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## **The Political Economy of Financial Systems—Historical Perspectives**

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The financial needs of governments—often for the waging of wars—have played a large role in shaping modern financial systems. To a financial historian, this is so evident that it would seem naïve and ahistorical to argue that politics and finance should be separated, or that good modern financial systems would emerge on their own from the pursuit of private interests and would be even better if governments just stood aside and got out of the way. Indeed, based on financial history, I have a working definition of the institutional make-up of a good financial system that places the government's finances in the leading position:

### Key Institutional Components of a Modern Financial System

- Sound public finances and public debt management
- A sound currency
- A good banking system
- An effective central bank
- Good securities markets (money, bond, stock, and derivatives markets)
- Good insurance companies and insurance markets

The idea that sound public finance and sound currencies are crucial to creating effective modern financial systems seems evident from history. Public finance is obviously province of governments, and the creation of currencies, while not necessarily

a province of government in theory, typically has been pretty much a function of government in practice.

In the pre-modern economic world before the 17<sup>th</sup> century, several Italian city-states came closest to installing such modern financial systems. Their governments taxed, borrowed (usually forced loans), and created hard currencies. Partly as a result, the Italian city-states became the richest and economically most dynamic economies of that period of history.

In the modern world of nation-states, the leading economies have all been ones that developed each of the key components of a modern financial system before they became leading economies. There have been only three economies recognized as world leaders during the past four centuries. They are the Dutch Republic, Great Britain, and the United States. All three had “financial revolutions,” a short and vivid term for the creation of modern financial systems during brief periods--a few decades at most—before they became the world economic leader. The Dutch had their financial revolution in the decades around 1600, the British had theirs in the decades around 1700, and the United States had its financial revolution in one decade, the 1790s. In each case, stabilization of public finances resulting in trading markets for public debt, the creation of hard currencies, and the founding of central banks came first, or at least early in the financial revolutions. Governments and government officials were the innovators. Banking systems and securities markets for other than public debts followed upon the innovations of governments. So did insurance companies and insurance markets.

Until quite recently, many argued that Japan was poised to become the next leader of modern economic history. Whether it does or doesn't, it is a most interesting case

because it is the one non-Western economy that has achieved parity in economic development with Western-world economies, and it did so in part by creating a modern financial system—by having a financial revolution—like those of Western-world economic leaders. Japan’s financial revolution came during the 1870s and 1880s of the so-called Meiji era. Japanese government officials consciously studied and emulated best-practice Western financial systems. They stabilized public finances, fostered a public-debt market, made the yen a hard currency, and founded a central bank. The private sector then developed a modern banking system and securities markets for other than public debt. But even in these private-sector developments the Japanese government maintained a hands-on role.

Other economies that more or less caught up with the economic leaders of modern history did so in part by emulating the modern financial systems of the leaders, and in part by adapting those systems to ‘local’ circumstances. In continental Europe, France, Germany, Italy, and several smaller countries are examples from the mid-19<sup>th</sup> century. In Britain’s overseas offshoots, Canada, Australia, and New Zealand are examples from the late 19<sup>th</sup> and early 20<sup>th</sup> centuries. British financial precedents were important for both of these groups of countries. In Asia, Korea, Taiwan, and Singapore are more recent examples of successful emulation of a financial leader, in these cases, Japan.

In every country mentioned thus far, governments and government officials—political institutions, if you like—were dominant forces in shaping financial revolutions and financial systems. Some were more effective in doing this than others. And in most of the countries there were periods of backsliding, that is, of taking actions that made good financial systems worse than they had been. Despite these differences and

backslidings, these countries as a group are the relatively rich countries of the world or ones that are rapidly becoming rich.

Most of the world's countries are not so fortunate. They either never developed modern financial systems or, if they did, they lost them. We should explore such 'negative' cases. Argentina is one of my favorites: far richer than Japan a century or so ago, it is now far poorer. It never had a modern financial system, and whenever it tried to have one, the experiment usually unraveled, mostly because unsound public finance undermined the other components of a good system. Typically, the first of the other components to be undermined by unsound public finances is the currency. Then capital leaves the country, and the banking system and the securities market shrivel up. Recent financial problems in Argentina have many precedents in earlier Argentine history. Most Latin American countries have had similar experiences. So have a number of countries in East Asia, and Russia as well, in the 1990s.

There is a positive correlation, I suspect, between levels of economic development and levels of financial development. Some would argue that this results from countries that are developed or developing demand, and getting, better financial systems. As Joan Robinson once put it, "By and large, ...where enterprise leads, finance follows." Much of the recent work of financial historians, however, reverses the causation: good financial systems often emerged before history's most successful economies became successful. The work of financial economists, Ross Levine and others, on larger sets of countries in recent decades appears to agree with that of the financial historians: the cause-effect

relationship seems to run from good finance to economic growth/development, not from economic growth/development to good finance.

Accepting the views of financial historians and contemporary financial economists, one can ask how some nations managed to get, and keep, good financial systems, and others failed at this. The latter either never had good systems, or lost them after they managed to have them for a time. I suspect that the role played by political institutions in both creating and supporting good financial systems, and in wrecking them now and then, is of primary importance. But it needs to be documented with comparative case studies of persistently successful financial systems (if, indeed, there are any), of mostly successful systems that backslid at times (what Rajan and Zingales have called 'great reversals'), of systems that looked promising for a brief time and then were wrecked, and of cases of countries that never came close to having anything resembling an effective financial system, if there are any (Afghanistan?).

I have a few ideas, derived from cases I've studied, about the role of political institutions in creating and supporting good financial systems. I suspect that I will have a lot more of such ideas after we meet February 7-8, 2003.