**: The share of NBR's loans in the total warfare expenses of Romania's government during WW I (in lei).




Source: Gh.M. Dobrovici, 'Istoricul desvoltării', pp. 335; C. Păunescu, M. Tone and N. Manea, 'Istoria Băncii Naționale', p. 89.

million was issued by the Romanian General Bank in the occupied territory.[39] All these facts reflect the high inflation which affected the leu at the end of WW I, and which became worse in the following years.

The covering reserve of this issue developed from lei 210,821,404 on 30 June 1914 to lei 842,526,160.41 on 31 December 1918. Thus, the covering percentage was 50.7 per cent on 30 June 1914 and 32.2 per cent on 31 December 1918. The structure of this covering reserve was as follows: Deposited gold – lei 493,730,430.41 (that is 58.60 per cent of the total) of which lei 315,154,980.41 in Russia, lei 80,469,650 in Germany (Reichsbank) and lei 98,105,800 in England (Bank of England); Bills of exchange and gold available – lei 348,796,280 which comprised 41.40 per cent of the total, a percentage exceeding significantly the legal maximum admissible ratio of 30 per cent of the total reserve.

Thus, besides the fact that the gold reserve of the NBR was not in the country, the bills of exchange had too large a weight in this reserve. That is why the *Memorandum sur les monnaies (1913–1921)*, published by the League of Nations in Geneva in 1922, calculated the leu covering percentage only in connection to NBR deposited gold. The covering percentage obtained was 19.8 per cent.[40] Since the treasure evacuated in Russia has never been recovered, the above percentage was closer to reality.

Unfortunately, if for most European countries the year 1919 marked peace and therefore the beginning of reconstruction, Romania continued to have to mobilise its army and involved it in the campaigns against the communists of the Hungarian Bolshevik Republic of Councils. Consequently, at the end of 1918, neither Romania nor the National Bank in Bucharest reached the end of the ordeal. If by then, the NBR was able

39 N.C. Angelescu, *Politica monetară*, p. 685.

40 V. Slăvescu, *Tratat de bancă*, II (Bucharest 1931), p. 264.

Table 4: The average rate of US dollar on the Romanian Monetary Market (1920–1921) in lei.

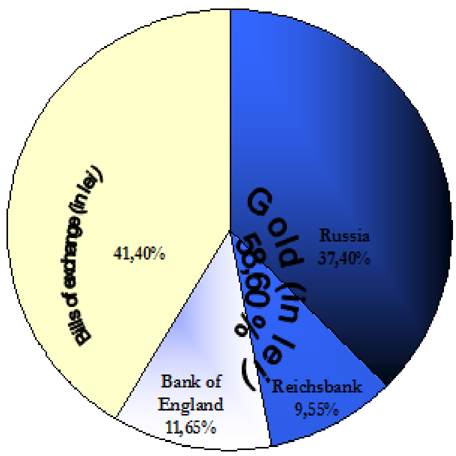
| Month | 1920 | 1921 |
|---|---|---|
| January | 45.6 | 73.9 |
| February | 67.6 | 72.1 |
| March | 65.5 | 72.2 |
| April | 64.9 | 63.5 |
| Mai | 59.8 | 56.4 |
| June | 43.6 | 61.4 |
| July | 37.2 | 69.1 |
| August | 39.9 | 73.9 |
| September | 46.6 | 97.9 |
| October | 51.3 | 130.6 |
| November | 64.8 | 158.5 |
| December | 68.6 | 136.1 |

Source: L. Ionescu, 'Relațiunile', p. 130.

– at least, nominally – to cover the banknotes in circulation, after the general armistice, the third stage of Romanian monetary policy began.[41]

This stage witnessed the transfer of state debt to the Bank (February 1919) and the granting of new loans to the government in order to be able to withdraw from circulation the crowns, rubles (coins that circulated in Romania, following the union of new territories) and tickets issued by the occupation authorities for other state needs. Thus, the costs caused by military training and the evolution of military operations were supplemented by those required to supply a country drained by years of occupation, the need for re-starting dysfunctional public services, resuming production and achieving monetary unification. Due to the complicated and outdated tax system, this created different tax systems in the united territories. As a result of the

**Figure 2**: The structure of the covering stock of the NBR at the end of WWI.[42]




Source: C. Păunescu, M. Tone and N. Manea, 'Istoria Băncii Naționale', p. 83.

41 L. Ionescu, *Relațiunile*, p. 130.

42 C. Păunescu, M. Tone and N. Manea, *Istoria Băncii Naționale*, p. 82-3.

reduced tax receipts following the almost total disruption of tax administration during the war, by 30 June 1922 public debt had risen to lei 12,339,249,230.[43]

Since 1922 a period that can be called the 'strengthening currency' began, which resulted in balanced budgets, tax collections, lower reported rates of government debt in terms of the volume of circulated banknotes (from 97 per cent in 1921 to 57.6 per cent in 1924), an increase in gold reserves at NBR for effective currency coverage, the inclusion of language into the mining law stipulating the role of the state monopoly to buy gold produced in the country and to sell it to the National Bank. On January 1926 a law came into force which ratified the following conventions: the abolition of state currency issuance; the strengthening of fiduciary coverage; state returns between the shareholders of the issuance bank; and the establishment of a special fund called 'The Clearing of the Issue made for the State Fund'.

To balance state credit and debit accounts required a time extension of a decade by the National Bank due to the insolvency of the government. The government continued to appeal to the central bank until the end of 1921, and delayed the achievement of monetary unification. All of these political, economic, monetary and financial issues led the National Bank and finance ministry to be concerned over the restoration of national currency convertibility. In this respect, on the same day, on 27 July 1928, several laws were adopted which gave the National Bank the authorisation to contract a support loan to the amount of 25 million US dollars, granted by several issuance banks, and to buy unlimited convertible into gold foreign currency. Also, the Romanian government was empowered to obtain a foreign loan to the amount of 250 million US dollars, of which the first part of 80 million dollars was designed to be used to stabilise the currency, and a short-term advance of 20 million dollars was reserved to enhance the NBR's cash exchange capacity.

The new monetary law (7 February 1929) re-established leu convertibility,[44] forcing the NBR to provide a rate of 35 per cent to cover its liabilities in gold or gold-convertible currencies. In addition, bank capital was increased to lei 600 million, and state participation was reduced to ten per cent.[45]

Considering the behaviour of NBR during the First World War as well as its consequences which extended until at least 1929, we may accept the conclusion advanced by contemporaries that the state could not cope with this war without the support of the central bank. At the same time, supporting the government to achieve the political aim of national unity, the bank's credit policy, previously independent of the government finances, witnessed a radical transformation. NBR relations with the economy were transferred to the background, while operations with the treasury became almost its only business. Thus, between 1918 and 1921, 94 per cent of the loans distributed by the central bank were consumed by the state and only six per cent were given to industry.[46]

43 Ibid., p. 137.

44 1 Leu = 10 mg of gold (900 per cent)

45 G.C. Marinescu, *Banca Națională a României*, pp. 474-5, 485, 488.

46 L. Ionescu, *Relațiunile*, p. 149.

# The Advent of Anglo Indian Banking in Calcutta and the Marginalisation of Bengali Compradors, 1770–1850.

Abhik Ray

When the East India Company obtained in 1765 the *Diwani*[1] of Bengal, Bihar and Orissa, it gave the Company a legal status for administering territory which they had acquired after the Battle of Plassey. Some of the features of the *Nawab's* administration, which the Company replaced, were continued, with the help of merchants, indigenous bankers,[2] leading *zamindars* or landholders and high-ranking Muslim officials. In addition, the Company also retained *compradors*, that is, *dewans* and *banians*,[3] representing the upper echelons of a large body of intermediaries. These *banians* were usually attached as commercial agents to European agency houses, which made their appearance after the Company's servants were prohibited by a regulation in 1788 from engaging in private trade. *Banians* were also employed by individual Europeans, more particularly the Company's servants, to act on their behalf in transacting private business. While some of the eighteenth century *banians* had extensive connections in inland trade, and some traded overseas, most of the others chose to confine their operations to Calcutta.

The British understood the importance of establishing connections with both indigenous bankers and *banians* since their arrival in India. In a letter to Fort St. George in 1677, the Court of Directors offered a reward of £20 to any of their servants or soldiers as 'shall be able to speak, write and translate the *banian* language, and to learn their arithmetic'.

It did not take long for the British to build up cordial relations with them. Rev. James Long recalled that in 1759 Robert Clive entertained Jagat Seth, the eminent banker of Murshidabad, the Nawabs' capital, for four days at a cost of Rs 17,374 including presents consisting of a set of diamonds worth Rs 3,222, eight tweezer cases at Rs 55 each and a gift of Rs 500 for the servants.[4] W.B. Firminger similarly reported that the Court of Directors in 1768 directed that the debts due by the Government to the Setts, one of the oldest groups of Calcutta merchants, be immediately paid as 'that family who have suffered so much in our cause are particularly entitled to our protection'.[5]

When the British decided to leave Hooghly and settle in the region then marked by three villages – Dihi Kalikata, Sutanuti and Gobindapur – a number of indigenous bankers of the Suvarnabanik caste followed them. Among these bankers was Lakshmikanta Dhar, popularly known as Naku Dhar, perhaps the richest and most influential among them all. In the early days of the East India Company, Naku Dhar was to them as

1 The *Diwani* granted by the Mughal Emperor Shah Alam conferred upon the Company the right of receiving the revenue of Bengal, Bihar and Orissa.

2 During Mughal rule, the indigenous bankers or shroffs not only financed trade but also advanced large sums of money to the Royal Treasury in times of need. For details see A. Ray, 'Two Centuries of Apex Banking: The State Bank of India and the Evolution of Modern Banking in India', in: G.D. Feldman and P. Hertner (eds.), *Finance and Modernization : A Transnational and Transcontinental Perspective for the Nineteenth and Twentieth Centuries* (Farnham 2008), ch. 12, pp. 258-59.

3 The term adopted from Vaniya, a man of trading caste, was ascribed to the Hindu trader of Gujarat and seems to have first gained currency among the Portuguese traders in India's west coast in the fifteenth century. See H. Yule and A.C. Burnell, *Hobson-Jobson: A Glossary of Colloquial Anglo-Indian Words and Phrases*, ed. W. Crooke (Calcutta 1990), p. 63. They were known as guarantee brokers in Bombay and dubashes in Madras. They had no counterpart in the West, but in a loose way corresponded to the Hong merchant of Canton, though he was not a member of any such trade monopoly.

4 Rev. J. Long, *Selections from unpublished records of Government for the years 1748 to 1767*, Vol. I (Calcutta 1869).

5 W.B. Firminger, *Bengal District Records*, Vol. 1 (Rangpur 1770-79).

Jagat Seth was to the Nawabs of Murshidabad.[6] Not only did he finance Robert Clive to overthrow Siraj-ud-daulah, the Nawab of Murshidabad, he also gave Rs 900,000 to the British to wage their first war against the Marathas. When the grateful Company's Government offered him the title of Maharaja, he refused and when pressed proposed Sookmoy, his grandson, for the honour.

Admiral John Stavorinus, who visited Calcutta in 1768, found most Europeans employing one or two *banians*,

> who note down all payments and receipts, and through whose hands all pecuniary matters go, as well as in buying as in selling. They serve, in this capacity, without any fixed pay, but they know how much more they may charge upon every rupee, than they have in reality paid.[7]

Eliza Fay, wife of a Supreme Court lawyer, who visited Calcutta on four occasions between 1780 and 1816, observed that the *banian* invariably took care to secure bonds for whatever he advanced, made up accounts yearly and meticulously added the sum for interest. His thoughtless master, who in fact became his slave, soon found his debt doubled and dared not complain unless he had the means to release himself, which alas were denied him.[8] Fay also recalled how the *banians* were anxious to secure employment and tried to outbid each other. One said, 'Master, better take me, will advance Rs 5000' – another offered seven, and perhaps, a third, ten thousand. An East India Company's servant particularly would always find numbers ready to support his extravagance.

Once in employment, the *banians* were often found to be 'dangerous…on account of the great expence [sic] in which they involve their employers, who let them too easily into their confidence, and whom they very soon contrive to ruin, without ever forgetting to secure their own private interests'.[9]

By the 1760s and 1770s, there could have been few Europeans of any substance who had not at some time borrowed money from one or more of a relatively small group of Indian businessmen. The banking house of Mathura Mohun Sen had extensive dealings with European merchants. Bonds with men like Hazari Mal (an extremely wealthy Punjabi), Gokul Ghoshal, Nabakrishna Deb or Krishnakanta Nandy (popularly known as Cantoo Babu) occur repeatedly in the inventories, accounts and correspondence of men from the most junior writer to the Governor.[10] The European merchants and administrators were dependent on them for more than one reason. Without Indian expertise they could not obtain goods, and without Indian capital they could not carry on their trade.[11] Over the years many of these banians amassed great personal fortunes in trade, finance and real estate.

The fact that Europeans borrowed from *banians* is borne out by a document of the 1770s wherein one W. Watts wrote to Maharaja Nabakrishna Deb, *munshi* or Persian clerk to the East India Company, seeking his intervention for having failed to repay a debt to Lal Mohun Dutt, the Sheriff's *banian*. The letter read thus:

6 See for details on Jagat Seth, J.H.Little, *The House of Jagat Seth* (Calcutta 1967).

7 P.T. Nair, *Calcutta in the 18th century: Impressions of Travellers* (Calcutta 1984), p. 165.

8 Ibid., p. 195.

9 F.B. Solvyns, 'Les Hindous' (Paris 1808-1812), in: R.L. Hardgrave, *A Portrait of the Hindus: Balthazar Solvyns & the European Image of India, 1760-1824* (Ahmedabad 2004), p. 274.

10 The Mayor's Court records bear ample evidence of the debts incurred by the Company's servants as well as private merchants to Indians, some of whom were extremely rich and also influential. Gokul Ghoshal, for instance, was *banian* to Henry Verelst, Governor of Bengal and Cantoo Babu was *banian* to Warren Hastings, the first Governor General. To Hastings, a *banian* was a steward or 'a minister' through whom much of his business with the outside world was conducted. See Hastings's letter to Elijah Impey, dated 12 October 1774, quoted by S.C. Nandy, *Life and Times of Cantoo Baboo: The Banian of Warren Hastings, Vol. II* (Calcutta 1981), p. 66.

11 In reality, says Marshall, the relationship was that of trading partners with the *banian* having brought his skill and his capital to the partnership and the European contributing his privileges. See P.J. Marshall, *East Indian Fortunes: The British in Bengal in the Eighteenth Century* (Oxford 1976), ch. II, p. 45.

Maharajah – I hope you will not release Loll Mohun Dutt's execution until Loll Mohun Dutt has released me – otherwise I must go to prison on Loll Mohun's account – this you could prevent and without paying one Rupee or any risk or loss.
I have frequently explained this to Ramsoonder – and I hope you will not settle with the Sheriff's Banian without taking care of me in this business.
You are my Friend and Protector therefore do not let Loll Mohun ruin me, when you have the power to prevent it.

I am Maharajah
Your humble servant
W. Watts

Rev. James Long, the Irish missionary and Calcutta's first sociologist, similarly reported an incident in 1765 in which one Radhanath Tagore, *banian* to a solicitor, was severely flogged and beaten on the head with his own slippers 'for his insolence' by the henchmen of an influential Member of Council for having threatened the Englishman of 'bad consequences' after he had repeatedly failed to repay Tagore's debt.[12]

Although the *banians* initially hailed mostly from the Vaisya (merchant) caste, Brahmins and Kayasths also appear as *banians* later.[13] Men of considerable social standing (Gokul Ghoshal was a Kulin Brahmin) and representatives of prominent merchant families like the Setts and Basaks, who had till then shunned the position of *banian* to the *sahib*, were drawn into European service. The Bengal Almanac of 1844 recorded altogether 43 native agents and *banians*, which included four Brahmins, 17 Kayasths and 18 Suvarnabaniks or *sounnar banians* (gold merchants). Among the prominent *banians* and merchants then were Ramdulal Dey (Kayasth), Dwarkanath Tagore (Brahmin) and Motilal Seal (Suvarnabanik).

Many of these *banians* started life as servant or *sircar* to a stevedore, then became a *banian* to a private trader or Company's factor, later to an agency house and finally a merchant in his own right. The rag-to-riches paradigm is perhaps true in the cases of Ramdulal Dey and Motilal Seal. Ramdulal was an orphan and at an early age became *sircar* to a prominent stevedore Madan Mohun Datta. Motilal was an impoverished young man who had his first break in the beer bottling-business. Eventually both were to become part of Bengali folklore as great merchant princes and billionaires.[14]

Nabakrishna Deb's rise came about under different circumstances. Even at the tender age of 16, the English were so impressed by his knowledge of Persian that Governor Drake rewarded him handsomely and appointed him munshi to the Company. Thus commenced the munshiship of Nabakrishna and he soon gained the confidence of Clive and Warren Hastings. He was conferred the title of Maharaja and also granted *talukdari* (not easily distinguished from *zamindari*) in perpetuity of the village of Sutanuti.[15]

12 Rev. J. Long, 'A Peep into the Special Life of Calcutta during the Second Half of the 18th Century', in: P.T. Nair (ed.), *British Social Life in Ancient Calcutta* (Calcutta 1983).

13 Caste or *varna* in Hinduism divides society into four groups in a hierarchy – the Brahmin (priest), Kshatriya (warrior aristocrat), Vaishya (cultivator and trader) and Shudra (who labours for the others). The Shudras mostly covered the vast majority of Hindus and embraced people of various sub castes like the Vaidyas (physicians), Kayasths (scribes), etc.

14 Ramdulal eventually became an immensely wealthy businessman worth more than 'half a million', thanks to his remarkable ability and honesty and his extensive dealings with Americans, who often borrowed from him heavily. He also acted as a *banian* of Fairlie Fergusson & Co., one of the largest and most influential agency houses in Calcutta in the beginning of the nineteenth century. Motilal, too, was a *banian* to a number of agency houses like Frith & Co., Tulloh & Co., etc.

15 Sutanuti, Dihi Kalikata and Gobindapur were the three villages which formed the nucleus of the town of Calcutta at the end of the seventeenth century.

It was these *banians* who supplied part of the working capital[16] of the European agency houses in Bengal engaged in financing external trade, and the production of indigo and opium in particular.[17] The services rendered by the *banians* included sale and purchase of goods and their insurance, negotiation of bills of exchange, managing their estates, etc. Charges varied according to the service performed.[18] The agency houses made enormous profits enabling their partners to retire to Europe from time to time, with fortunes of £100,000 or £150,000 each, sometimes indeed of a quarter of a million, or even half a million pounds sterling.[19]

The *banian* sometimes charged his European principal or partner interest at a rate lower than that prevailing in the market. This was, however, dependent on the *banian's* relationship with his foreign associate and was usually low when the former was confident of being compensated by a share in the profits of trade.

When the first government-sponsored joint-stock bank was set up as the Bank of Calcutta in 1806,[20] the *banian* of Alexander & Co., a large agency house of Bengal, was one of the first two borrowers of the bank. More than three-fourths of the loans disbursed by the bank in 1806 (May–December) alone went to Indians of which a sizeable number were *banians*. Among the large European borrowers during the early years of the bank were agency houses like Alexander & Co., Trail Palmer & Co. (later Palmer & Co.), Mackintosh Fulton & Co. (later Mackintosh & Co.), Hogue Davidson & Co. and their partners.[21]

After the abolition of the East India Company's monopoly of trade between Britain and India in 1813 and the growth of India's exports (particularly cotton and opium) to China, agency houses, which had grown up mainly to utilise the savings of European residents including East India Company soldiers and civil servants in India and to carry on trade in commodities along routes in which the dominance of the Company was not absolute, gained importance and with it their *banians*. Prior to 1832, Indians obtained between two-thirds and four-fifths of the loans disbursed by the Bank of Bengal (the re-designated Bank of Calcutta on being issued a charter). Many of them were *banians* of European firms who borrowed in order to finance the business operations of their principals.[22] Prominent among them were Russomoy Dutt (Cruttenden Mackillop & Co.), Ramdulal Dey (Fairlie Fergusson & Co.), Ganganarain and his son Kamalakanta Doss (Palmer & Co.), Kissenmohun and Connyloll Burrall (Alexander & Co.) and Mothooramohun Sen, a leading Indian banker.

Inadequate aid from the Bank of Bengal (in view of restrictions laid down in its charter) sometimes saw the East India Company's government too lending money to the European agency houses either to keep up the price of public securities or to help them tide over a shortage of liquidity when they were involved in the sale of goods like indigo or opium on which the government's own revenue or remittance operations

16 In 1827, John Palmer, head of the biggest agency house in Calcutta, wrote of the dependence of the great mercantile houses on the 'native moneylenders'. See for details, A. Webster, *The Richest East India Merchant: The Life and Business of John Palmer of Calcutta, 1767-1836* (Woodbridge 2007), ch. 3. But the main resource of these agency houses was of course the deposits lodged by British officers, serving or retired, and private businessmen who were promised a much higher return than the rate of interest (about four or five per cent) on government paper. The usual rate of interest on such deposits was six to eight per cent which could even go up to ten per cent if employed in the Canton money market.

17 The East India Company actively promoted the entry and prosperity of private European business in the trade of both indigo and opium. British agency houses like Palmer & Co., Alexander & Co., Colvin & Co., Fergusson & Co., Cruttenden, McKillop & Co. and Mackintosh & Co. were involved at each stage of the production of indigo, from the growing of the plant to its manufacture into saleable indigo and finally to its export to Europe, its main market. Indigo became a major vehicle for remittance and stiff competition pushed up its price in the Indian market while that in London remained stagnant or even downward, deepening the crisis of indigo planters.

18 For details see K.W. Porter, *The Jacksons and the Lees* (Massachussets 1937), Vol. 1, pp. 57-66.

19 A. Tripathi, *Trade and Finance in the Bengal Presidency* (Calcutta 1979), ch. 5.

20 For a history of the Bank of Bengal (including its years of infancy as the Bank of Calcutta) and its successors including today's State Bank of India over two centuries, see Ray, 'Two Centuries of Apex Banking', etc. in: Feldman and Hertner (eds.), *Finance and Modernization*, etc., ch. 12, pp. 257-70.

21 A.K. Bagchi, *The Evolution of the State Bank of India* (ESBI), Vol. 1, *The Roots, 1806-1876* (Bombay 1987; reprinted New Delhi 2006), ch. 4.

22 Bagchi, *ESBI*, Vol. I, ch. 5.

depended. In May 1822, for instance, the government financed several agency houses including Palmer & Co. to the extent of Rs 3.5 million for six months at six per cent.

Indigo formed more than a quarter of the total exports from Bengal then. The East India Company nurtured private enterprise first with an eye to the future profitability of the indigo produced in Bengal and then with an eye to the needs of the British textile industry, particularly when supplies to Britain from the West Indies and the Americas stood disrupted. By then, European capital of about Rs 8 million had been invested in indigo plantations and indigo works in Bengal and more and more private investment flowed in with promises of higher returns than government paper could give.[23] But the speculative nature of the indigo market in Europe made the business vulnerable because of the time lags between the sowing and manufacture of indigo (from six to eight months) and between its shipment and its arrival in England (another six to seven months). A commercial slump in England in 1825 depressed the demand for indigo. To compensate for low prices, still more indigo was produced and exported. Bullion imports declined causing a serious contraction of money supply in Bengal.[24] The prices of indigo went down by nearly 50 per cent and most agency houses faced bankruptcy. The Bank of Bengal, by then armed with the enhanced power of issuing notes up to the value of Rs two crores,[25] stepped in with more loans under pressure from the partners of the large agency houses who were heavily represented on its board. Rules laid down in the charter of the bank on loans were flouted as large advances were released to the agency houses with their *banians* as guarantors.[26]

In the midst of this financial crisis, partners of agency houses began to withdraw a large portion of their capital to England. Four of the partners of Palmer & Co., for instance, withdrew their capital almost simultaneously, with one J.S. Brownrigg alone returning with Rs 800,000 or about £80,000. The failure of the indigo crop in 1826 and decline of indigo prices in London led to the bankruptcy of some of the biggest planters in Bengal like Davidson & Co. and Mercer & Co., causing a further fall in prices and a crisis of confidence among the Indian community to whom they were heavily indebted.[27] Many Indian houses failed as a result and serious doubts were expressed about the solvency of the agency houses.[28] The failure of the planters adversely affected the fortunes of six large agency houses, who were their largest creditors. Unable to recover their loans, the redoubtable Palmer & Co. failed in early 1830 leading to a commercial crisis in Calcutta. Soon Alexander & Co., Mackintosh & Co., Cruttenden Mackillop & Co., Fergusson & Co. and Colvin & Co. failed, all between 1830 and 1833. The total liabilities were a staggering Rs 153 million. The loss incurred by the Bank of Bengal amounted to more than Rs 900,000.[29]

Taking refuge under the provisions of the Relief of Insolvent Debtors in the East Indies Act passed by the British Parliament on 19 July 1828, the partners of the bankrupt houses declared themselves insolvent,

23 See G.A. Prinsep, 'Remarks on the External Commerce and Exchanges of Bengal (1823)' in: K.N. Chaudhuri (ed.), *The Economic Development of India under the East India Company* (Cambridge 1971), p. 62.

24 For details see Tripathi, *Trade and Finance in the Bengal Presidency*, ch. 5.

25 One crore is equal to ten million Rupees.

26 See letter dated 4 October 1833 from the Directors of the Bank of Bengal to William Bentinck, Governor General in Council, Fort William in *Alexander's East India Magazine and Colonial and Commercial Journal*, January 1835, Vol. 9, explaining the moves of the Bank of Bengal to keep the 'unimpeachable' agency houses then sinking afloat.

27 In 1826 and 1827 at least five European business houses (including planters) failed for a total sum of Rs 15.7 million of which Davidson & Co. accounted for Rs 6.5 million and Mercer & Co. Rs 5.5 million.

28 Of the seven Indian houses which failed in 1826 and 1827 for a total sum of Rs 2.16 million, Muthooramohun Sein & Co., the leading Indian banker, alone accounted for Rs 1.3 million.

29 If the doubtful debts written off by the Bank of Bengal between 1830 and 1833 are taken into account, the total losses would amount to more than Rs 1.5 million. See Bagchi, *ESBI*, Vol. 1, ch. 6, pp. 191-92.

gained complete immunity and secured discharge from all obligations.[30] Many who returned to England came back to India soon and started business afresh. James Young, for instance, a partner of the bankrupt Alexander & Co. became secretary of the Union Bank two years later and the Sheriff of Calcutta in 1838.

After seeing John Palmer, the head of Calcutta's largest agency house take advantage of the Insolvency Act, the Indian *banians* could not but look upon the Act as 'a law to enable the crafty to swindle the honest' and a tool to 'defraud' them.[31] Such was the state of insolvency law that the insolvents passed the ordeal of the Insolvency Court 'without a single inquiry' only 'to renew with undiminished boldness' the old course of 'extravagance and speculation'.[32]

In order to recover its losses the Bank of Bengal then filed cases against the *banians* of the bankrupt agency houses – Kamalakanta Doss, *banian* of Palmer & Co., Connyloll and Kissenmohun Burrall, *banians* of Alexander & Co., Ruggooram Gossain, *banian* of Palmer & Co. and Radha Krishna Mitter, *banian* of Fergusson & Co. – all endorsers or co-signatories of promissory notes given to the Bank. A large part of the dues was thus recovered from their assets. Some were arrested and even put behind bars. These events caused a serious dent in the confidence of the *banians* as 'the atmosphere of confidence and expansiveness evaporated overnight'.[33]

Notwithstanding the setback, the period immediately thereafter provided a new opportunity for venturesome entrepreneurs when in 1833 the East India Company lost the Indian trade altogether and the monopoly of the China trade. The need for creating modern factories and plantations and developing better communication facilities saw the *banians* develop a new confidence in western-style business operations and enterprise. While investments in agency houses increased considerably, some *banians* entered into co-partnership with Europeans. A contemporary observer found them assuming '[...] airs which their more wealthy predecessors had never taken on themselves; they treated their European connections not only with contemptuous disregard, but often with much insolence. The Hindu star was in the ascendant…'[34] Prominent among such *banians* were Rustomjee Cowasjee, a long time Parsee merchant of Calcutta, who established Rustomjee, Turner & Co. in 1834; Dwarkanath Tagore, a western-educated Bengali Brahmin, who pioneered the interracial business enterprise of Britishers and Indians by first setting up the Union Bank in 1829 and then following it up with the Carr Tagore and Company in 1834; and Motilal Seal who set up Oswald Seal and Company in 1840.

The most colourful among all these enterprises was of course the Union Bank which started operations in 1829 with a capital of Rs 1.5 million contributed by hundreds of shareholders, both European and Indian (including distinguished landlords of Bengal). The bank provided the merchants 'a mechanism through which they could cooperate to mobilise capital, expand credit, engage in exchange banking, issue bank notes and influence the production and prices of agricultural commodities'.[35] It soon became a strong rival of the Bank of Bengal.

In its anxiety to make its presence felt, the Union Bank increased its capital more than six fold to Rs ten million between 1836 and 1840. This augmentation in capital forced it into unwise speculations in exchange

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30 The Act of 1828, applicable in the three presidency towns, was based on an earlier British law for the relief of insolvent debtors in Britain, but was more liberal in its treatment of insolvent debtors than its British counterpart. Although the law applied equally to British citizens and East Indian subjects, provisions such as the production of the *London Gazette* containing notice of insolvency of the debtor involved as proof of insolvency, the barring of any Indian creditor apart from the petitioning creditor from the choice of the assignee, which discriminated against Indians.

31 *Alexander's East India Magazine and Colonial and Commercial Journal*, Vol. VII, January-June 1834.

32 'Commercial morality and commercial prospects, etc.', *Calcutta Review*, Vol. IX, January-June 1848.

33 B. Kling, *Partner in Empire : Dwarkanath Tagore and the Age of Enterprise in Eastern India* (Calcutta 1981), ch. II.

34 J. Capper, *The Three Presidencies of India* (London 1853), p. 385.

35 Kling, *Partner in Empire*, ch. IX.

operations and enormous investments in the production of a single export commodity – indigo. The bank did not survive the severe commercial crisis which engulfed Britain in the autumn of 1847 and it formally suspended all operations in January 1848.[36] It meant the end of the effort in Calcutta at developing new industries such as tea, steam shipping and coal mining and the application of new forms of business organizations – the joint stock company, the managing agency system and commercial banking under the joint direction of Indian and British entrepreneurs, with capital coming mostly from Indians. Dwarkanath and his friends had assiduously promoted these from about 1833-34.[37] The collapse of the bank also resulted in a large loss of capital for many of the wealthy businessmen of Calcutta. While a number of those who had escaped the crisis in the 1830s were impoverished, many stood completely ruined.

The failures hastened the process of elimination of Bengalis from mercantile pursuits. From entrepreneurs they increasingly became investors in landed estates. But this was not a new phenomenon. Fortunes made in business were known to have been transformed into landed estates by 'comprador rajahs' even earlier. Sobharam Basak, the successful mid-eighteenth century merchant, for instance, left as many as 37 houses in Calcutta to his heirs in 1780. When Ramdulal Dey died in 1825, he left behind landed estates worth more than Rs half a million in Calcutta alone yielding an annual rent of about Rs 25,000. The Roys and Debs of Sobhabazaar were similar cases.[38]

The setback of the 1840s hastened the process of withdrawal of the Bengali *banians* from any further adventurous business activity. Only a few were left on the scene in the second half of the nineteenth century. Prominent among them was Prawn Kissen Law & Co., the noted mercantile and *zamindari* firm, which flourished under Maharaja Durga Churn, son of Prawn Kissen, Ramgopal Ghose & Co. and Ashutosh Day. More than half the native bankers of Calcutta in 1864 were Marwaris including firms like Tarachand Ghanshyamdass, Bunseelall Abeerchand and Sitalprasad Khargaprasad. The composition of the *banian* class had changed perceptibly in favour of the north Indian merchants and bankers. Equipped with a network of *kothees* extending to the far corners of the country, they could gather information more expeditiously than even the British merchants, keep track of changes in domestic channels of trade and finance and adapt themselves accordingly.

By the end of the nineteenth century, several Marwari firms had gained control of the crucial inland trade in jute and cotton piece goods. A few like Tarachand Ghanshyamdass also became *banians* to firms like Shaw Wallace & Co. And all this happened while the descendants of the 'comprador rajahs' squandered the wealth of their forefathers and relied on English magistrates for the security of their property.[39]

As Bengali entrepreneurs moved away from mercantile pursuits, they turned their attention to other areas – religion, literature and politics – and soon gained prominence in them. By about the beginning of the twentieth century, the traditional Marwari merchant and banker, who had stepped in to fill the vacuum, emerged in a new role – that of an entrepreneur – investing a major part of his enormous trading and speculative profits made before and during World War I in jute mills and collieries. It would not be long before the Goenkas, Kanorias, Bajorias, Bangurs and others would replace the British as owners of industries and emerge as the new commercial elite of Calcutta.

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36 The bank lost close to Rs 2.5 million on the production of indigo alone. See Kling, *Partner in Empire*, ch. IX and C.N. Cooke, *The Rise, Progress and Present Condition of Banking in India* (Calcutta 1863), pp. 177-200.

37 The joint enterprises included the Calcutta Steam Tug Association, Steam Ferry Bridge Company, Bengal Tea Association, Bengal Coal Company, Bengal Salt Company, etc.

38 See for details P. Sinha, *Calcutta in Urban History* (Calcutta 1978), ch. I.

39 After the death of Ramdulal Dey in 1825, his sons, Chatu Babu and Latu Babu, for instance, spent Rs 600,000 on his sradh (rituals performed by descendants of deceased).

# The North European Model of Early Central Banking: Collateral Policy before the Real Bills Doctrine.[1]

Juha Tarkka

## Introduction

What forms of credit are appropriate for banks of issue and what assets constitute suitable cover for banknotes, are classic questions in the theory of monetary policy. Until recently, it was commonly thought that these questions were almost of historical interest only, because the Keynesian and Monetarist revolutions had pushed them out of the centre stage of the theoretical banking debate. As a result, central banking had come to be thought of mostly in terms of the supply of reserves, or interest rate policy. In practical central banking, collateral issues were present, of course, but, in the words of a recent survey, they were mostly left to the 'narrow circles of central bank technicians'.[2] This appears to be changing now, as a result of the global financial crisis which erupted in 2007–2008. Central banks around the world have again begun to consider their collateral and investment policies as instruments which may be used to influence the state of financial markets and the whole economy. Once more, the qualitative aspects of central bank credit have become a matter of general interest. In this context, the historical development of the collateral policies and investment policies of central banks may also be of some interest.

The classical model of central banking was based on the (often conflicting) ideas of the real bills doctrine and the currency principle, and in practice exemplified by the Bank of England and the Banque de France. However, the classical model did not become predominant until long after the banks of issue proliferated in Europe, and it was preceded by other practices and models of banking. This paper is about one pre-classical tradition, that of proto-central banking in the Baltic Sea region. We survey the early development of central banking institutions in the area from the very beginning until the period when they became fully-fledged central banks in the classical sense. The term 'proto central banking' is used here in order to acknowledge the fact that a two-tier banking system with a central institution had not fully developed in the period which we study.

The Baltic Sea area is particularly interesting for the study of proto-central banking because public banks of issue emerged there relatively early, and also reached a scale not insignificant in their day. For instance, it is well known that the Swedish Stockholm Banco was the first bank in Europe to issue banknotes; and one may note that in the first decades of the nineteenth century, the comparable value of the banknotes in circulation of the Russian Assignat Bank was larger than that of the Bank of England. Moreover, it will be shown below that the structures and principles of operation of the proto-central banks of the Baltic Sea region display certain similarities which allow one to speak about a particular North European model of proto-central banking. This model was clearly different from the classical model of central banking and survived until the latter half of the nineteenth century, when the classical model was finally adopted in the Baltic sea area as well.

An important difference between the early North European and the classical models of central banking is in the forms of credit considered appropriate for a bank of issue. Whereas the classical model of central banking emphasised the liquidity of the banks' investments, which is the essence of the real bills doctrine,

1 The author thanks the participants of the conference on 'Designing Central Banks' in Eltville, 8-9 November 2007, and the participants of the *EABH* conference on 'The Critical Function of History in Banking and Finance' in Nicosia, 15-16 May 2009, for their comments.

2 A. Chailloux, S. Gray and R. McCaughrin, 'Central Bank Collateral Frameworks: Principles and Policies', *IMF Working Paper,* WP/08/222 (2008).

the early North European model of proto-central banking emphasised another criterion, the underlying security of the banks' investments, and was based more directly on the idea that the role of issuing banks was to monetise otherwise illiquid assets. The proto-central banks were indeed often established to alleviate what was seen as a shortage of liquidity and means of payment in the economies. These concerns led to a lending policy where long term lending on land had an important role, although loans to government were also important in many cases.

In the remaining parts of the paper, we contrast the defining principles of classical central banking with those of North European proto-central banking. After that we present an overview of the development of proto-central banks in the countries of the area. We also survey the developments which eventually led to the abandonment of the early North European model and the adoption of classical central banking principles also in the countries around the Baltic sea.

## I.

The particular characteristics of the early North European model of central banking are best understood by contrasting them to the two classical norms of central banking, the real bills doctrine and the currency principle. The real bills doctrine was famously defined by Adam Smith in 1776 in 'The Wealth of Nations'.[3] Basically, this doctrine states that banks of issue should grant credit only against 'real' (meaning trade-related) bills of exchange.

The idea is to ensure that the asset position of the issuing bank is easy to adjust in changing market conditions. If the demand for banknotes were to diminish for any reason, and be presented for payment, the issuing bank would have to reduce its assets and needed flexibility in its lending in order to do this. An investment policy concentrating on 'self-liquidating' claims – such as short-term real bills – would be appropriate for two reasons: first, the bills bought by the bank would be short term and would turn over several times in a year; and second, the business of the debtors would by its 'real' nature generate the cash flow needed to redeem the bills.

Even though contemporary criticism during the suspension of the gold standard in England (such as Thornton) and later scholarship (notably Friedman and Schwarz) have presented the real bills doctrine mainly as a fallacious antithesis of the quantity theory, the original purpose of the real bills doctrine seems mainly to have been to oppose the mercantilist idea of land banks. The question of land banks and of money backed by real property was very topical in the eighteenth century, starting from John Law's *Money and Trade Considered* (1705), in which he first proposed the monetisation of landed property.

Despite the spectacular failure of Law's Banque Royale in France, the idea of using land to back paper money remained alive in the continental discussion and banking practice. The theoretical argument for using land as collateral for banknotes was summarised by Sir James Steuart in his *Principles of Political Economy* (1767). Steuart divided bank credit into three categories: 'real' (backed by fixed assets), 'mercantile' (backed by obligations of merchants or manufacturers), and 'personal' (backed by the capital invested by the banker himself). Steuart considered mercantile credit, including trade bills, as the most insecure of these and argued strongly in favour of the more tangible real backing – in effect mortgages of land. Steuart considered liquidity to be a secondary consideration for the rational creditor: 'Coin may be wanting, upon some occasions, to men of the greatest landed property. Is this a reason to suspect their credit?' Land credit was seen as the preferable backing to banknotes because of the greater security and solidity it would give the banking institution.[4]

3 A. Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776, reprinted New York 1991), p. 269.

4 J. Steuart, *An Inquiry into the Principles of Political Economy* (1767, reprinted Edinburgh 1966), pp. 479-483.

Among the leading contemporary authorities, the preference for real collateral is shared by the important German cameralist von Justi, for instance. Justi thought Law's system had failed not because the ideas behind it was fundamentally flawed but because of a lack of caution. Justi wanted to promote the use of paper money, but stressed the importance of maintaining trust in its value.[5] In his *Grundfeste* of 1770, Justi writes that 'a bank with complete security is of enormous benefit for the state', but maintains that only properly insured real property is secure enough as collateral.[6]

In England, the idea of a land-based bank of issue was not successful, and the operations of the Bank of England developed along the lines of the real bills doctrine. There had been a land bank proposal in England, competing with the bill-based alternative of the Bank of England, in the late seventeenth century, but it was not adopted[7] (Scottish banks in the eighteenth century took a more liberal attitude to loans secured by land).[8] In France, too, after the two well-known and disastrous experiments with land-based money (first Law's scheme and later the revolutionary assignats), the Banque de France was established in 1800 firmly on real bills principles and it concentrated its activities on the discounting of bills of exchange.[9] This turning-away from land bank ideas contrasts sharply with North European developments, where land-based proto-central banks of issue became the norm rather than the exception.

The other main component of classical central banking doctrine was the currency principle, articulated in the course of the great monetary policy controversies in England during the first half of the nineteenth century in the writings of Ricardo and Lord Overstone. According to this, banknotes should be representative money only, and emulate the functioning of metallic circulation in most respects except by their greater convenience and reduced transaction costs. The currency principle had its roots in the rules governing the operation of the old public banks of exchange, the municipal banks of Amsterdam and Hamburg which were established already in the first decades of the seventeenth century. These banks maintained – or at least were supposed to maintain – 100 per cent metallic cover of their liquid liabilities, so that they could not influence the quantity of money.

The obvious advantage of the currency principle is in the assurance it gives of the convertibility of the bank's liabilities and thus the stability of their value. The obvious dilemma is how to reconcile this with any lending activity, be it on long term mortgages, as in the North European proto-central banks, or on bills of exchange as in the classical mode of central banking. A solution to this problem was usually sought in organisational design, and the Bank of Hamburg provided an influential example. It was divided into two departments, an exchange department (*Wechselbank*) and a loan department (*Lehnbank*). The exchange department operated a transfer system on deposit accounts, convertible to silver, and the loan department for its part made short term private loans on the pledge of precious metals (and occasionally lent money to the city council as well).[10] It is immediately obvious how this two-department structure resembles the solution later adopted in England by Peel's Bank Act of 1844,[11] but for the purposes of the present survey it is remarkable that we can show in what follows that a similar two-department structure was prevalent in the proto-central banks of the Baltic sea area already long before it was introduced in England.

5 U. Adam, *The Political Economy of J.H.G. Justi* (Bern 2006), pp. 189-194.

6 J.H.G. von Justi, *Die Grundfeste zu der Macht und Glückseeligkeit der Staaten; oder ausführliche Vorstellung der gesamten Policey-Wissenschaft*, Erster Band (1760, reprinted Aalen 1965) pp. 620-635.

7 A.E. Murphy, *John Law, Economic Theorist and Policy-Maker* (Oxford 1997), pp. 50-51.

8 S.G. Checkland, *Scottish Banking: A history 1695-1973* (London 1975), pp. 227 and 258-260.

9 G. Ramon, *Histoire de la Banque de France d'apres les sources originales* (Paris1929).

10 A. Soetbeer, *Beiträge und Materialen zur Beurtheilung von Geld- und Bank-Fragen* (Hamburg 1855), pp. 90-100.

11 K. Horsefield, 'The Origins of the Bank Charter Act, 1844', *Economica*, Vol. 11, No. 44 (1944), pp. 180-189.

## II.

During our period of interest, i.e. from the last decades of the eighteenth century until the middle of the nineteenth century, the Baltic Sea financial and trading region comprised Denmark, Sweden, Prussia and the north-western parts of the Russian Empire. Poland and Finland must be included in their own right, because they had their particular financial systems even after they were annexed by Russia as a result of the Napoleonic wars. One must also include Norway, although it has no Baltic coast. Under the period which we consider, Norway was in political union first with Denmark and later with Sweden, and these political links were also reflected in its monetary and banking developments. The trading and banking cities of Amsterdam and, after about 1795, especially Hamburg acted as commercial and financial hubs for the entire region.

Although the monetary systems of the countries in the region were legally based on silver, the convertibility of banknotes to metal was suspended in all of the countries during the Napoleonic wars (in Russia, the banknotes had been inconvertible in practice already since the late 1780s). Soon after 1815, when the long period of wars was over, the countries of the area roughly managed to stabilise the value of their banknotes, but only at rates considerably below par. Return to the silver convertibility of banknotes was achieved only later, but when it was done, the countries of the Baltic sea area moved in close succession: Sweden resumed convertibility to silver in 1834, Denmark in 1838, Russia in 1839, Finland in 1840 and Norway in 1842.[12]

With some simplification, one may characterise the influence of the above-mentioned banking doctrines on the development of the proto-central banks of the Baltic Sea area in the following way. In the early stages, there was a strong influence of the idea of land banks; parallel to that, in order to maintain credibility, the issue of currency and the granting of credit were, however, often superficially separated into different departments or institutions, as the currency principle would have required. In practice, the activities of these departments or institutions were closely intertwined, and the additional integrity created by the separation to the issuing bank, or department, seems doubtful (even in the Bank of Hamburg, it seems that the good credit enjoyed by the institution was probably more due to the strict collateral policy of the bank than to its two-department structure).

**Sweden**. The Bank of Sweden is known for Europe's first banknotes which were issued in the 1660s by its predecessor, Stockholms Banco (established 1656), an institution which soon failed and was then permanently taken over by the Swedish parliament. The organisation of the Bank of Sweden followed the model of the Bank of Hamburg in that it was divided into two separate departments, the bank of exchange (*wäxel-banco*) and the loan bank (*låne-banco*). The practical operations of these two departments were much less restricted than in the case of the Bank of Hamburg, however. Heckscher has shown that the Bank of Amsterdam was actually used as an example when the charter for Stockholms Banco was written; it is however apparent that the structure of the Swedish bank resembles even more closely that of the Bank of Hamburg.[13]

The loan department of the Bank of Sweden was allowed to lend against a variety of real collateral, such as precious metals, exportable merchandise, and real estate. Of these, only real estate loans were of long term. In practice, in the last decades of the eighteenth century, the loans on real estate were by far the predominant category of loans to the private sector, but these were often surpassed in magnitude by the bank's loans to the crown and crown enterprises.[14]

12 S. Brisman, 'Tiden 1803-1834', in: *Sveriges Riksbank 1668-1924. Bankens tillkomst och verksamhet* (Stockholm 1931); K.E. Svendsen and K.A. Hansen, *Dansk pengehistorie 1700-1914.* (Copenhagen 1968); W.M. Pintner, *Russian Economic Policy under Nicholas I* (Ithaca 1967); H. Pipping, *Paperiruplasta kultamarkkaan* (Helsinki 1961); N. Rygg, *Norges Banks historie. Förste del* (Kristiania 1918).

13 E. Heckscher, 'The Bank of Sweden in its Connection with the Bank of Amsterdam', in: J.G. van Dillen (ed.), *History of the Principal Public Banks* (1934, reprinted London 1964).

14 Brisman, *Sveriges Riksbank*, pp. 10-13.

From the start of the nineteenth century, the Bank of Sweden started to increase its short-term private lending through so called discount offices. There agencies were initially only partly funded by the Bank of Sweden, having private shareholders, too, and issuing their own notes, but when they all failed around 1815 after the end of the Napoleonic war, the bank resumed discount office activities by establishing semi-independent discount offices under its own umbrella and full ownership.[15]

The purpose of the discount offices in Sweden was to grant short-term commercial and personal credit, of maturities of less than six months. In the early years of their activity, they also issued bonds and notes in their own name (however, drawn on their credit facility in the Bank of Sweden). The significant novelty was that the discount offices could grant loans against personal guarantee, so that pledging physical collateral was not necessary. In Steuart's terms, the discount offices provided 'mercantile' credit. Despite their name, the discount offices were not allowed to buy bills of exchange. Their name merely referred to the short-term nature of their lending, and the practice of charging the interest on the loan at the time when the loan was disbursed, not when it was paid back.[16]

In the course of the first half of the nineteenth century, the short-term lending of the Bank of Sweden through its discount offices reached a significant share of the total assets of the bank. However, long-term real estate loans lingered on as a major activity of the bank itself, as did the traditional export loans on the collateral of merchandise. The difference from the classical model of central banking is clearly visible in that the discounting of bills was not practiced, and that it was thought necessary to organise the short-term commercial lending business separately from the bank itself; in discount offices under their own management – although financed by the Bank of Sweden.[17]

**Denmark**. The Copenhagen Assignat, Exchange, and Loan Bank (Den Københavnske Assignations-, Veksel- og Laanebank), usually called the Kurantbank, was established in 1736 in order to support the commerce of the city. The bank was given the exclusive right to issue banknotes ('assignats') denominated in Danish rigsdaler courant (the domestically circulating silver coinage, hence the nickname of the bank). The bank was obliged to redeem its notes with the courant coins at any time.

According to its statutes, Kurantbank could lend against a broad range of collateral, including merchandise. The lending was constrained in principle to be short-term, of less than six months' maturity. Most of the constraints initially intended to apply to the lending activities of the bank were eventually disregarded, however. Loans were often renewed so that they became effectively long-term, and were given against real estate collateral – sometimes even without collateral. By the 1760s, lending by the bank grew strongly and most of it went to the crown.[18]

After the British navy attacked Copenhagen in 1807 and Denmark then joined the war on the French side, the volume of banknotes put into circulation rapidly increased and their value started to decline. By December 1810, the banknotes were worth only 22 per cent of their nominal value in silver. In 1812–13, the value of the notes collapsed further, and in 1813 the Kurantbank was finally closed. A comprehensive monetary and banking reform was initiated and a new monetary unit, the rigsbankdaler (state bank thaler), was introduced.

A temporary institution, the Rigsbank (State Bank), was founded to issue and manage the new currency. The measures involved were extreme. The Rigsbank obtained, by decree, a primary mortgage of six per cent of all fixed property in Denmark, which the landowners however could redeem in silver. Moreover, the land-

15 S. Brisman, *Sveriges affärsbanker. Grundläggningstiden* (Stockholm 1924), pp. 17-60.

16 Brisman, *Sveriges Riksbank*, pp. 120-144.

17 Brisman, *Sveriges affärsbanker*, pp. 22-30; Brisman, *Sveriges Riksbank*, p. 117.

18 J. Wilcke, *Kurantmønten 1726-1788* (Copenhagen 1927) pp. 322-344.

owners owed annual interest at 6.5 per cent for the mortgages held by the Rigsbank. The resulting structure of the Rigsbank was extraordinary. Not only was it an issuing bank based on land credit, but the collateral had been obtained by a compulsory levy.[19]

The Rigsbank was only a temporary institution, and in 1818 a new bank of issue, the Danish National Bank (Danmarks Nationalbank, at first called Nationalbanken i Kjøbenhavn) was established. This bank was organised along the lines of the classical central banking model. It was a private corporation with a royal charter. Despite its privileged position, including the monopoly right of note issue, the Danish National Bank was a private company, legally separate from the government.

For its initial assets and revenues, the National Bank acquired the forced mortgages of its predecessor. Although the bank was established with the classical, banking school type of central bank in view, it was clear that, with its land-based asset structure inherited from the Rigsbank, it would take time to complete the transition to the classical model, especially as the bank had to conduct a deflationary monetary policy in order to stabilise the value of its banknotes. As a result, during the first two decades of its activity, most resources of the bank had to be devoted to withdrawing enough notes from circulation to ensure that their value was gradually brought to par with silver. This limitation of new lending of course prolonged the land-based asset structure of the institution.[20]

**Norway**. The Norwegian banking history resembles (and stems from) the Danish. The Bank of Norway (Norges Bank) was established in 1818, soon after Norway was separated from Denmark. Originally, a quarter of the bank's funds had been reserved for the discounting of bills, but this came to nothing in practice. Instead, loans on mortgages were the clearly predominant form of credit for the Bank of Norway from the start, and it turned out to be another land-based bank of issue in the wider region. In 1830, for instance, almost all of the bank's lending was on real estate mortgages, and ten years later, still 84 per cent. As a justification for this, it was explained that lending on mortgages was more secure than bills of exchange – the old mercantilist argument. Moreover, the Bank of Norway had to conduct a deflationary policy until the convertibility of banknotes to silver could finally be achieved in 1842. In these prolonged circumstances of restrictive policy, it was difficult to expand the lending activities of the bank to new areas.[21] Consequently, the asset structure of the Bank of Norway remained mostly based on long term loans on real collateral until the late 1850s.[22]

**Prussia**. In Prussia, the Royal Bank (Königliche Bank) was established in 1765 in Berlin and it soon obtained the right to issue banknotes. Like many other North European proto-central banks, the Royal Bank was divided into two departments, an exchange bank (Giro-Banque) and a loan bank (Lehn-Banque). The exchange bank was to take transferable deposits and issue banknotes against the deposit of coin. However, the exchange bank was not at all successful and the volume of banknotes issued remained very small.[23] The loan bank department of the Royal Bank was more significant. It was further divided into two departments, the discount office and the Lombard office. The discount office would discount short-term bills of exchange up to a maturity of two months, whereas the Lombard office would grant credit against collateral, which according

19 Svendsen and Hansen, *Dansk pengehistorie*, pp. 87-115.

20 Svendsen and Hansen, *Dansk pengehistorie*, pp.125-145.

21 Rygg, *Norges Banks*, pp. 231-241.

22 J.T. Klovland, 'Monetary Aggregates in Norway 1819-2003', in: Ø. Eitrheim, J.T. Klovland and J.F. Qvigstad, 'Historical Monetary Statistics for Norway 1819-2003', *Norges Bank Occasional Papers* No. 35. (Oslo 2004), p. 208.

23 M. von Niebuhr, *Geschichte der Königlichen Bank in Berlin* (1854, reprinted Glashütten 1971); H. von Poschinger, *Bankwesen und Bankpolitik in Preussen*, Erster Band (Berlin 1878), p. 131.

to the statutes of 1766 could only consist of gold, silver, or jewels. Because of the modest success of the bank of exchange, most of the activities of the loan bank came to be financed by interest bearing deposits.[24]

Despite the quite strict collateral requirements in the original statutes, the Royal Bank soon expanded its lending to comprise long term loans to government departments and, after 1794, also into mortgage credit. A large part of lending by the Royal Bank was extended in mortgages to the parts of Poland annexed by Prussia in the partitions of 1793 and 1795. The investment in Polish mortgages and the associated real estate boom in the conquered areas lasted for about a decade.[25] The defeat of Prussia in 1806 in the War of the Fourth Coalition against Napoleon caused a financial crisis and proved fatal for the Royal Bank, however. The bank had to stop payments and it was practically out of operation from late 1806 until 1817. Even after that, a very large part of its assets were in the process of slowly being liquidated and phased out.[26]

The new activities of the Prussian Royal Bank after the war (from 1818 onwards) were much more limited than before the war, and its lending grew only slowly. The bank only discounted bills of exchange and made Lombard loans on moveable collateral, mainly on government paper and precious metals, but also on inventories of merchandise. Mortgage bonds, which had caused the bank large losses when the war broke out, were no longer accepted as collateral.

After the war, paper money circulation in Prussia was mainly in the form of treasury notes, and the Royal Bank was not very active as a bank of issue. So, interest bearing deposits continued to be its main source of funds. However, it issued some large-denomination cash notes (Kassenscheine) in the 1820s, until 1834, when the note circulation in Prussia was unified and taken completely over by the treasury.[27] The issue function was only resumed by the bank in 1847, when the Royal Bank was converted to a new institution, the Prussian Bank (Preussische Bank), which was fashioned as an issuing bank of the classical type.[28]

**Russia**. The Russian proto-central banking development can be considered to have begun with the simultaneous establishment in 1786 of two banking institutions, called the Assignat Bank and the State Loan Bank. Taken together, these institutions which, according to the imperial decree by which they were created, were to operate 'as a single entity', actually constituted a typical North European proto-central bank. The joint entity issued banknotes and granted long term loans on mortgages; moreover, it also gave large loans to the government, which was in financial difficulty at the time because of a war with the Ottoman Empire.[29]

After 1786, the amount of banknotes issued by the Assignat Bank increased by leaps and bounds, especially during the several wars which Russia either started or was drawn into. The convertibility of the assignats to metal had to be suspended and their value declined. In the spring of 1812, when Napoleon's invasion of Russia was imminent, the assignats were declared legal tender. This was done in a very particular way, however; they were to be received as legal tender for the value quoted in the St. Petersburg bourse, instead of their nominal value. The silver rouble thus remained the legal unit of account and the basis of the monetary system.[30]

The volume of assignats peaked during Napoleon's invasion of Russia. At the same time, their value bottomed out when the assignat rouble was quoted in the St. Petersburg bourse as only 20 per cent of the silver rouble. Despite the decline in value, the total stock of assignats was still worth more than the whole

24 Niebuhr, *Geschichte*, pp. 189-196.

25 Niebuhr, *Geschichte*, pp.71-76.

26 Poschinger, *Bankwesen I*, pp. 215-219.

27 Poschinger, *Bankwesen I*, pp. 224-226.

28 H. von Poschinger, *Bankwesen und Bankpolitik in Preussen*, Zweiter Band (Berlin 1879), pp.15-23; D. Ziegler, 'Zentralbankpolitische Steinzeit? Preussische Bank und Bank of England im Vergleich', *Geschichte in Gesellschaft*, Vol. 19, No. 4 (1993), pp. 475-505.

29 *Polnoe sobranie zakonov Rossiiskoi imperii s 1649 goda* (PSZ). Tom XVIII. 1767-1769 (St. Petersburg 1830), Chapters 13.219 and 16.407.

30 L. Zieliński, *Die Rubel jetzt und vor 100 Jahren* (Jena1898).

Bank of England circulation at the time. Bank of England note circulation in 1815 was 26 million pounds and the note circulation of the Russian Assignat Bank,[31] converted to pound sterling was 36 million pounds (calculated from data quoted by Zielinski).[32]

The lending activities of the Russian State Loan Bank were broadly typical of an agricultural mortgage bank. It extended 20-year loans to the landowning nobility against the collateral of their land. A special feature was that, as collateral, the property was valued according to the number of serfs attached to it. To finance its activities, the loan bank took sight deposits, which grew to considerable amounts, especially in the 1850s, and was also financed by the other parts of the state banking system (the Assignat Bank and the State Commercial Bank, of which see below).

The Russian government made attempts to develop short term commercial credit as well. Discount offices were established in the major Russian ports in 1797, as subsidiaries to the Assignat Bank, to finance Russian merchants, but their activities remained relatively insignificant. The volume of commercial credit started to grow only after 1817, when the discount offices were converted into a State Commercial Bank. This institution took deposits and discounted bills of exchange, and made short term loans on the collateral of commercial inventories. However, the volume of credit extended by the Commercial Bank remained very small compared to the long term lending by the State Loan Bank, and in fact, the State Commercial Bank transferred a large part of its deposits to the latter for use in agricultural mortgage lending. In practice, then, the state banking institutions of Russia in that period were not really separate from each other but constituted a closely integrated system.[33]

The structure of the Russian proto-central banking system thus displayed all the main features typical of the early North European central banking model: state ownership and control; emphasis on long term mortgage credit financed by issuing banknotes (and taking liquid deposits); and a structure in which the issue function and the lending function were formally, but only formally, separated into different departments. The Russian and the Swedish cases are remarkably similar to each other in that both added a third component to the state banking system: agencies formally separate from the bank of issue for the short-term financing of commerce. In the case of Sweden, this was constituted by the discount offices, and in the Russian case, the State Commercial Bank. In both cases, even the commercial part of the system was financially connected with the bank of issue and the loan bank, however.

**Finland.** The Bank of Finland (Suomen Pankki, whose original name in Swedish was Växel-Låne-och Depositions Contoiret in Storfurstendömet Finland, meaning 'The Exchange, Loan and Deposit Office in the Grand Duchy of Finland') was established in 1811, after the country had been conquered by Sweden and annexed by Russia as an autonomous Grand Duchy. The bank was initially subordinated to the imperial Finnish government until it was handed over to parliament (the Estates of Finland) in 1867, following the Swedish system.

Characteristically, the bank was divided into two departments called funds, which, however, were under the same management. The 'original fund', consisting of the bank's own capital and retained profits, was to be used for long term mortgage lending on real estate. The term of these loans was 20 years. The other department, which was called the 'small notes fund', was financed by the bank's own note issuance. Apart from holding a fraction of cash reserves, this fund was to be used for short term lending, with maturities

31 'Bank of England liabilities and assets: 1696 onwards', *Bank of England Quarterly Bulletin*, Vol. 7, No. 2 (1967), pp. 159-163.

32 Zieliński, *Die Rubel*, p.10.

33 K. Heller, *Die Geld-und Kreditpolitik des Russischen Reiches in der Zeit der Assignaten 1768-1839/43* (Wiesbaden 1983) pp. 258-259.

from six months to one year. Priority here was to be given to loans for manufacturers against the pledge of their unsold inventories.

In practice, long term real estate loans constituted the largest share of the bank's lending until the 1840s when, as a consequence of a monetary reform, the banknote circulation grew rapidly and increased resources became available for short term lending. But even then, most of this short term lending was against tangible collateral such as merchandise. Bills of exchange were not mentioned in the original statutes and the bank did not discount any for almost three decades after its establishment.[34]

**Poland**. Bank of Poland (Bank Polski) was founded in 1828 as a part of the financial reconstruction of the Kingdom of Poland, created by the Congress of Vienna in 1815 with the Russian Emperor as its king. The Bank of Poland was, from its founding, intimately connected with the other important government-sponsored banking institution in the country, the Land Credit Society (Towarzystwo Kredytow Ziemskie), founded in 1825. This was a mortgage association, in effect a guarantee pool, founded upon earlier Prussian examples.[35] When the Bank of Poland, the national bank of issue, was founded, as a state institution, half of its capital of 20 million zloty was paid in the form of mortgage bonds of the Polish Land Credit society, and 'drawn upon national wealth'.[36]

The tasks of the Bank of Poland included the management of debt which the new kingdom owed to foreign countries and foreign nationals, as well as to support 'the expansion of credit, trade, and national industry'. The bank could issue banknotes, convertible to silver, up to the value of its own capital. According to its statutes, the Bank of Poland could accept transferable deposits, as well as time deposits, and make loans. It could lend against the security of mortgage bonds (issued by the Land Credit Society), government paper, or the pledge of tangible collateral (such as agricultural products, manufactured articles and other valuables). It could also discount bills of exchange. In practice, the bills of exchange remained a very small part of the balance sheet until the 1860s, at least according to the scant balance sheets published by Radziszewski.[37]

## III.

Over time, the influence of the real bills doctrine increased in the Baltic sea region, however. This is evident from the gradually increasing reluctance everywhere to cover banknotes with long-term mortgages. Around the mid-nineteenth century, in most countries of the region, a transition was already happening from proto-central banks of the land bank type towards classical central banking. As we will see, this transition starts already in the 1840s, and is clearly almost complete when the gold standard was adopted in the area in the 1870s (and later in Russia).

The North European proto-central banks were phased out or transformed around the mid-nineteenth century by banking and monetary reforms in countries of the region. There was a lot of country-specific variety in the timing and actual form of this change, but the direction was the same throughout the whole Baltic Sea area; it was towards the English (or French) model of an independent bank of issue, concentrating on the discounting of bills of exchange.

The first country in the region to complete this transition was Prussia, where the Royal Bank was converted to the Prussian Bank (Preussische Bank) by the bank ordinance of 1846. The reason for the reform was that the supply of money, which in Prussia at that point was based on notes issued by the treasury, was

34 Pipping, *Hopearuplasta*, tables 2, 3 and 5.

35 S. Jasiukowicz, *Der landschaftliche Kreditverein im Königreich Polen 1825-1910* (Munich 1911), pp. 31-47.

36 H. Radziszewski, *Bank Polski* (Warsaw 1910), p. 508.

37 Radziszewski, *Bank Polski*, pp.522-530.

seen as too inflexible. Therefore, it was decided to revert to the more conventional system of money supply in which notes were issued by a central bank. According to the first paragraph of its statutes, the objective of the Prussian Bank was 'to promote money circulation, to make capital available, to support trade and industry, and to prevent an excessive increase in the interest rate'.

Ziegler has noted that the statutes were designed to make the money supply more responsive to the demand for money and credit and that they followed the prescriptions of the English banking school to some extent.[38] Actually, the new system resembled in many respects that of the Banque de France. (Silver) Specie and bills of exchange were now the preferred types of cover for banknotes; in practice, too, bills of exchange became the predominant form of credit granted by the Prussian Bank. In 1856, all remaining state paper money in Prussia was finally converted to banknotes of the Prussian Bank.[39]

The Prussian Bank was to be, of course, the core of the future German State Bank, the Reichsbank, which was established after German unification. One of the institutions which were merged into the Reichsbank (in 1875) was the old and by now old-fashioned Bank of Hamburg. Although the Bank of Hamburg began to discount bills of exchange (on a very small scale), in 1856, it was swept away as an institution by the German monetary union and by the emergence of private commercial banks. The old bank had suffered a severe blow in the great commercial crisis of 1857, when a large part of Hamburg banking houses had had to stop payments, and the Bank of Hamburg itself was criticised for its inability to assist in the liquidity crisis. After that, according to Sieveking, the demands for banking reform in Hamburg could no longer be suppressed. It was obviously felt that the liquidity crisis had proved that the Hamburg application of the currency principle was too inflexible, in the same way that the principle turned out to be unhelpful in England during the great banking crises of the nineteenth century.[40]

The Danish National Bank was fashioned in a 'classical' way from its start in 1818, as far as its new business is considered. Moreover, the Danish National Bank was founded as a private company like the Bank of England and the Banque de France. However, the Danish National Bank had, by the act of its foundation, acquired the mortgage assets and the banknote liabilities of its predecessor, the Rigsbank. In the beginning, these constituted the largest part of the new bank's balance sheet, and could be phased out only very gradually. Another challenge was that in 1818, the banknote liabilities of the bank stood about 25 per cent below their par value in silver. A long period of transition followed, during which the Danish National Bank pursued a restrictive monetary policy until the value of banknotes rose to par with silver and the mortgage debt had been paid off. These goals were achieved by about 1835, after which the National Bank could operate along the lines of a classically constituted central bank.[41]

In Norway, an independent mortgage bank was established in 1852, and this made it easier for the Bank of Norway to refocus its lending from mortgages to the discounting of bills. The international crisis of 1847 had already demonstrated that the asset structure of the Bank of Norway of that time, still mostly consisting of real estate mortgages, was not well suited to a bank of issue. It prevented the bank from using the discount rate as an instrument to regulate reserve flows and the amount of banknotes in circulation. Also, it made the bank's liquidity position very vulnerable. According to Rygg, the reduction of mortgage-based lending was resisted by parliament, however. The gradual phasing out of the long term mortgage loans and the growth of the bills of exchange portfolio took a long time, roughly until Norway joined the gold standard in 1873.[42] In Sweden, the transition from proto-central banking to the classical model of central banking was gradual and

38 Ziegler, *Zentralbankpolitische Steinzeit*.

39 Poschinger, *Bankwesen I*, pp. 229-233; Poschinger, *Bankwesen II*, pp. 15-48.

40 H. Sieveking, 'Die Hamburger Bank 1619-1875', in *Festschrift von Melle* (Hamburg 1933), pp. 103-110.

41 Svendsen and Hansen, *Dansk pengehistorie*, pp. 131-134 and 220-222.

42 Rygg , *Norges Bank I*, pp. 231-237; Rygg, *Norges Banks historie. Annen del* (Oslo 1954), pp. 113-116.

took a long time. In the course of the 1860s, loans on fixed property, which were no longer so important, were phased out of the balance sheet of the Bank of Sweden. At the same time, short term loans, made through autonomous discount offices financed by the Bank of Sweden, were growing in importance. In 1864, the bank itself was allowed to start to discount bills of exchange and the former discount offices were merged into the bank. At first, and until 1874, the newly created discount department remained under separate management from the rest of the bank. Broadly speaking, it can be said that, in Sweden, the transition to classical central banking was completed almost simultaneously with the adoption of the gold standard (which occurred in 1873). However, the share of bills of exchange in the bank's portfolio grew only gradually, so that they did not constitute the biggest asset category until the 1880s.[43]

In Russia, the old state banking system met insurmountable difficulties soon after the great international financial crisis of 1857. In November 1857, the exchange rate of the rouble collapsed and in the following spring deposits started to flow out of the state banks. The situation was critical, which is apparent from the fact that during the year 1859 alone, deposits in the state banks were down by two thirds. In an attempt to improve the banks' liquidity, all new lending against fixed property was halted and any rescheduling of existing loans was forbidden. Sight deposits were converted to perpetual bonds issued to depositors. As if to make the situation even more complicated, this occurred at the same time as the government was preparing a huge land reform, the emancipation of the serfs.[44]

In 1860, a new central bank was founded, called the State Bank of the Russian Empire (Gosudarstvennyi Bank Rossiskoi Imperii). This bank succeeded the former State Commercial Bank, the State Loan Bank, and the State Credit Note Bureau (which had succeeded the old Assignat Bank in 1843), acquiring their assets and obligations.[45]

In theory at least, the new Russian central bank was organised along classical lines. In particular, the structure of private credit allowed to the bank was completely changed. Land credit on mortgages was no longer permitted. Instead, the bank could extend credit to private parties by discounting bills of exchange of less than six months' maturity. It could also make short-term loans against a security of precious metals, or government paper (or private bonds, or shares guaranteed by the government). In the typical early North European fashion, however, it could also lend against the pledge of merchandise, i.e. inventories of export and import goods.[46]

The transition from agricultural mortgages to short-term commercial credit marked a notable change in the way the Russian money supply was organised, since 90 per cent of the private lending of the previous state banking institutions had been in agricultural mortgages.[47] On the other hand, it should be noted that for decades after the reform, the government, not the private sector, remained the major debtor of the State Bank. This obviously reduced the significance of the change in the lending doctrine. In many ways, the bank remained 'little more than a treasury bureau'.[48]

The dependence of the new Russian State Bank on the treasury is apparent from the fact that at this stage, Russian banknotes remained formally the liability of the Russian treasury, and the State Bank merely redeemed and exchanged them on the account of the treasury. The volume of the notes over and above their

43 D. Davidson, 'Tiden 1834-1860', in: *Sveriges Riksbank 1668-1924. Bankens tillkomst och verksamhet* (Stockholm 1931).

44 S.L. Hoch, 'The Banking Crisis, Peasant Reform, and Economic Development in Russia, 1857-1861', *The American Historical Review*, Vol. 96, No. 3 (1991), pp. 795-820.

45 *Polnoe sobranie zakonov Rossiiskoi imperii s 1649 goda (PSZ). Sobranije vrotoje*. Tom XXXV. (St. Petersburg 1860), Chapter 35.847; Zieliński, *Die Rubel*.

46 I.N. Levicheva, 'Stanovlenie i razvitie Gosudarstvennogo banka', in: *Iz istorii gosudarstvennoj kreditnoj sistemy Rossii* (Moscow 2004), pp. 75-106 and 173-201.

47 Zieliński, *Die Rubel*.

48 C. Conant, *A History of Modern Banks of Issue* (New York 1915), p. 260.

metallic cover was simply entered in the balance sheet of the bank as treasury debt. This arrangement was continued until the gold standard reform in Russia in the 1890s during the financial administration of Count Witte.[49]

In Poland, the transition towards classical central banking occurred parallel to the process of integrating the Bank of Poland into the Russian central banking system. This started soon after the January uprising of 1863. The lending practices changed as well, particularly after the rebellion, when the Bank of Poland refocused its activities on the discounting of bills of exchange. This can be interpreted as a first step towards 'modernisation' i.e. towards the classical central banking model.[50] In 1870, the control of the Bank of Poland was taken over by the Russian ministry of finance, and its right to issue banknotes was abolished. The liquidation of the Bank of Poland was initiated in 1885 and in 1894 it was finally integrated into the State Bank of the Russian Empire.[51]

Whereas the early bank of issue of Poland was subsequently unified with the central banking structure of the Russian Empire, the development in Finland took a different direction. Despite the position of Finland as a part of the Russian Empire, the transition to the classical model of central banking happened on a national basis. The development of the Bank of Finland, initially a quite primitive proto-central bank, towards classical operating principles started slowly in 1840, when it was allowed to discount bills of exchange.[52] Until that point, long-term agricultural credit on mortgages had been the predominant form of lending by the bank.

The share of commercial credit in the activities of the Bank of Finland started to grow soon after the end of the Crimean war in 1856. The year 1859 has been proposed as the watershed.[53] However, most commercial credit continued to be given in the old-fashioned way against the pledge of merchandise, i.e. inventories of export goods. The bills of exchange became the predominant form of credit for the Bank of Finland quite late, actually only after 1878 when Finland joined the gold standard.[54]

## IV.

The proto-central banking institutions in the area of the Baltic sea basin during the century before the adoption of the gold standard display quite remarkable common characteristics. Clearly, there existed a North European model of proto-central banking which can be characterised especially by the reliance on real collateral (especially land, and also merchandise). Bills of exchange, which are the preferred type of lending in the classical central banking model were either entirely excluded or remained of little importance as cover for banknotes. The North European model emphasised the presumed solidity of its collateral, identified with tangibility, whereas the classical model, exemplified by the Bank of England and the Banque de France, put greater weight on the liquidity of the collateral.

Another characteristic feature of the North European model was the institutional separation of the different functions to different departments, funds, or even to closely linked separate banks. This was presumably done to ensure trust that the currency was not going to be over-issued and its value jeopardised. The third characteristic feature of the North European proto-central banks is the typically public ownership and control of the banking institutions (as opposed to the formally private corporation which was the ideal for the classical model of central banking).

49 H. Parker Willis, 'Monetary Reform in Russia', *The Journal of Political Economy*, Vol. 5, No. 3 (1897), pp. 277-315.

50 G. Wójtowicz and A. Wójtowicz, *A Monetary History of Poland* (Warsaw 2005), pp. 139-141.

51 J. Schön, *Das Polnische Bankwesen* (Katowice 1928), pp. 80-82.

52 E. Schybergson, *Finlands Bank 1811-1911* (Helsinki 1914), pp. 96-102.

53 Pipping, *Paperiruplasta*, p. 529.

54 Pipping, *Paperiruplasta*, tables 3 and 5; H. Pipping, *Kultakannan turvissa. Suomen Pankki 1878-1914* (Helsinki 1969), table 3.

The structure and activities of the proto-central banks of the Baltic sea area also reflected the underlying economic structure of the region, its requirements and the kind of collateral which it could supply. It also reflects the interests of different power groups and political constituencies in the respective countries.

It is difficult to pinpoint, with certainty, any single reason which caused the transition from proto-central banking to the classical central banking era in the Baltic sea area. Broadly speaking, this transition took place during the latter half of the nineteenth century, with Germany and the Scandinavian countries proceeding faster and Russia slower. But why did this change happen? There are several alternative explanations. The old model failed clearly and spectacularly only in Russia, where financial problems created by the Crimean war (and the financial excesses of the railroad boom after that, which we have not had the space to discuss here) were the proximate reasons for the failure. Of course, the Russian mortgage system, underlying the old state banking system, was unsustainable and incompatible as it was dependent on the institution of serfdom.

Among the hypothetical reasons, which may have caused the transition to classical central banking in the area, one might propose the following:

Factors such as industrialisation, liberalisation of trade, and improved communications increased the supply of bills of exchange suitable for the backing of banknote issues. As a result, transition to the classical model became possible;

Political influence of the industrialists and merchants increased at the expense of landowners, a change which redirected the credit policies of politicised, state-run credit institutions. This may have triggered a change in the objectives of financial policy;

The rising ideology of economic liberalism caused the governments to adopt a less interventionist and less restrictive approach to financial policy. The consequent rise of the private banking sector (and thus the transition to a two-level banking system) made the role of the proto-central banks and their land-based lending more or less redundant;

Transition to the gold standard and financial integration with London and Paris, the hubs of the international gold standard, made it necessary to emulate the central banking arrangements in these centres, lest the competitiveness of the countries in the international capital market would have suffered.

It is not possible here to discriminate between these four alternative explanations for the change in the central banking landscape of the Baltic sea area after about 1850. It is nevertheless evident that the idea of issuing banks based on long term mortgages was seen as outdated by the middle of the nineteenth century. By the last decades of the century, the real bills doctrine had become the standard theory of how banks of issue should be designed, and was to remain so at least until the Great Depression. The question whether the transition from proto-central banking to classical central banking was merely a result of 'real' economic development, or whether this transition may have had an independent effect on the industrialisation or stability of the economies of the Baltic sea region, constitutes an interesting problem which would certainly merit closer study.

# The Political Economy of Monetary Integration in the EU and Implications for Cyprus.

Andreas Theophanous

## Introduction

The European Economic and Monetary Union (EMU) in many ways constitutes a unique experiment in economic history, representing a case of monetary union without a comprehensive political union, but with a single currency and a common monetary authority. The EMU ran ahead of fiscal and financial integration and happened at a time of diverse economic records and circumstances in Europe. In the process, rather inevitably, considerable costs were created for several countries. However, multiple benefits have accrued to its member countries over time. The EMU has forged the necessary nominal policy anchor for macro-economic stability, increased transparency and enhanced competition, it has helped develop integrated capital markets, induce structural change and stimulate productivity growth.

The introduction of the single currency, where the conditions of an optimum currency area did not fully apply, presents a number of problems, challenges and potential threats. However, the more fundamental question is, how will the EMU fare in the longer run? And what are the challenges that the euro must survive in order to become and/or be sustained as a leading international currency? Such a development may also mean, among other things, that the euro will become the/a main reserve currency.

This paper looks at the European Union (EU) from a historical perspective and pays particular attention to the creation of the EMU and the relevant future challenges. Within this framework, the paper assesses the potential political ramifications and implications. The position is advanced that in the long run for the euro to be successfully sustained and to also be a permanent leading international currency, the EU must further advance its political integration.

The paper also briefly considers the case of Cyprus' adoption of the euro and the political and economic implications. In the final section we put forward some concluding remarks with a special emphasis on suggestions for further research.[1]

## I. From the European Community to the European Union

Although the creation of the European Community (EC) is not independent from the overall dynamic process of the formation of regional economic blocs and even globalisation, it is important to recall the conditions under which the EC was founded.[2] This analytical framework enriches the overall evaluation.

Europe has a long record of national rivalries and conflict. In the twentieth century alone it was devastated by two World Wars that started and were mainly fought on its soil. Following the Second World War and the rise of the Soviet Union, a new set of circumstances was created. For the US it was imperative to contribute toward the reconstruction of Europe in the context of the American strategic objectives to maintain supremacy and leadership as well as to contain the Soviet Union. On their part, European leaders felt that the time had come for a new approach of cooperation and communality. Europeans realised that ethnic rivalries were not conductive to the promotion of their common interests. Consequently, with the

1 Pipping, *Paperiruplasta*, tables 3 and 5; H. Pipping, *Kultakannan turvissa. Suomen Pankki 1878-1914* (Helsinki 1969), table 3.

2 For example, see D. Weigall and P. Stirk (eds.), *The Origins and Development of the European Community* (Leicester 1992).

initiative of France and (West) Germany, the traditional European rivals, a process of economic (and other forms of) cooperation began in the 1950s, which culminated in the Treaty of Rome in 1957.

Although the Treaty of Rome practically set up a Customs Union among six countries (W. Germany, France, Italy, Netherlands, Belgium, Luxembourg), in essence, it paved the way for a much more ambitious project. It should be noted that at about the same time a European Free Trade Area (EFTA) was founded which had a less ambitious agenda. More specifically, EFTA was concerned with advancing free trade. Over time the EC was successful in becoming much more influential and in the end almost all countries that originally belonged to EFTA joined the EC/EU.[3] It is interesting to note, however, that Britain, which has been the leading country of EFTA to the present day, pursues a philosophy which does not encourage the political integration of the EU.

It is important to stress that if one examines retrospectively what has been achieved, the record of the EC/EU is remarkable. When the EC was founded in the 1950s its objectives, tacitly and implicitly, were the following:

Reconciliation: to heal the wounds of the past;

To promote peace and security;

To create the conditions for the economic reconstruction of Europe;

To pave the way for the economic ascendancy of Europe;

To help contain the Soviet Union and the spread of Communism;

To sustain democratic institutions and human rights;

To promote the ultimate objective of political unification of Europe and thereafter work toward assuming a protagonist role in world affairs.[4]

By 1989 much had been achieved. Western Europe was successful in overcoming the divisions of the past and had also enjoyed an unprecedented period of peace and economic prosperity. Not only was the EU successful in achieving a quick recovery from the ruins of the Second World War, but it also laid the foundations for its economic ascendancy globally. It must be acknowledged though that the contribution of the US for this outcome was very important. Furthermore, it is important to note that with the collapse of communism and of the Soviet Union, the Berlin Wall fell and Germany was reunited peacefully. Indeed, the fall of the Berlin Wall and the reunification of Germany were also symbolic of the beginning of a new era of peace, prosperity and security. The EU was about to embark on a new path of further integration involving both the deepening and widening of the Union.[5]

Undoubtedly, there were at times different stumbling blocks which seemed to impede or rather decelerate the process of European integration. The EC always found ways to move forward. For example, during the 1980s when the EC faced what came to be described as Euro-sclerosis, European leaders rose to the occasion and the outcome was the Single European Act, which aimed at promoting a truly Single European Market.[6] Europe 1992 became both an ambitious slogan and a new reality; in its turn this development contributed

3 See J. McCormick, *The European Union: Politics and Perspectives* (Boulder 1996), pp. 56, 76-78, 133.

4 It may be argued though that the objectives of ascendancy as well as of a political protagonistic role were not in the minds of all the founders.

5 P. Cecchini, M. Catinat and A. Jacquemin, T*he European Challenge 1992: The Benefits of a Single Market* (Aldershot 1988); L. Cockfield, *The European Union: Creating the Single Market* (Chichester 1994); C. Egenhofer, S. Kurpas and L.V. Schaik, *The Ever-Changing Union: An Introduction to the History, Institutions and Decision-Making Processes of the European Union* (Brussels 2009), pp. 3-15. J. McCormick, *The European Union: Politics and Perspectives*, op. cit., pp. 64-83. A. Duff, J. Pinder and R. Pryce (eds.), *Maastricht and Beyond: Building the European Union* (New York 1994).

6 J. McCormick, *The European Union: Politics and Perspectives*, op. cit.; C. Egenhofer, S. Kurpas and L.V. Schaik, *The Ever-Changing Union: An Introduction to the History, Institutions and Decision-Making Processes of the European Union*, op. cit., pp. 6-7.

to a great extent to paving the way for the later adoption of the euro. Within this framework the Treaty of Maastricht was indeed a milestone.[7]

The EC exhibited a great degree of flexibility and foresight with respect to its enlargement over time. In 1973 the UK, Ireland and Denmark joined the Union; in 1981 Greece and in 1986 Spain and Portugal also became members. Following the end of the Cold War and the dawn of a new international environment, Austria, Finland and Sweden joined the Union in 1995. What is remarkable is that there has been, over time, a simultaneous process of widening and deepening. This is particularly important in view of the fact that repeatedly the view put forward was that there was a trade-off between these two processes.[8]

The EC/EU pursued a pragmatic approach which aimed at maximising the benefits subject to the existing constraints. The EU understood the difficulties of trying simultaneously to advance both widening and deepening, but at the same time the EU realised that it would be losing the forest for the tree if it inflexibly chose to advance deepening at the expense of widening or vice versa. It was of vital importance for the EU to expand the security and prosperity zone. It is within this overall philosophical perspective that the enlargement from 15 to 27 members – with the accession of eight Central and Eastern European countries as well as Malta and Cyprus in 2004, and that of Bulgaria and Romania in 2007 – should be understood. Nevertheless, further expansion is now considered in a different light in terms of the absorption capacity of the EU. In other words, although it is expected that more countries will join the EU, it is also understood that there is a limit to the process of further enlargement.[9]

Inevitably, during all these years the member-countries learned the art of compromise and flexibility. The European institutions acquired an importance of their own in the eyes of national policy-makers as well as of people at large. And gradually it was both understood and accepted that a reallocation of powers, jurisdiction and authority between Brussels and the national capitals was a natural evolution of the continuous development of the EC/EU. Nation-states compromised with the idea that national sovereignty has been going through a process of transformation, allowing the EU to acquire more powers, authority and jurisdiction.

The EU has been repeatedly criticised for what it was not successful in doing. For example, it has been suggested that during the Yugoslav crisis, in the 1990s, the EU's actions proved to be inadequate in containing the crisis, the tragedy and the bloodshed in the Balkans.[10] Although this criticism is valid, it finally prompted the member states to seriously raise the issues of common foreign policy, defence and security at the EU level. This development, despite its shortcomings, confirms the perspective that the concept of the nation-state in the EU is undergoing a transformation. It is also within this overall framework that the decision of the EU member states to adopt a single currency should be assessed. Undoubtedly, it was a radical and bold step. It also reflected both a symbolic change and a new beginning both for the EU and the member states.

7 Th. Christodoulides and C. Stephanou (eds.), *The Treaty of Maastricht* (in Greek) (Athens 1993); J. McCormick, *The European Union: Politics and Perspectives*, op. cit., pp. 64-83.

8 M. Jachtenfuchs, 'Deepening and Widening Integration Theory', *Journal of European Public Policy*, Vol. 9, No. 4 (2002), pp. 650-657; A. Faber and W. Wessels, 'Wider Europe, Deeper Integration? A Common Theoretical and Methodological Framework for EU-Consent', paper for the Kick-off Meeting, Brussels, 18 Novembern 2005.

9 B.F. Nelson and A. Stubbs (eds.), *The European Union: Readings on the Theory and Practice of European Integration*, 2nd ed. (Boulder 1998); R. Dehousse (ed.), *Europe: The Impossible Status Quo* (English translation by C. Morgan) (New York 1997); M. Emerson, S. Aydin, J. De Clerck-Sachsse and G. Noutcheva, 'Just what is this 'absorption capacity' of the European Union?', *CEPS*, Policy Brief No. 113 (2006); European Commission, '2005 Enlargement Strategy Paper', COM (2005) 561 final, Brussels, 9 November 2005; L. Tsoukalis, *What Kind of Europe?* (New York 2003).

10 T. Lambrias, *'Phantom' Europe – In the Era of Globalization and American Hegemonism* (in Greek) (Athens 2000).

## II. The Advent of the Euro and the Economic and Monetary Union

As early as 1969 at the Hague European summit, the leaders of the six member states of the then EC agreed on the adoption of a common currency within the framework of an Economic and Monetary Union over a period of ten years. However, at the 1980 Luxembourg European Council meeting the EC heads of state abandoned the objective of completing the final stages of a European Monetary System within the initial timetable when it was realised that the target was too ambitious. Nevertheless, the important element was that there was a vision to move in the direction of a common currency.[11]

As a result of both the adoption of the Single European Act and of full capital mobility it was becoming increasingly clear that the European Monetary System (EMS), which was adopted in 1979, was inadequate to meet the new challenges. The Treaty of Maastricht in 1992 marked a turning point in the process of European integration. The member states agreed to proceed toward the completion of an Economic and Monetary Union (EMU), leading to the adoption of a common currency. These objectives were accompanied by a time schedule, but there were serious reservations about whether this project would be successful.[12]

Moreover, there was much criticism about the wisdom of such a move. According to Feldstein, the adoption of a common currency made sense only if a political decision to move forward to a Federal Europe was taken. He argued that in the absence of such a vision and clear political objectives the adoption of the euro would create more problems than benefits. Among other things, he predicted the persistence of unemployment and, given the existence of asymmetrical shocks and different circumstances in each country, the emergence of a new set of developments which could cause considerable strife at both the European and international level.[13]

Nevertheless, the idea of the EMU and the euro were received positively by others. The adoption of a common currency made sense from an economic perspective irrespective of the *a priori* existence or not of political objectives. According to Wyplosz, a single market which was moving toward further integration in conjunction with different national currencies would always lead to situations of currency crises, as an outcome of speculation or other fundamental factors.[14] Moreover, the adoption of a common currency could lead to price stability and harmonisation, drastic reduction of transaction costs and would also contribute to the creation of a truly single integrated European market.[15]

At the same time, it should be stressed that the adoption of the euro created processes that could lead not only to further economic integration but also to the possibility of further political cooperation. The creation of the European Central Bank (ECB) and the introduction of the euro were thought of as potentially applying pressure to develop political mechanisms for holding monetary policymakers more accountable. In relation to this, it may be underlined that while in the past there have been cases of strong nation-states and/

11 C. Egenhofer, S. Kurpas and L.V. Schaik, *The Ever-Changing Union: An Introduction to the History, Institutions and Decision-Making Processes of the European Union*, op. cit.

12 R.A. Mundell, 'EMU and the International Monetary System', *The Monetary Future of Europe* (London 1993); N. Dettani, 'Economic and Monetary Union', in S. Stavridis, E. Mossialos, R. Morgan and H. Machin (eds.), *New Challenges to the European Union: Policies and Policy Making* (Dartmouth 1997), pp. 201-223; M. Emerson, D. Gros and P. Ludlow, 'Coming to Terms with EMU and Enlargement', *CEPS 4th IAC Annual Report* (Brussels 1999); L. Tsoukalis, 'Economic and Monetary Union: The Primacy of High Politics', in B.F. Nelsen and A. Stubbs (eds.), *The European Union: Readings on the Theory and Practice of European Integration*, 2nd ed. (Basingstoke 1998), pp. 335-344.

13 M. Feldstein, 'The Political Economy of the European Economic and Monetary Union: Political Sources of an Economic Liability', *The Journal of Economic Perspectives*, Vol. 11, No. 4 (1997), pp. 23-42; M. Feldstein, 'EMU and International Conflict', *Foreign Affairs*, Vol. 76, No. 6, Nov./Dec. 1997, pp. 60-73.

14 C. Wyplosz, 'EMU: Why and How it Might Happen', *The Journal of Economic Perspectives*, Vol. 11, No. 4 (1997), pp. 3-22.

15 R.A. Mundell, 'EMU and the International Monetary System', op. cit.; D.P. Calleo, 'The Strategic Implications of the Euro', *Survival*, Vol. 41, No. 1, Spring (1999), pp. 5-19.

or empires with weak currencies (i.e. Soviet Union and the rouble) there has never been a strong currency without a state.[16]

## III. The Political Economy of the EMU: the Record and the Challenges

The EMU has generated many positive results and benefits for member countries. Most importantly it has led to integrated capital markets, has supported a more stable economic environment by anchoring inflationary expectations, lowered borrowing costs across the board and thus underpinned considerable economic growth. This ultimately helped to advance the objective of real convergence (although much more remains to be done), thus reducing the marked disparities in per capita income levels. At the same time, the elimination of transaction costs and increased price transparency further enhanced trade and benefited the consumer.

Following the marked devaluation of the US dollar in the period of 2005–2008, the euro has come into focus as an alternative international currency. Consequently, the strength and governance of the new currency constitute areas of increasing interest in global finance. But the single currency in the framework of divided and/or shared sovereignty raises a number of issues and potential threats.

There is what may be described as the optimum currency area challenge, the fiscal challenge, the growth challenge and the financial stability challenge. Moreover, the fundamental question and challenge is whether in the long run the euro can be successfully sustained without further political integration. Alternatively put, the question raised is whether the euro will dynamically create a process which will lead to further political integration?

### Lessons from the Past

The essence of a monetary union is that all member states adopt the same currency which means that there is only one exchange rate *vis-à-vis* the rest of the world and a common monetary policy with, among other things, the sole responsibility for setting interest rates. Monetary unions in the past were configured for two primary reasons: first, to facilitate trade and second as part of the creation of a nation state from a number of smaller political units. Nation building was also combined with the creation of a fiscal union.

Monetary unions in the past can generally be distinguished between two categories: national and multinational unions. Examples of the former include the US, Germany and Italy, which were also cases of nation building. Examples of past multinational monetary unions include the Latin Monetary Union between France, Belgium and Switzerland, and the Scandinavian Monetary Union between Sweden, Norway and Denmark.[17]

The experiences of monetary unions in the past provide us with a number of useful lessons. Most importantly, national and multinational monetary unions were set up for broadly the same economic objectives: to facilitate trade by reducing transaction costs of currency exchange; reduce or even eliminate trade restrictions; reduce exchange rate volatility; and prevent wasteful competition for seigniorage. National monetary unions were set up for the added political imperative of creating nation states.

Unlike national monetary unions, multinational monetary unions in the past did not survive the test of time. For instance, the Latin Monetary Union and the Scandinavian Monetary Union broke up in the First World War. Multinational monetary unions could not survive in an unstable international environment. The

16 It should be acknowledged that privately issued currencies by banks and other institutions were the norm well into the nineteenth century in the US and elsewhere. In this regard it should be noted that we are using the term currency to mean money.

17 M.D. Bordo and H. James, 'A Long Term Perspective on the Euro', *Economic Papers*, Economic and Financial Affairs, European Commission, No. 307 (2008).

pressures of war put the various member states on divergent paths regarding the optimal mix of national fiscal and monetary policies.

National monetary unions have endured for centuries despite considerable strains (civil war in the US, the postwar division between East and West Germany), reflecting the cohesion of their underlying nation states. National monetary unions all developed central banks as part of the process of monetary unification. They also evolved into fiscal unions whereby considerable economic powers were transferred from the regional level to the national authority, either centralised or federal. Fiscal prudence and stability therefore emerge as necessary conditions for the viability of a monetary union.

The EMU is different from earlier experiences of monetary unification in a number of respects. Whereas multinational monetary unions in the past kept separate monetary authorities, the EMU has created a single currency and a common monetary authority. In contrast with national monetary unions, member states have kept a substantial part of their political sovereignty and also a large degree of fiscal sovereignty. A key potential problem is conflict among national agendas for growth and employment. This problem of course is related to the incidence and severity of potential asymmetric shocks. Political will toward greater political integration or the creation of cooperative fiscal arrangements will be vital for the underlying durability of the EMU.[18]

## Perspectives from the Optimum Currency Area Literature

There is a substantial body of literature on Optimum Currency Areas (OCA) that is relevant to monetary unions. OCA theory considers the conditions necessary for a monetary union with a single currency to be successful. Initially OCA literature focused on the trade related benefits of adopting the single currency.[19] The conclusion was that the corresponding reduction of transaction costs would benefit national economies in direct proportion to their degree of trade openness.

By definition the adoption of a common currency implies the loss of independence over monetary policy. However, in an interdependent world, the need for stability of the currency would by itself limit the extent to which monetary policy would be absolutely discretionary. Small countries in particular with fixed or pegged exchange rate regimes would have serious limitations exercising discretionary monetary policy. It is also doubtful to what extent a currency devaluation would benefit such an economy in the long run.

Given the EMU and the adoption of a common currency and effectively common interest rates, national governments do not have the option of monetary discretion. The implication is clear: it may be more difficult for a particular economy to get out of a recession when it is in a currency zone and the currency and the interest rates are not likely to be affected by its own predicament. This point raises another issue: how are small and big countries differently affected by a recession and how do they affect the common currency and common interest rates? In this framework it should be clarified that the adjustment process under conditions of monetary integration is greatly facilitated by the free flow of resources. This is a basic tenet of OCA theory.

Such problems must also be addressed within the framework of asymmetric shocks as, for example, when Eurozone countries experience different phases of the business cycle which could lead them to prefer different interest rates. Given a common currency and common interest rates, other means would have to be

18 For a historical discourse on the conditions of maintaining monetary unions see M.D. Bordo and L. Jonung, 'The Future of EMU: What Does the History of Monetary Unions Tell Us?', *NBER Working Paper* No. W7365 (Cambridge 1999).

19 R.A. Mundell, 'A Theory of Optimum Currency Areas', *American Economic Review*, Vol. 51 (1961), pp. 509-517; R.I. McKinnon, 'Optimum Currency Areas', *American Economic Review*, Vol. 53 (1963), pp. 717-724; P. Kennen, 'The Theory of Optimum Currency Areas: An Eclectic View', in: R. Mundell and A. Swaboda (eds.), *Monetary Problems of the International Economy* (Chicago 1969), pp. 41-61.

sought to accelerate the end of a recession in a particular country. It may be important to revisit the role of the EU and its institutions and policy options for this reason.

The loss of independence over monetary policy implies a cost associated with asymmetric shocks. In the absence of flexible labour and product markets, the result of asymmetric shocks would be the loss of output and employment in the countries experiencing negative shocks. Similarly there would be gains in the countries experiencing positive shocks at the same time. In this context there is scope for a common fiscal authority for transferring resources from the positively affected regions to the regions and countries adversely affected. Of course the role of a fiscal authority is not limited to this function.

In the case of capital mobility, the introduction of a common currency eliminates destabilising speculation in foreign exchange markets for the national currencies of the countries in the monetary union. The resultant exchange stability eliminates one source of asymmetric shocks and provides added benefits (in the context of a monetary union).[20]

There is also an extensive literature on the endogeneity of OCA.[21] This literature argues that removing barriers to trade, thus enlarging a potential trading area, and sharing a common currency promotes deeper trade and overall economic integration. The endogeneity of the OCA paradigm however, does not imply that any group of countries can form a currency area in the expectation that endogeneity effects will automatically manifest themselves. Minimum conditions, involving nominal convergence, must be met *ex ante*; this has been one of the major objectives of the Treaty of Maastricht.[22]

Empirical evidence regarding the extent to which the euro area satisfies the OCA criteria would suggest the following stylised facts:[23] Adjustment to region-specific shocks is slower in Europe than in the US; intra-regional mobility and international migration in the euro area are low; wages and prices are sticky in the short run, which implies costs of adjustment to negative shocks. These facts stress the need toward more fiscal integration in the Eurozone.

## The Fiscal Challenge

One of the most important questions raised relates to the impact of the adoption of the single currency on the fiscal policies of the countries of the Eurozone. The interdependencies of monetary and fiscal policies cannot be overlooked. Sargent and Wallace for instance,[24] convincingly argued in 1981 that particular monetary objectives cannot be met independent of what is going on in the fiscal domain. The argument can of course be reversed. Fiscal objectives may not be independent of developments in the monetary domain.

From a practical perspective the adoption of the euro involves a policy of fiscal restraint. In the long-run this leads to extremely positive outcomes such as accountability in relation to how public funds are allocated and spent, pushing aside wasteful spending and thus promoting efficiency and so on. But in the short run, fiscal restraint may cause hardship and the adjustment costs may be high.

In the case of the EMU, a fiscal union may evolve through a federal structure which would, *inter-alia*, involve the transfer of competencies and functions from the national authority to the supranational level.

20 R.A. Mundell, 'Uncommon Arguments for Common Currencies', in H.G. Johnson and A.K. Swaboda (eds.), *The Economics of Common Currencies* (London 1973), pp. 114-132.

21 J.A. Frankel and A. Rose, 'The Endogeneity of the Optimum Currency Area Criteria', *NBER Working Paper* No. 5700 (Cambridge 1996).

22 In relation to the Maastricht criteria and theoretical issues revolving around the EMU, see: G.D. Demopoulos, 'The Economic and Monetary Union' (in Greek), in: Th. Christodoulides and C. Stephanou, *The Treaty of Maastricht* (in Greek), op. cit., pp. 177-196.

23 M.D. Bordo and H. James, 'A Long Term Perspective on the Euro'.

24 T.J. Sargent and N. Wallace, 'Some Unpleasant Monetary Arithmetic', *Federal Reserve Bank of Minneapolis Quarterly Review*, Vol. 5 (1981), pp. 1-17.

Federalism would limit the independence of national governments, thus further eroding the sovereignty of the state.

Much attention has also been paid to the existence of several independent fiscal authorities linked with a single currency and a common monetary authority.[25] The main conclusion is that minimum fiscal constraints on the national economies are necessary in order to avoid excessive deficits at the national level that would hinder the effectiveness of monetary policy. The Maastricht Criteria, defining the preconditions for adopting the single currency, perform exactly this role. The Stability and Growth Pact performs a similar role after accession to the Eurozone and adoption of the single currency. It is the failure to operate within these constraints that has recently revealed significant difficulties across a number of Euro area countries.

Fiscal federalism can offset the effects of asymmetric shocks thus adding to the operation of a monetary union. But what are the characteristics that make a fiscal union successful? Bordo and James consider the national monetary unions of the US, Argentina and Germany in historical context and conclude the following:[26] Historical precedence shows that fiscal unions are preceded by political unions; institutional developments were usually the consequence of extraordinary circumstances such as economic disasters; there was a learning by doing element in institutional evolution.

The transfer of more fiscal responsibility from the national level to a would-be federal authority in the Eurozone seems to be necessary for the viability of the monetary union but one which is difficult to achieve. It is interesting to note that in the US over time there has been a transfer of functions and competencies from the states to the centre and vice versa. Poor coordination of national fiscal policies poses a threat to the cohesion and the long-term viability of the monetary union. Hence, some additional institutional reforms will be needed. It is essential to revisit the relationship(s) between monetary integration on the one hand and fiscal policy on the other.

## The Growth Challenge

Long-term economic growth is ultimately critical for the long-term viability of the monetary union. Low growth *per se*, or variable growth rates across member countries, leads to conflict and brings political pressures over elements of the common monetary policies. Where growth patterns diverge amongst member countries, the efficacy of one-size-fits-all monetary policy will be questioned. Different regions will favour a different monetary policy according to their specific situations. Unavoidably all this will strain common monetary policy.

High rates of economic growth tend to reduce fiscal imbalances, thus aiding the effectiveness of the single monetary policy. By the same token, low rates of economic growth heighten fiscal imbalances making a common monetary policy more controversial as the needs of individual member countries begin to diverge. In such a context of low growth and rising fiscal imbalances the ECB will be increasingly the focus of criticism. People fearing the consequences of slow economic activity in terms of their jobs, and politicians looking to take advantage of evolving problems, would find it expediant to direct their rhetoric against the single currency. The next five to ten years will be particularly challenging for the EMU. This is because growth rates will be much lower than previously and also, more importantly, because growth differentials are clearly widening.

25 V.V.V. Chari and P.J. Kehoe, 'On the Desirability of Fiscal Constraints in a Monetary Union', *NBER Working Paper* No. W10232 (Cambridge 2004); H. Uhlig, 'One Money, but Many Fiscal Policies in Europe: What Are the Consequences?', *Centre for Economic Policy Research Discussion Paper* No. 3296 (London 2002).

26 M.D. Bordo and H. James, 'A Long Term Perspective on the Euro'.

Germany has been a laggard in the EMU with Italy and France close in line. The smaller countries were the most dynamic element whereas southern countries like Spain have seen (until 2009) unprecedented growth amidst remarkable macroeconomic stability. Germany entered the EMU with an overvalued exchange rate. However, in the period of the operation of the EMU, unit labour costs in Germany have declined relative to Italy and France. At the same time Germany's share in Eurozone exports increased at the expense of Italy and France. These trends support large relative movements in competitive positions.

The housing sector in which several but not all EMU countries experienced a strong and sustained boom in the period 2003–2007, constitutes another area of disequilibrium. For example, Spain, Italy and France experienced strong growth in the construction and housing sectors, while in Germany the overall record was more restrained. In effect, as the housing cycle has unwound, growth patterns inside the EMU are changing, causing considerable strain and tensions.

The EMU will most likely survive these strains for the very simple reason that the cost of leaving it for any one member with a high debt burden and accumulated imbalances is most severe.[27] Nevertheless, much remains to be done in the direction of further economic and political integration for the EMU to be successful in the long run.

### The Financial Stability Challenge

At the same time, financial sector shocks can potentially undermine monetary regimes and discredit central banks responsible for their operations. The Eurozone is an integrated capital market with a common currency and monetary authority. Yet the regulatory framework is in the hands of the national authorities. As a result the extent to which the regulatory framework can provide preventive supervision is limited. That is, there is no central body or authority that would be aware of financial problems from early on. However, shifting supervision to the supranational level may have practical difficulties as Bordo and James argue.[28] Specifically, regulation is typically linked to lender of last resort functions. This has a significant fiscal dimension, which may be difficult to transfer from the national to the supranational level.

## IV. The Political Economy Challenge: Economic Ramifications and Political Implications

The adoption of the single currency encourages the deeper integration of all the economies in the Eurozone. In the long run this would – through different processes – lead to a more efficient, thus more competitive, economic structure. The adoption of the euro involves essentially the transfer of competencies in several areas from each nation-state to the EU and its institutions. This in turn raises expectations regarding the role of the EU as a supra-national structure.

It has already been noted that while in the past there have been cases of strong powers and weak currencies, there has never been a case of a strong currency without a state. Again the implication is that, with the adoption of the euro, the EU has irrevocably entered a path which will lead to more changes. More specifically, the EU may have to adopt a modern constitution and also promote a common foreign and security policy. If the hypothesis is correct that the best possible performance of a currency in the international arena requires a full political entity, this is a necessary though not a sufficient condition. The EU will have to advance its political institutions and move toward the direction of further political integration.

27 P. De Grauwe, 'The Twin Shocks Hitting the Eurozone', *Centre for European Policy Studies Commentary*, 16 September 2008; D. Gros, 'Will EMU Survive 2010?', *Centre for European Policy Studies Commentary*, 19 February 2007.

28 M.D. Bordo and H. James, 'A Long Term Perspective on the Euro'.

Given the historical experiences with financial and currency crises, fiscal strains and low economic growth constitute major risk considerations for the EMU and the single currency. On the other hand such circumstances tend to enhance the need for solidarity and coordination.

Following the Second World War, Europe experienced a steady and sustained rise in government spending. This was the result of social and distributional policies that saw the rise of the welfare state as we know it today. Whilst the welfare state can be the basis of much social stability and economic resilience in Europe, the classic trade off between social welfare and economic efficiency sets limits on the extent of the welfare state.

Government finances are coming under severe strain as a result of two interconnected developments. On the revenue side there is increasing pressure in a globalised world to reduce corporate tax rates. On the spending side a number of interrelated factors – the ageing of the population, rising medical costs, and rising demand for public services in general – are straining public finances. Lack of coordination of national fiscal policies may create a serious threat to the single currency.

The long run success of the euro also critically depends on a sustained rate of real growth. Low growth or markedly variable growth rates across different regions and countries have begun to generate political strains against the euro. The anti-globalisation movement in Europe is directed toward protecting jobs at the national level and supporting businesses against takeovers. The single currency is seen as a problem and a threat to job security, for the very simple reason that a common monetary policy means that interest rates will be low in some parts and too high in others. Through the political system the anti-globalisation movement can succeed in forcing its agenda. In this context support for a monetary policy framework in line with the Federal Reserve in the US where growth is given consideration along with price stability, will grow.

The euro has evolved as the second *de facto* reserve currency of the world. However, the euro stands in contrast to the dollar in a number of respects. Unlike the dollar, the euro is not the currency of a superpower. The euro is held for the purposes of diversification and for political reasons. More importantly, it is not dependent on continued capital inflows like the dollar.

The EU at the same time features healthier current account dynamics than the US. In fact the major reason for the appreciation of the euro in the last six years or so has been the current account imbalances of the US versus the Asian economies, mainly China. The reluctance of the Asian economies to allow their currencies to appreciate led to the sustained appreciation of the euro.

An expensive euro, however, imposes high costs on export sectors making it vulnerable to global challenges. At the same time, being a reserve currency generates obligations that sometimes can run contrary to domestic concerns, making it difficult to maintain cohesion.[29]

Coming back to the issue of whether the euro itself will pave the way for further political integration it is important to note that during the deep international financial and economic crisis of 2008–2009, the euro proved to have ameliorated the negative impact in the countries of the Eurozone. The multidimensional usefulness of the euro is very much understood and complaints about loss of national monetary and economic independence are gradually put aside. The sustainability of the euro, while at the same time trying to achieve other economic objectives, is the core issue. These dynamics raise *de facto* the issue of further economic deepening and political integration. Even if not all of the countries of the EU and even of the Eurozone may be interested in discussing the further economic and political integration, this will be undertaken by some countries. This may lead to the scenario of a multi-speed EU with the core moving toward a form of federation.

29 M.D. Bordo and H. James, 'A Long Term Perspective on the Euro', especially pp. 25-26.

## V. Cyprus' Adoption of the Euro and the Implications

Cyprus' adoption of the euro as of January 2008 is without doubt its most important achievement since accession to the EU in 2004. This development is expected in the longer run to have far reaching economic, social and political implications.[30]

The process of transition to the euro has been smooth without any significant obstacles. The government consistently pursued a prudent fiscal policy without upsetting social fundamentals and other parameters. This policy in conjunction with satisfactory GDP growth paved the way for nominal convergence with the Maastricht criteria. This was important but at the same time it must be acknowledged that much remains to be done for real convergence in the years ahead.

The Maastricht criteria have their broader economic rationale; to create a framework of macroeconomic stability and an environment of low inflation. The period of nominal convergence that precedes the adoption of the euro is a period of disinflation, which necessarily implies a more restrictive mix of monetary and fiscal policies. But this is a cost that mostly occurs during the period of accession negotiations and prior to entry into the Exchange Rate Mechanism 2.

The benefits of euro adoption therefore are of greater interest; these are classified into two main categories: a) the direct implications of monetary integration, and, b) the long-term adjustment processes set in motion for real convergence. The adoption of the euro accelerates the process of financial integration, intensifies the competitive forces in the domestic market and facilitates corporate access to financing sources. At the same time the consequent removal of exchange rate risk pre-empts potential destabilising possibilities associated with sudden changes in the movement of capital. Nominal interest rates fall at least by the previous exchange rate premium, whilst the improvement in the macroeconomic framework generates the conditions necessary for attracting added foreign direct investments and for encouraging domestic investments. These new trends in turn provide added stimulus to economic activity and help improve productivity levels, raising at the same time the consumption possibilities of the country.

The loss of independence over monetary policy is considered a cost of euro adoption for a simple reason. To the extent that the Cyprus economy might experience a low degree of real convergence with the economies of the Eurozone, the implications of adverse exogenous shocks would be destabilising. This would shift the burden of adjustment to the labour market and public finances with a corresponding slowing of economic activity.

Whilst these parameters are important we doubt the extent to which they apply in the case of Cyprus. The degree of real convergence of the Cyprus economy is relatively high reducing the likelihood of an uncongenial monetary policy by the European Central Bank. More importantly, however, the ability of a small open economy like Cyprus to implement its own independent monetary policy is limited irrespective of euro adoption.

For Cyprus the adoption of the euro is an important milestone for another specific reason. As the country tries to achieve real convergence with the EU it will also have to rise to the challenge of reunification. At the same time a number of issues that were raised by the Turkish Cypriot side during the negotiations that led to the Annan Plan of 2004, most importantly the objective for separate central banks and a neutral currency in the federal state, other than the Cyprus pound, have been eliminated *a priori* after the introduction of the euro.

30 A. Theophanous and Y. Tirkides (eds.), *Accession to the Eurozone and the Reunification of the Cyprus Economy*, op. cit.; A. Theophanous, Y. Tirkides and Th. Pelagidis, 'Cyprus Accession to the Eurozone and the Reunification of the Island's Economy', op. cit.

The euro has the potential to be a unifying tool in Cyprus, not only economically but also socially and politically. The euro calls for a more unified economic and political structure in the event that the two sides can find a solution. This has clear implications: if a unified Cyprus is to meet its obligations as a member of the EMU, it must follow uniform and consistent economic policies. This requires coordination and cooperation. The risks of instability as a result of fiscal pressures consequent upon an eventual solution and re-unification without the euro are now being eliminated.

All these issues must receive their fair share of attention by the political and business leaders of both communities in Cyprus. The euro can prove to be the catalyst for new thinking in relation to the reunification of Cyprus. It should be noted that in federal arrangements it is of utmost importance to advance a common value system, common objectives and common institutions. The euro serves these objectives in direct and indirect ways. At the same time the euro entails responsibilities in relation to fiscal prudence and also raises the issue of a broader economic policy coordination. In sum, Cyprus' adoption of the euro also influences the type of solution to the Cyprus question: the reunification of this island-state presupposes an integrated society, economy and political structure.

In this regard perhaps it is important to consider the possibility of a paradigm shift: from the bizonal bicommunal federal model in which power is essentially concentrated in two constituent states to a model of functional federation in which power derives basically from the central government. Within the framework of this discussion it is also essential to acknowledge that the functional federal model entails an integrationalist approach and also allows market forces to play an important role.[31] For this scenario to materialise though the consent of the Turkish (Cypriot) side is important.

## VI. Concluding Remarks and Suggestions for Further Research

The introduction of the euro has had far reaching implications in the countries that have adopted it and in the international monetary system generally. The EMU is a unique endeavour in monetary history in the sense that it is the only case of monetary union with a common currency and a common central bank but without a comprehensive political union. It is today the most advanced form of economic integration and provides many advantages for its members. The euro has created a nominal policy anchor necessary for macroeconomic stability which has been more supportive for trade, investment and ultimately economic growth. The reduction of transaction costs and the absence of exchange rate volatility across the countries of the Eurozone have greatly enhanced trade and productivity.

At the same time in terms of political repercussions, the introduction of the euro constitutes an act of transfer of competence and, indeed, power from the national level to a supra-national structure. Given that the adoption of the euro may also be symbolic of a further reduction of the sovereignty of the nation-state and a simultaneous further upgrading of the EU, it is only natural that there may be higher expectations from the union.[32]

But the euro is only ten years old and has not really been tested in a protracted low growth environment. Low growth or variable growth rates across member countries heighten fiscal imbalances making a common monetary policy more controversial as the specific needs of individual countries begin to diverge. Globalisation and intensified competition means that real growth patterns in the EU are changing.

Fiscal federalism can offset the effects of asymmetric shocks and consequently can play an important and complementary role to monetary policy. Government finances at the national level are coming under severe

31 A. Theophanous, *The Political Economy of a Cyprus Settlement: The Examination of Four Scenaria* (Nicosia, PRIO Report 1/2008).

32 For interesting readings and perspectives see M. Farrell, S. Fella and M. Newman (eds.), *European Integration in the 21st Century: Units in Diversity?* (London 2002).

strain as a result of a number of factors: the ageing of the population, rising medical costs and rising demand for public services in general. Lack of coordination of national fiscal policies raises a singular threat to the single currency. Hence, the development of fiscal federal arrangements may be of great importance to the functioning of the EMU. However, fiscal federalism will be most difficult to achieve outside a distinct process for political unity.

In the financial sphere, in order to enhance the stability of the system, it might also be necessary to shift some elements of supervision to the supranational level. The EMU is an integrated capital market but regulation is in the hands of national authorities which limits the ability to provide preventive supervision.

For small open economies like Cyprus, for which monetary policy independence and exchange rate autonomy may not be adequate to weather the consequences of adverse exogenous shocks, the introduction of the euro has been particularly beneficial. Cyprus' adoption of the euro is without doubt the most important achievement since accession to the EU in 2004. It has been accompanied by lower interest rates, reduced inflation, higher investment rates and accelerated growth. Per capita income in purchasing parity terms has risen to almost 90 per cent of the EU average. This coupled with considerable progress toward real convergence reduces the possibility of adverse exogenous shocks being destabilising.

At the same time the euro has the potential to be a truly unifying tool in Cyprus socially and politically as well. A number of contentious issues in the negotiation process that preceded accession are being settled by virtue of the fact that the euro will be the common currency of a potentially reunified country. The euro also has important implications for the economic and political structure in the event of reunification. In order to meet the requirements of EMU membership and of the stability and growth pact a high level of cooperation and coordination will be required at all levels. In essence, introduction of the euro and participation in the Eurozone may require a paradigm shift from the discussion of a loose bizonal bicommunal federation to an integrationalist functional federal model.

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