Editor's Introduction

Rapidly changing technology, financial innovation, and increased linkages among the world's financial markets pose many challenges for commercial banks, other financial firms and markets, and their public regulators. History suggests, however, that while the challenges we face today may be unique, many are not fundamentally dissimilar from the problems others have faced in the past. For example, regulators now confront the issue of whether and, if so, how to regulate the issuance of private electronic money. In the nineteenth century, the private issuance of banknotes raised a similar regulatory question. A second example is the current problem, for banks, of increased competition from nonbank financial firms and markets that is associated with regulatory and technological change. As Eugene White points out in the first article in this *Review*, banks faced a similar challenge in the nineteenth century.

The twenty-second annual economic policy conference of the Federal Reserve Bank of St. Louis focused on lessons from financial history for current policymakers, especially with regard to financial regulatory issues. The papers and commentaries presented at that conference and published in this issue of the *Review* are described briefly in this introduction. The specific topics of the articles vary widely, but they fall naturally into three themes: (1) the question of what makes banks unique and how differences in their structures might affect a country's economic performance; (2) the evolution and effects of financial reform; and (3) the efficiency of alternative payments mechanisms.

THE ROLE OF BANKS

The first session of the conference focused specifically on the role of commercial banks—what makes banks unique and how their institutional form might affect a country's economic performance. In the first article, Eugene White discusses the functions of banks and the question of whether banks are becoming less unique in carrying out those functions. Much has been written about the apparent recent decline of banking as other financial firms and markets are increasingly providing lending, saving, and transaction services. White argues that this decline in the uniqueness of banks merely continues a trend that was already under way in the nineteenth century.

Modern theory ascribes a special role to banks as delegated monitors and evaluators of information about borrowers. Banking theorists in the nineteenth and early twentieth centuries focused on the problems associated with evaluating the creditworthiness of potential borrowers and argued that banks should protect themselves by making only guaranteed, short-term commercial and agricultural loans, i.e., "real bills." White shows, however, that in practice banks deviated significantly from the Real Bills Doctrine precisely because of their willingness to meet the demand for loans of borrowers who required close monitoring and flexible arrangements. After the Civil War, credit instruments evolved away from trade acceptances, which were used to finance specific transactions and guaranteed by a second party, to direct, single-name (unguaranteed) loans from banks to borrowers. This transition, according to White, caused banks to begin to concentrate on the analysis and monitoring of borrowers, rather than on specific transactions and acceptors of commercial bills; thus, it gave banks their modern attributes. Two case studies complement White's analysis, illustrating how banks specialized in the evaluation and monitoring of borrowers. Finally, the author describes how technological improvements, including the development of accounting standards, establishment of credit analysis services, and improvements in communications reduced the cost of information gathering and analysis. These changes, he argues, gave rise to the development of the commercial paper market and other bank competitors and began the erosion of the special niche of banks—an erosion that continues to this day.

In her comments on White's paper, Naomi Lamoreaux argues that the decline of localized lending explains much of the erosion of banks' unique role as gatherers and evaluators of information. Partly, the barriers to branching placed limits on banks' ability to meet the geographically dispersed demands of their customers. Universal banking, in which banks hold equity in firms, underwrite securities issues, and sometimes involve themselves in management decisions, might have been an option, but it was not adopted widely in the United States. Other countries, such as Germany, however, did adopt universal banking.

In the second article, Caroline Fohlin considers whether the institutional form of banks can affect a country's rate of economic growth. Specifically, she challenges the widely accepted view that universal banking is superior to systems in which banks only lend and take deposits. She contrasts the experience of Germany, which has a system of universal banks, with that of the United Kingdom, which does not have universal banks, and she argues that the evidence does not support the view that universal banking gave Germany an economic advantage in the late nineteenth and early twentieth centuries. Fohlin shows that German banks' share of their country's financial assets was smaller than English banks' share of U.K. financial assets. She also finds that German banks and English banks held roughly comparable shares of their assets in nongovernment securities and that German banks held little equity in industrial firms. Fohlin's findings suggest that policymakers should be cautious about accepting unsubstantiated claims regarding the economic benefits of universal banking.

Commenting on Fohlin's paper, Peter Temin questions whether the universal banks' relatively small share of Germany's financial assets indicates that these banks were ineffective at mobilizing capital for economic growth. After all, he argues, Germany experienced rapid economic growth in the late nineteenth and early twentieth centuries. Perhaps the small share implies that the universal banks were in fact quite efficient at mobilizing capital. Moreover, since the United Kingdom was already industrially developed, the U.K. experience may be a less relevant comparison for Germany than the experience of a less-developed country that could not mobilize its savings.

FINANCE AND DEVELOPMENT

Continuing the theme established by Fohlin, the second session of the conference focused more broadly on the development of financial systems and their impact on economic growth and stability. In his article, Larry Neal focuses on the British financial crisis of 1825, arguing that the crisis arose from a combination of information problems and an unstable monetary regime. Neal traces the crisis specifically to the resumption of gold convertibility by the Bank of England following the Napoleonic Wars—both the contractionary policies the Bank pursued to achieve convertibility in 1821 and the monetary expansion that followed convertibility. Neal also examines the flotation of Latin American securities in the London market and describes the severe information problems U.K. investors faced in distinguishing high- from low-quality securities.

The stock market crash of 1825 was followed by a banking panic, in which numerous U.K. banks failed, and a recession in 1826. Neal argues that the Bank of England's response to the crisis was both late and insufficient. Nevertheless, as a consequence of the crisis, institutional reforms were initiated that lessened information problems associated with finance and set the course for increased financial stability over the ensuing years before World War I. These reforms included repeal of the Bubble Act, which eased the process of obtaining corporate charters, and the establishment of Bank of England branches and joint-stock banks outside of London. The latter two reforms, Neal argues, facilitated the development of the market for commercial bills that, along with subsequent reforms, eased financial information problems, led to the Bank of England's assumption of lender-of-last-resort responsibilities, and generally enhanced the stability of the U.K. financial system.

Commenting on Neal's paper, Michael Bordo emphasizes the role of the Bank of England in fueling the financial and economic boom that preceded the crisis of 1825 and notes that the Bank tightened policy immediately before the crash. Bordo also cites instability of the price level—first inflation, which contributed to a lending boom and risky investment before the crash, then deflation, which increased the real burden of debt—as contributing to the crisis. Finally, Bordo attributes less significance to the institutional responses to the crash, especially those affecting the Bank of England, noting that the Bank failed to act properly as a lender of last resort during four subsequent crises.

Whereas Neal traces financial and economic development and stability in the United Kingdom to institutional developments prompted by a financial crisis, Richard Sylla argues in his article that the financial and political reforms associated with the adoption of a new constitution in 1788 paved the way for rapid financial and economic development in the United States during the early nineteenth century. The main financial reforms included consolidation of national and state debts, the establishment of a federal tax system to fund debt payments, the establishment of a national mint, and the founding of a federal bank—the Bank of the United States. These reforms encouraged the development of a world-class financial system, organized around both commercial banks and active securities markets, which Sylla contends provided a financial basis for the emergence of new manufacturing and transportation technologies, the settlement of the trans-Appalachian West, and U.S. integration with the world economy.

Besides the government, commercial banking benefited most from the development of American securities markets, Sylla argues. The American banking system grew rapidly—by 1825, for example, U.S. banks had 2.4 times the capitalization of England's banks. Banks raised capital in the securities markets, and government and corporate securities were often pledged as collateral for bank loans. Securities markets, in turn, benefited from the development of banks, whose portfolios included loans to brokers, dealers, and securities investors.

Commenting on Sylla's paper, Kenneth Snowden echoes the theme of the importance of financial development, but he calls for further research into banks' impact on early American growth and on the motivations for the institutional reforms associated with the Federalist Revolution. Specifically, Snowden questions whether the Federalist financial reforms, which Sylla argues were crucial for the nature and pace of private-sector financial development, were made in response to the demands of specific private interests or were simply imposed on an environment with no organized interests.

THE EFFICIENCY OF PAYMENTS SYSTEMS

The final two articles in this volume focus on payments systems, a subject of considerable current interest because of today's rapid technological change and innovation. The authors are especially concerned with the question of a central bank's role in providing payment services. Arthur Rolnick, Bruce Smith, and Warren Weber consider the widely held view that open competition in providing payment services can, in the absence of government intervention, produce an efficient payments system. The Suffolk Banking System, which operated during 1825-58, is frequently cited as evidence for this claim. The Suffolk Bank of Boston organized and operated a net-clearing system for commercial banknotes, and several scholars have concluded that this private-sector organization functioned efficiently and offered inexpensive payment services to its member banks. Rolnick, Smith, and Weber, however, find that Suffolk earned extraordinary profits from its note-clearing business and exhibited characteristics of a natural monopolist. Consequently, they argue, the Suffolk System may not have been socially efficient.

Suffolk—according to Rolnick, Smith, and Weber—earned high profits in part because it enjoyed economies of scale. The Bank also benefited from economies of scope by combining note-clearing and lending services. Suffolk required the banks for which it cleared notes to hold deposit balances with the Suffolk Bank. In addition to providing clearing services, Suffolk lent to these banks on overdraft. The authors contend that Suffolk had an advantage over other potential lenders because of the information about borrowers that it gained from providing clearing services. Thus, they note that while private provision of payment services might not be inefficient—even if extended by a natural monopolist—the Suffolk System "may not support the case for a laissez-faire approach to the payments system."

Commenting on this article, Randall Kroszner questions whether Suffolk was indeed a natural monopolist. Kroszner points out that the Suffolk System did not operate in a completely unregulated environment and that Suffolk received some government support, including legislation that encouraged banks to join the Suffolk System. He also notes that governments limited entry into commercial banking, that within-state branch banking was restricted, and that interstate branching was prohibited (for state-chartered banks). It is not clear, Kroszner argues, that a single note-clearing system, rather than competing systems, would have arisen in the absence of government intervention.

Kroszner argues that branch banking restrictions substantially distorted the U.S. payments system and could explain the evolution of the Suffolk System monopoly. Similarly, Alton Gilbert contends that branching laws caused the U.S. payments system to operate inefficiently in the late nineteenth and early twentieth centuries. Gilbert investigates whether the establishment of the Federal Reserve System and its provision of interregional payment services enhanced the efficiency of the payments system.

Before the Fed's founding in 1914, interregional collection of checks and bank drafts was carried out mainly through correspondent bank networks. An out-of-town check deposited at a bank in one city might be sent to one or more correspondents of the receiving bank before being presented to the bank upon which the check was drawn. This system was widely deemed unsatisfactory because the time and expense of interregional clearing often seemed excessively high. An important motive for establishing the Fed, Gilbert argues, was to improve the efficiency of interregional payments.

In clearing checks, the Fed had at least two advantages over existing private arrangements: The Federal Reserve was a system of regional Reserve Banks, most of which had branch offices, and the Fed could demand that its member banks remit payment for checks at face value ("par"), rather than at a discount, even if such checks were sent by mail. The establishment of the Fed did not preclude banks from using existing payment arrangements. The Fed's services were widely used, however, and old means of interregional settlement, such as shipment of cash, largely disappeared soon after the Fed's founding. Moreover, Gilbert finds that the Fed's provision of payment services allowed banks to economize on their holdings of cash, which, along with the rapid growth in the Fed's market share, suggests that the Fed enhanced the efficiency of the payments system.

In his comments on Gilbert's article, John James agrees that the Fed's provision of payment services probably enhanced the efficiency of the interregional payments system, though he questions whether efficiency alone is a sufficient criterion on which to evaluate the Fed's involvement in the payments system. Bank drafts, usually drawn on New York City banks, were one means of settling interregional payments. James finds that, over time, improvements in transportation and communication lowered the cost of making interregional payments by draft. Despite falling costs and, seemingly, greater efficiency, however, drafts gave way to checks as the preferred form of interregional payment in the last years of the nineteenth century. This change occurred, James argues, because bank customers found checks more convenient to use, and their convenience outweighed their inefficiencies. Thus efficiency alone, he argues, might not be a sufficient criterion for evaluating the relative appeal of alternative payment arrangements.

In addition to the six full-length articles and commentaries described above, this issue of the *Review* includes a short summary of a new historical banking data set being compiled by Charles Calomiris of Columbia University and Joseph Mason of the Office of the Comptroller of the Currency. When this project is completed, a comprehensive compilation of individual national and state member bank *Reports of Income and Condition*, at several call dates between 1929 and 1935, will be available to scholars.

Finally, I would like to thank the authors and other participants in the Federal Reserve Bank of St. Louis' twenty-second annual economic policy conference for providing excellent papers and discussion, all of which highlight how the lessons of history can inform current policy analysis. I also would like to thank the Bank's research and production staff, especially Beverly Benham and Heidi Beyer, for their assistance in organizing the conference and preparing the articles for publication.

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