

Schumpeter Redux: A Review of Raghuram G. Rajan and Luigi Zingales's *Saving Capitalism from the Capitalists*

RICHARD SYLLA*

*Saving Capitalism from the Capitalists*¹ is an ambitious probe into capitalism's past, present, and future. Whereas Joseph A. Schumpeter viewed capitalism as doomed because it was losing its political and social supports, Rajan and Zingales see it more as threatened from within by established or "incumbent" industrialists and financiers who become enemies of free markets. The authors contend that free financial markets foster economic progress while undermining the ability of incumbents to have their way. Rajan and Zingales may overstate the significance of "the great reversal" of financial development in the middle decades of the twentieth century, and their evidence and interpretations are sometimes flawed. Nonetheless, they make a strong case for the fundamental importance of financial development for economic modernization and their warnings about the antimarket tendencies of incumbents are well worth pondering.

1. Introduction

Every now and then, economists pause from everyday labors of studying how the modern economy works to create sweeping portraits of its past, present, and future. In the nineteenth century, for example, Karl Marx explored how the capitalist economy emerged from feudalism, how it had led to

remarkable economic advances, and yet how its internal economic contradictions would cause it to collapse and be replaced by socialism and then communism. In the last century, the young Joseph A. Schumpeter (1934; first edition 1911) presented a striking theoretical analysis of how capitalism's driving forces—entrepreneurship and finance—led to unprecedented economic development and growth. Later, the mature Schumpeter (1942), in stark contrast to Marx but sharing Marx's conclusion, argued that capitalism's astounding success in multiplying wealth would undermine its ability to survive. Capitalism, Schumpeter reasoned, requires political and social supports to survive.

* Sylla: New York University.

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Increasing wealth and the spread of democracy, however, created devastating social critiques of capitalism's modus operandi, and of its defects such as economic inequality, as well as increased political demands to correct these inequities. As these demands were implemented in the form of anticapitalist policies, capitalism would begin to wither away. It was too successful for its own good. The end result would be something like Marx's socialism.

Raghuram G. Rajan and Luigi Zingales have written a book in a similar vein. Although they mention Marx more often (five index entries) than Schumpeter (one), the book is essentially an extension and amendment of Schumpeter's analysis, with a less fatalistic conclusion regarding the future of capitalism and free enterprise. Like Schumpeter, at least implicitly, they see entrepreneurship and finance as capitalism's driving forces. Like Schumpeter, they argue that capitalism needs the support of an institutional framework. This is best provided by political structures and governmental actions that reflect an understanding of its potential for wealth creation. Supporting institutions must also provide remedies for deficiencies innate to pure capitalism. Unlike Schumpeter (and Marx), Rajan and Zingales see capitalism as threatened rather than doomed. They prescribe a variety of policies that might be used to diminish or remove the threats.

What is the nature of the threat to capitalism? Rajan and Zingales argue that it arises from within the heart of the system, not from limousine liberals, social critics, reformers, and disadvantaged groups on capitalism's fringes. Established enterprises, the "incumbents," constantly seek to co-opt the political system and use it to stifle entry to industry, access to financial services, and competitive markets in order to protect their privileged positions and profits. "Capitalism's biggest political enemies are not the firebrand trade unionists spewing vitriol against the system but the executives

in pin-striped suits extolling the virtues of competitive markets with every breath while attempting to extinguish them with every action" (p. 276).

Incumbents are not always successful in achieving their self-serving, anticompetitive objectives. If they had been, the developed nations of the world would not be as rich as they are. Incumbents have greater success in less developed countries, which is why those countries are less developed. But they can be successful in developed countries, especially when economic crises lead to widespread calls for "reforms" of capitalism, which the incumbents then manipulate to achieve anticompetitive objectives. Rajan and Zingales find their main evidence for this in what they title part 3 of the book, "The Great Reversal" of free-market development that occurred throughout the world during the interwar period, 1919–39. Their book appears to be an outgrowth of, or a parallel development with, a similarly titled journal article, Rajan and Zingales (2003).

"The Great Reversal" was itself reversed in recent decades, less by the actions of leaders who sometimes receive the credit for it (such as Margaret Thatcher in Britain and Ronald Reagan in the United States) and more by the internal contradictions of the Bretton Woods system. When Bretton Woods collapsed, capital began to flow freely again, financial innovations flourished, and access to financial services expanded as perhaps never before in history. Incumbents either shaped up to become competitive or they were sent packing. Capitalism once again became Schumpeter's "creative destruction."

With the end of the 1990s boom, the downturn of equity markets, the revelations of corporate scandals, the exposure of conflicts of interest in accounting and finance, and growing angst over outsourcing and globalization, Rajan and Zingales fear that another great reversal may be unfolding. Protection for the steel industry in the United States, increased subsidies for farmers

in the developed world, and antiglobalization activities in many countries, rich and poor, provide them with some grounds for that fear. They hope their book will help nip another reversal in the bud.

The foregoing is a summary of some of the Rajan and Zingales's key ideas. Their book is a rich tapestry, ranging widely over economic history, political economy, and the modern literature on the relationship of financial development to economic growth. In what follows, borrowing the titles of the four parts of the book, I attempt to summarize and evaluate their evidence and arguments.

2. *The Benefits of Free Financial Markets*

Rajan and Zingales begin their analysis by adopting a very Schumpeterian view: "Free financial markets are the elixir that fuels the process of creative destruction, continuously rejuvenating the capitalist system." But they immediately add, "As such, they are also the primary target of the powerful interests that fear change" (p. 25). In their view, those powerful interests prevailed in most places and periods of modern economic history but were routed in the "Financial Revolution" that occurred in the three decades that began in the early 1970s.

This financial revolution, with its roots in the breakdown of the Bretton Woods system and the reappearance of relatively unfettered international capital flows, unleashed a host of positive developments, including banking deregulation, an active market for corporate control, junk bonds, a host of new financial derivatives, increasing institutionalization of stock ownership, and better financial monitoring of companies. Moreover, it led to an abandonment of stifling financial regulations and restrictive practices. In the United States, banks were at last allowed freedom to extend branch networks within and across state lines, regulatory ceilings on interest rates disappeared, and stock exchanges and brokers were forced to give up fixed commissions on securities market

transactions. These changes ended what Rajan and Zingales call the tyranny of collateral (i.e., you can borrow provided you don't really need to; otherwise, no) and connections (i.e., you can borrow provided I know and trust you; otherwise, no). The result was that individuals' and firms' access to arms-length finance and a vastly expanded array of financial services increased so much that "We have come closer to the utopia of finance for all" (pp. 66–67). The financial revolution thus improved and expanded the financial system's ability to mobilize and allocate financial resources, and provided system participants with new ways to manage risks.

Nonetheless, Rajan and Zingales recognize that finance has its "dark side." Financial crises—the manias, panics, and crashes of the past four centuries that were cataloged and analyzed by Charles P. Kindleberger (2000)—are persistent if episodic features of modern financial systems. As financial economists, they view such episodes as evidence of "mispricing" and "deviations from fundamental value," but they also use more vivid terms such as "bubbles," as in the Internet Bubble. Rajan and Zingales even allow that money managers have incentives to follow the herd on the way up and on the way down, so that institutional investors may actually behave in ways that make modern financial markets more, rather than less, prone to mispricing. They estimate that a quarter of the capital, nearly half a trillion dollars, raised by telecoms in the period 1996–2001 was wasted. That is not quite a utopian situation.

So is financial development worth the candle? Yes, Rajan and Zingales answer emphatically. They survey growing bodies of evidence, recent and historical, concluding that better financial arrangements cause economic growth: "few would now doubt that there exists a causal link between the development of the financial sector and the growth of the economy." Joan Robinson (1952, p. 86) espoused a different point of

TABLE 1
 REAL GDP PER CAPITA RELATIVE TO WORLD AVERAGE, SELECTED
 COUNTRIES, 1500-1998
 (WORLD AVERAGE = 100 AT EACH DATE)

| Date | Country | | | | | | |
|------|---------|-------------|-----|-----|-------|--------|---------|
| | Italy | Netherlands | UK | USA | Japan | France | Germany |
| 1500 | 195 | 133 | 126 | 71 | 88 | 129 | 120 |
| 1600 | 185 | 231 | 164 | 67 | 88 | 142 | 131 |
| 1700 | 179 | 343 | 203 | 86 | 93 | 160 | 145 |
| 1820 | 167 | 273 | 256 | 188 | 100 | 184 | 159 |
| 1870 | 173 | 318 | 368 | 282 | 85 | 216 | 210 |
| 1913 | 170 | 268 | 326 | 351 | 92 | 231 | 242 |
| 1950 | 166 | 284 | 327 | 452 | 91 | 249 | 184 |
| 1973 | 259 | 319 | 293 | 407 | 279 | 320 | 292 |
| 1998 | 311 | 354 | 328 | 479 | 358 | 343 | 312 |

Source: Derived from Maddison (2001), table B-21, p. 264.

view: “where enterprise leads finance follows.” She and others argue that financial institutions and markets arise whenever there is an economic demand for them. Rajan and Zingales, among other recent analysts, attempt to stand these older views on their heads by indicating that financial development leads economic growth.

Rajan and Zingales could have made a stronger case had they delved deeper into the literature of financial history. There the concept of “financial revolution” is one of long standing, not a recent discovery. I and others have surveyed and contributed to that literature (see, for example, Richard Sylla 2002; Peter L. Rousseau and Sylla 2003, 2005), finding that financial history gives considerable support to the idea that financial development leads economic growth. In the case of medieval and renaissance Italy, although the link between finance and growth has not been much explored, we know that the Italian city states pioneered modern financial techniques and that in 1500 they had the highest per capita income in the world (see table 1, based on Angus Maddison 2001).

The case for finance-led growth becomes stronger in the case of the Dutch Republic. The Netherlands experienced its financial revolution during the sixteenth and early seventeenth centuries. Continuing from that era through the eighteenth century, the Dutch had their golden age and led the world in per capita income. Scholars date the English financial revolution from 1688 to the mid-eighteenth century, *before* the Industrial Revolution that catapulted Britain into world per capita income leadership during the nineteenth century. The U.S. financial revolution occurred in the years 1789–95. During this period, the U.S. economy embarked on a high growth trajectory; in roughly a century the United States would overtake the United Kingdom as the industrial and per capita income leader. Continental Europe had its financial revolution(s) in the middle of the nineteenth century (David S. Landes 1969, pp. 204–10), and it was after those events that countries such as France and Germany closed the per capita income gap between them and Britain. Japan had its financial revolution in the 1870s and 1880s, and went on to become

in a century the one non-Western nation to equal Western income levels. (At first glance, the Japanese data in table 1 do not seem impressive until the past half century, but it may be noticed that, during the period 1870–1913, Japan grew faster than a fast-growing world economy and gained on the world average while older leaders, such as the rich Netherlands and United Kingdom, regressed.)

Where finance leads, enterprise follows. The longer sweep of history is pertinent because it indicates that financial development was arguably exogenous to the economy. In historical financial revolutions, the impetus for financial development usually arose out of the needs of states to pay for wars. These needs led some states to make credible commitments to respecting property rights, servicing their debts, and refraining from debasing their currencies. As a result, banks and capital markets emerged and flourished. Thus, the dictates of politics, not the demands of economics, led to financial modernization, which then led to faster economic growth. Rajan and Zingales seem to miss this connection of war to historical financial modernizations, although they come close to a realization of it at one point (p. 156) when they quote Richard Ehrenberg (1928): “England would not have been the Great Britain of today, it would not have conquered half the world, if it had not incurred a national debt of 900,000,000 pounds between 1693 and 1815.”

3. *When Do Financial Markets Emerge?*

Rajan and Zingales (p. 129) pose fundamental questions: “If finance is so beneficial, why don’t we see more of it? . . . Why is a functioning financial system still a chimera in most countries?” Their answer is that in most countries, even many constitutional democracies, vested interests or incumbents “prefer that others have little access to finance” (p. 130). Accordingly, the incumbents use government to stifle financial development.

Financial underdevelopment thus becomes an entry barrier, one that is perhaps less obvious than other such barriers. Repressing financial development protects incumbents from competition.

How then did today’s developed countries managed to put in place the modern financial systems that led to their development? Rajan and Zingales argue that the key steps were, first, that government learned to respect private property rights. They, like many others, relate respect for property rights to the emergence of representative governments. Next, representative governments created infrastructures supportive of finance. In their view, not so clearly developed in the book, those infrastructures included relatively free incorporation of limited liability companies, both financial and nonfinancial, and mandatory disclosure laws for companies.

To show how representative government emerged, Rajan and Zingales embark on an interesting and curious foray into early modern English history. The interesting aspect is motivated by an influential article by Douglas C. North and Barry R. Weingast (1989). North and Weingast argue that England’s Glorious Revolution of 1688 resulted in a constitutional monarchy that respected property rights and Parliamentary control of the power of the purse. Together these institutional changes, and others that accompanied them such as the founding of the Bank of England in 1694, led to the credible commitment of the English state to honor property rights and repay its debts. These changes were the foundations of the financial revolution that propelled England to political and economic greatness.

Rajan and Zingales consider the North–Weingast argument incomplete because it does not tell how Parliament obtained the power to impose the constitutional monarchy and to exert control over taxation. To complete the argument, they go back to the seizures of lands held by the church and some members of the aristocracy,

and the transfer of those lands to gentleman farmers who efficiently managed their new estates. As the numbers and wealth of the country squires expanded, Parliament provided them with a coordinating mechanism by which they could compel respect for their property rights. In return, they allowed themselves to be taxed, and the reformed English state discovered that it made more sense to tax increasing wealth than to steal it.

What is curious about the Rajan and Zingales analysis is that neither merchants, bankers, the Bank of England, companies, brokers, securities markets, equity investors, public debt holders (apart perhaps from the landed gentry, although even that is not clear), nor the revenue-gathering bureaucracy figure anywhere in the story. These, after all, were groups more likely to participate in the day-to-day operations of England's new financial system than were gentleman farmers. Other accounts, for example Peter G. M. Dickson 1967, John Brewer 1988, Larry Neal 1990, and Niall Ferguson 2001, provide more complete and balanced treatments of the many economic and financial interests that were benefited by England's Glorious and financial revolutions, as well as giving more attention to the key role of war finance as the impetus for revolutionary change.

Given their emphasis on the opposition of industrial and financial incumbents to financial development, Rajan and Zingales need to explain how that opposition was overcome in developed countries with modern financial systems. By ignoring the key role of war in spurring financial innovations, they do not provide an explanation for how incumbents were overcome in England, and they do not even get into the similar cases of the Dutch Republic and the United States.

In chapter 8, "When Does Finance Develop?" Rajan and Zingales offer four answers to this question:

- Political change can lead to financial reform and development. Rajan and Zingales illustrate this point by examining the bourgeois revolutions of nineteenth century Europe, which led to new forms of banking in France—forms that were opposed by the incumbents: the Bank of France and the Rothschilds—and that spread to Germany, Austria, and other countries.
- Incumbents may be led to support financial development if new investment opportunities are significant in relation to the incumbents' ability to finance them. "In the 1850s and 1860s," the authors argue, "the dramatic reduction in the cost of transportation suddenly expanded the potential size of the market that each firm could service," and this shift encouraged incumbents to favor freer trade, the gold standard with its fixed exchange rates, and intercountry flows of capital. (This may be putting the cart before the horse, as it was the advent of railroads and steamships that reduced transport costs, but only after substantial investments in these transportation modes. Railroads' appetite for capital caused changes in capital markets and financial systems in many countries.)
- Technical change enhances competition from without. Rajan and Zingales cite the undermining of unit banking in the United States by the advent of ATMs and improvements in credit reporting, which allowed banks without a local presence to gather deposits and make loans in competition with local unit banks.
- Openness to trade and the flow of capital undermines attempts by a country's government to protect incumbents. Rajan and Zingales provide a provocative analysis of how freer flowing capital in the 1980s undermined France's policies of bank nationalization, subsidized credit for government-favored enterprises, and inflationary financing, and forced Mitterand's socialist government to abandon them. The authors also show how the availability of Euromarket bond financing for Japanese firms loosened the cozy

control of the Japanese bond market by Japan's government, banks, and securities firms.

With some bending and stretching, the first two causes cited by the authors could be made to characterize the historical Dutch, English, American, and Japanese financial revolutions, or "liberalizations" in today's parlance, which resulted from the imperatives of war, threats of war or foreign domination, and the management of accumulated war debts. Rajan and Zingales seem to ignore the historical link between war and financial liberalization, perhaps because they want their vision of financial development to suggest policy implications for today. Certainly, it would not do to use historical precedents to contend that the road to better financial systems should begin with the cultivation of enemies and going to war. What developing countries may require, however, for the promotion of better financial systems are moral equivalents of war. It is not so evident that political and technical change, and enlarged investment opportunities constitute those modern equivalents. Even if they did, there would still be the question of how to bring them to bear in a developing country. Political change leading to openness of trade and the flow of capital might suffice, but what incentives would lead incumbents in developing countries to embark on such a course? Rajan and Zingales do not raise that question.

4. *The Great Reversal*

Rajan and Zingales locate their great reversal, that is, the point at which finance worsened generally, in responses to and results of World War I and the Great Depression. They present "systematic evidence" drawn from their own work (Rajan and Zingales 2003), that compares various measures of financial development across selected countries in 1913 and 1980, to reinforce their argument that incumbents reversed the progress of finance between

the two dates. Unfortunately, there are flaws in this evidence that cast doubt on the validity of their conclusions, however correct they might be on other grounds.

World War I, Rajan and Zingales contend, taught governments how to command and control their economies. They argue that the social turmoil emerging during and after the war made more radical the working classes of most countries, which had never been friendly to capitalism. Then, after Wall Street crashed in 1929 and the U.S. economy slowed in 1930, enactment of the Smoot-Hawley tariff provoked other countries into retaliatory protectionist measures. Cross-border trade and capital flows dried up, and the world economy slipped ever deeper into the Great Depression, engendering a popular revulsion against markets. Politicians responded by abandoning the gold standard, curbing domestic and foreign competition, imposing controls and regulations on financial markets, and introducing a variety of other measures for relief, recovery, and reform.

What Rajan and Zingales add to this fairly standard story of the interwar era is that industrial and financial incumbents in many countries used the cover of the antimarket revulsion and their political influence to dictate in their own interests the particular forms the antimarket revulsion took.

Rajan and Zingales use three national case studies—Italy, Japan, and the United States—to illustrate the great-reversal thesis. In Italy during the depression, the government bailed out leading banks and became a major shareholder in Italian industry and finance. It created a new company to hold these stakes, but allowed incumbent industrialists and financiers to control them. Thus, "the private sector retained control without having to pay for it" (p. 214). Moreover, approvals of all equity and bond issues, bank lending and borrowing rates, and the allocation of bank credit were centrally determined by a committee headed by the governor of the central Bank of Italy.

These “cozy arrangements” for incumbents persisted until the 1990s, when the Italian government, in order to meet the Maastricht criteria for joining the European Monetary Union, was forced to reduce its debt and deficits by privatizing its holdings in state-controlled firms, and EU rules prohibited subsidies to state-owned companies.

In Japan, a banking crisis in 1927 forced legislation that led to banking concentration. Thereafter, a coalition of the largest banks and the militarist government gained control of finance by suppressing the country’s once flourishing bond and equity markets. Most Japanese firms were assigned to a main bank, on which they became dependent for finance. The bank–government coalition determined which firms were granted financing and which were not, an obvious advantage for Japan’s war efforts. After the Allied occupation authorities tried but failed to end these cozy arrangements, bank and government domination of Japanese finance continued into the 1980s, when Japanese firms began to access the Euromarkets, and Japan’s domestic capital markets revived in response to foreign competition.

The great reversal of finance in the United States was not as serious as in Italy, Japan, and other countries, an outcome Rajan and Zingales attribute to the U.S. federal system that distributes political and judicial power widely and to Americans’ historical aversion to financial concentration. What happened in the United States was a segmentation of finance that reduced competition but did not suppress it, as happened in Italy and Japan. Each segment of the banking sector gained something from the New Deal reforms. Small unit banks received federal deposit insurance, which, along with restrictions on bank entry, insured their survival. Large commercial banks gained from the prohibition of interest payments on demand deposits and interest-rate ceilings on time deposits. Investment banks gained from the Glass–Steagall separation of commercial

and investment banking, which stopped commercial banks from competing with them in underwriting corporate securities. Segmentation and cartelization of banking limited entry and access to finance for half a century before the financial revolution revealed its weaknesses.

Why did the great reversal persist so long? Rajan and Zingales lay part of the blame on the Keynesian consensus that called for active fiscal and monetary policies to manage demand. When that consensus was combined with the Bretton Woods fixed exchange rate system, it became obvious—from the so-called trilemma—that what had to give was the free flow of capital across borders. Restrictions on the free flow of capital among countries enhanced what Rajan and Zingales call “relationship capitalism” in which banks flourish, financial markets are repressed, and governments become less responsible in their fiscal, monetary, and other economic policies. Who gained and who lost from the great reversal? “In general,” Rajan and Zingales state, “incumbents—whether they were large firms, unionized workers, farmers, or the aged—gained at the expense of outsiders, such as would-be entrepreneurs, foreign firms, unorganized workers, immigrants, or the young” (pp. 243–44).

The great reversal ended and the financial revolution began when a chain of developments undermined the Bretton Woods system. The U.S. government’s Cold War spending, along with the overseas expansion of U.S. multinational firms, led to a growing accumulation of dollars outside the United States, giving birth to the Eurodollar markets. In the 1960s, the U.S. government attempted to stanch the outflow of dollars with an interest-rate equalization tax and “voluntary” restraints on capital exports. These policies were to no avail. U.S. money-center banks simply moved facilities to London, where they were welcomed by the British who sought to regain past financial-center glories. The banks increased their

international banking operations using Eurodollars, beyond the reach of stifling domestic U.S. regulations. In the early 1970s, the United States ended the dollar's convertibility to gold and the Bretton Woods fixed exchange rate system, ushering in a new era of the relatively free flow of capital among countries, thus reversing the great reversal.

5. *How Can Markets Be Made More Viable Politically?*

Clearly, Rajan and Zingales believe that the political foundations of free markets are fragile and that technological change, free trade, and free flowing capital are creating "new legions of the distressed" (p. 292) all over the world. They seem to fear that, once again, the incumbents will form to their advantage an alliance to shape an antimarket backlash. In the last section, the authors propose policies that will save capitalism from the incumbent capitalists.

The policies recommended fall into two categories: measures that will weaken the power of incumbents and measures that will alleviate the suffering of the distressed. In the former category, the authors' strongest recommendation is to keep borders open to trade and capital flows. That, of course, is what industrial and financial incumbents want to undermine, so their power must be weakened. Incumbent power can be weakened by policies designed to reduce its concentration and to insure that economic resources are used more efficiently. Specific policies that would do that are antitrust laws that would reduce not only the economic power but also the political clout of incumbents; more emphasis on property taxation and less on income taxation; better corporate governance; and an inheritance tax designed to prevent incumbents from transferring corporate control to their supposedly incompetent children. The arguments in support of these particular policies are brief and not very convincing.

To alleviate those distressed by free trade and capital flows, Rajan and Zingales propose a version of a safety net that reduces or eliminates the influence of incumbent firms and politicians. This seems to imply, for example, not aiding steel workers by means of higher tariffs on imported steel when cheap foreign steel imports cause domestic layoffs. Rather, it means that the government should commit in advance to giving a lump-sum relief payment to every such job loser, which will provide the proper incentive to look immediately for another job. The authors argue that, if people are insured directly rather than through the firms they work for, any situational advantage to the incumbents would be avoided. Again, this safety-net policy recommendation is brief and unconvincing.

Rajan and Zingales's last recommendation is not really one of policy. It is, rather, a call to the economics profession to educate the public about how much it stands to gain from free markets and how incumbents are ever intent on taking away those gains. Adam Smith said much the same thing 230 years ago and few modern economists would find fault with this recommendation.

6. *My Conclusions*

The big picture. In a larger historical context, how important was the great reversal of twentieth century financial development—the events that prompt Rajan and Zingales to warn us to save capitalism from the capitalists? Looking back at the long sweep of modern economic history portrayed in table 1, it is not clear that Rajan and Zingales's great reversal, beginning in the interwar era and lasting until the start of the financial revolution in the 1970s, did much damage to the economic growth of that set of developed countries. With the exception of the United Kingdom, each country's economy grew faster than did the world economy and, by 1973, had reached a per capita income that was well above where

it had stood in 1913, as compared to the world average. Moreover, it is not apparent from comparing 1973 and 1998 data in the table that the financial revolution reversing the great reversal led to markedly higher rates of growth.

For these rich countries, the story of financial development that matters is one that took place long before 1913 in the financial revolutions of earlier centuries. Financial development does lead to economic growth, but once a country has a modern financial system, whether through revolutionary or evolutionary change, there is not much the incumbents can do to reverse the beneficial economic effects of such systems. Perhaps there is less reason to be alarmed about the nefarious goals of incumbents than Rajan and Zingales would have us believe.

Or perhaps not. Implicit in table 1 is another story about much of the world being left behind as a relatively small number of now-developed countries used modern financial systems to attain wealth. Rajan and Zingales provide enough evidence to lead a reader to think that the incumbent problem is not so much related to the rich countries with representative governments than it is to the poorer countries where incumbents and elites have disproportionate power. A lot of effort is being expended on improving financial systems of the less developed countries; nonetheless, progress seems painfully slow. Rajan and Zingales suggest an explanation for the lack of progress: incumbents do not really want it because it does not serve their interests.

A few quibbles. The late John Dunlop, Harvard labor economist and public servant, once told me that he had enjoyed a favorite weekly news magazine that kept him informed on national and world affairs until he happened to read one of its stories covering issues about which he knew quite a lot. He found that story to contain so many errors and misrepresentations that he wondered if he could trust its other news

reports. I had a similar feeling when I read some passages about the United States in Rajan and Zingales's book, although much of the rest of it seemed to hold true.

Rajan and Zingales appear to view the United States for most of its history in much the way that many economists view China today. That is, although the United States made tremendous strides in economic growth when compared to other countries, it was plagued until the financial revolution of recent decades by a relatively underdeveloped financial system that was heavy on cronyism, club-by-relationship banking, and regulations favoring incumbents. For example, Rajan and Zingales say:

The equity market in 1913 was much more important in England, Belgium, and France than in the United States. The differences cannot be explained on the basis of differences in economic development alone. For example, per capita income in Japan was only one-fourth that of the United States, but its equity market was much more developed (p. 193).

To most financial historians this would seem odd, but Rajan and Zingales explain it by reiterating their hypothesis that a country's financial development correlates positively with its openness to product and capital flows, and then conclude that the United States, "despite being among the most industrialized countries in the world" in 1913, had "a relatively underdeveloped equity market because it was relatively closed to trade" (p. 194). A problem with this conclusion, even in terms of their own analysis, is that, although the United States did have high tariffs in 1913—as well as a huge and quite competitive domestic market—it was entirely open to flows of capital and was, in fact, the largest international "debtor nation" in the world.

Most of Rajan and Zingales's cogitations on comparative financial systems are based on so-called systematic evidence from their 2003 article, some of which is presented in their book (p. 192). That evidence indicates,

for example, that in 1913, the ratio of “Stock Market Capitalization to GDP” was 1.09 in the United Kingdom and only 0.39 in the United States, while the simple average of the fourteen countries in the table was 0.57. Apparently the United States was a notable underachiever when it came to equity markets.

When, however, one checks the unpublished data appendix to Rajan and Zingales (2003), it becomes apparent that the United Kingdom figure for 1913 includes corporate stocks and bonds, which they justify in their published article (p. 46) by saying that “from an investor’s point of view, bonds and stocks were perceived as very close substitutes.” For the United States, on the other hand, stock market capitalization is based only on listed stock prices in New York and four other regional markets, but not the New York Curb Exchange, other regional exchanges, or the extensive U.S. over-the-counter dealer market (that eventually became the NASDAQ market). And, in contrast to their treatment of U.K. data, Rajan and Zingales do not count at all the vast U.S. corporate bond market, the largest in the world in 1913.

In short, Rajan and Zingales are comparing apples and oranges, and calling them all apples. They have little grounds to conclude from their evidence that the U.S. equity market was far less developed than the U.K.’s and other countries’ in 1913. If they had informed their data collection with earlier research having more cross-country consistency than their own (Raymond W. Goldsmith 1985), they would have found that the ratio of corporate stock to GDP in the United States in 1912 was 0.95—less than the U.K.’s ratio of 1.21 in 1913, but well above the 1913 French (0.78) and Japanese (0.41) ratios.

Another of their measures of financial development is the ratio “deposits to GDP,” a measure of the extent of bank intermediation. Again, the United States at 0.33 is below the fourteen-country average of 0.50,

although is rather oddly ahead of the U.K.’s 0.10. (There must have been tremendous banking development in the United Kingdom between 1913 and 1929, for Rajan and Zingales (2003, p. 14) indicate that deposits there went from 10 percent of GDP in the former year to 288 percent in the latter, while the United States remained at 33 percent. Financial historians appear to have missed this remarkable U.K. banking development!) The 1913 deposit data, indicating that the United States seemed to be an underachiever in banking just as it was in equity markets, are taken from Mitchell’s *International Historical Statistics*, the same source used by another scholar (Ranald Michie 2003, pp. 51–53) to argue that, in 1913, the United States claimed far more deposits than any other country, 30 percent of the total world deposits and 36 percent of world commercial banks deposits.

When the same data source is used to imply that U.S. banking in 1913 was both underdeveloped and quite highly developed according to other nation’s standards, a closer look at the data is warranted. A primary source of historical U.S. banking data, the Board of Governors of the Federal Reserve System (1959, table A-1), matches up with the data from Mitchell used by both Rajan and Zingales and by Michie. But Mitchell’s data are incomplete, counting for the United States only commercial bank *demand* deposits and deposits of savings banks. Omitted are commercial bank time deposits and interbank deposits, the latter being an integral component of the U.S. correspondent banking system and its services to financial markets. Together, the omitted items total more than a third of all U.S. deposits and raise total U.S. deposits from \$13 billion to \$20.5 billion. Assuming that the data for other countries are correct, the revisions indicate that the United States had more than 40 percent of world deposits in 1913, and almost 50 percent of world commercial bank deposits. Thus, the ratio of deposits to GDP rises to 0.52 from the 0.33

reported by Rajan and Zingales. From Goldsmith (1985), one can calculate ratios of currency plus deposits to GDP in 1912–13. These ratios are approximately the same for the United States and Great Britain, and they are higher for both France and Japan, possibly because the equity markets in those countries were less important than in the United States and Britain.

Rajan and Zingales's allegations of U.S. banking and equity market underdevelopment in 1913 are thus based on flawed data. A lesson: check sources carefully, compare them with other extant sources, and deal with obvious apples–oranges problems before running cross-country regressions and before leaping to conclusions that may not otherwise be supportable.

The negative view that Rajan and Zingales take of U.S. financial development until the recent financial revolution, based as it is on flawed data, also affects their qualitative discussions. Sometimes these discussions appear self-contradictory:

New England banks in the early nineteenth century lent a large portion of their funds to members of their own boards of directors or to others with close personal connections to the board. What prevented this practice from being overly oppressive was that free entry was allowed into banking. Nevertheless, because only the rich or reputable could set up banks, finance was effectively restricted to incumbents (p. 34).

Free entry for only “the rich or reputable” would seem to be an odd definition of free entry. The source for this passage, Naomi Lamoreaux 1994, in no way implied, however, that New England's state banking systems were oppressive or that they restricted finance to incumbents. On the contrary, Lamoreaux's view was positive. Banking developed more freely in New England than anywhere in the United States, and the region led the way in U.S. industrialization in part because of close relationships among banks, bank investors, and manufacturers. Rajan and Zingales's distrust of relationship

banking should not have led them to distort the conclusions of those who have studied it, even if relationship banking might have produced negative results in other contexts.

In another passage (pp. 296–97), Rajan and Zingales favorably cite Andrew Jackson's 1830s destruction of the Bank of the United States as the nation's central bank in keeping with their concept of an implicit political antitrust law at work against financial concentration. A more widely held view of financial historians is that Jackson used his veto power as president to advance the interests of states' rights, along with those of incumbent state bankers, by ridding them of a federal regulator and competitor. Since the United States deemed it useful to reinstitute a central bank after a hiatus of some decades marked by periodic banking crises, Jackson's action might better be considered an early example of financial reversal rather than one that helped to save capitalism from the capitalists.

The same passage (pp. 296–97) cited also credits the implicit political antitrust law for “the creation of the Federal Reserve in 1913 to counter the power of the House of Morgan.” Earlier in the book, Rajan and Zingales noted that “finance in an underdeveloped system tends to be clubby, uncompetitive, and conservative, an apt description of finance in the United States in the beginning of the twentieth century.” But data better informed than Rajan and Zingales's indicate that the U.S. financial system, as compared with those of other nations at almost any date after 1800, was far from underdeveloped (see Goldsmith 1985, Robert E. Wright 2002). Moreover, U.S. financial historians (Ron Chernow 1990, chapters 7, 9; Elmus Wicker 2005) know quite well that representatives of the House of Morgan and other leading New York banks were instrumental in shaping the Federal Reserve Act, even if the bankers would have preferred a Fed with more bank-led control and less governmental control.

Had Rajan and Zingales studied U.S. history more carefully, they perhaps would have found that the American experience furnishes one of the better historical examples of financial development leading to economic growth, rather than the conundrum they make it out to be.

Bottom line. Quibbles aside, Rajan and Zingales have provided us with an ambitious and thought-provoking analysis of the uses and abuses of finance in capitalist economies. The worldwide persistence of incumbent influences in business, finance, and politics could well make the reader wonder whether such mutual back-scratchings might not be a force in itself, a force that makes for stability in the political economy of nations. A recent, modestly titled working paper by North, John Joseph Wallis, and Weingast (2005) argues that, for most of recorded human history, political economy has been characterized by “natural states” in which political authorities gain the support of elites, a concept similar to the incumbents of Rajan and Zingales, by protecting their property rights and limiting the access of nonelites in order to create rents for the elites. The elites/incumbents then return the favor by supporting friendly politicians and governments. In the North–Weingast–Wallis view, the limited-access order of the natural state has already been replaced in developed countries by an open-access social and economic order more conducive to development and growth.

Rajan and Zingales, on the other hand, offer to the reader a colorful palette of reasons to doubt whether we are so close to an open-access order, even in developed countries. Moreover, even if recent advances in financial development have moved us closer to such an order, these authors offer us the opportunity to wonder whether the gains will persist.

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