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Entry, information, and financial development: A century of competition between French banks and notaries ☆

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Abstract

Poorly developed financial markets are widely believed to block economic growth, because only modern financial intermediaries such as banks can mobilize large amounts of financial capital at low cost. This claim is supported by cross country regressions, but the regressions assume that credit intermediation is measured accurately before modern financial intermediaries arrive. If traditional intermediaries were mobilizing large amounts of financial capital before banks or other modern intermediaries appear, then the strength of the relationship between financial development and economic growth would be cast into doubt. Using an original panel dataset from nineteenth-century France, we provide the first estimates of how much financial capital key traditional intermediaries (notaries) were mobilizing for an entire economy during its first century of economic growth, and we analyze the lending that the notaries made possible in French mortgage market. The amount of capital they mobilized turns out to be large. We then analyze the effect that financial deepening had on the notaries as banks spread and find that the banks' and notaries' services were in all likelihood complements. The implication is that the link between financial development and economic growth may therefore be weaker than is assumed.

JEL classification: G21; O16; O17; N23
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1. Introduction

It is now common in development economics to put part of the blame for low levels of income on poorly developed financial markets.[1] The same is true in

[1] King and Levine, 1993; Demetriades and Luintel, 1996; Levine, 1997; Demirguc-Kunt and Levine, 2004; Rajan and Zingales, 2004; Burgess and Pande, 2005.

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economic history.[2] At bottom, the argument is that barriers to entry or to the flow of information leave borrowers beholden to a particular intermediary. Because this intermediary is a monopolist or inefficient, the cost of credit intermediation is high and the volume of loans is low.[3] Economists have advocated policies that encourage entry by new financial intermediaries—banks in particular—although such measures may be blocked by politics or by the banks' reluctance to enter underserved sectors of the economy. The assumption is that if they could enter, they would boost the supply of loanable funds, lower interest rates, and presumably displace traditional intermediaries.

France is often held up as a poster child for this thesis. In the eighteenth century, so the argument goes, financial development stagnated there, while commercial banks were flowering in England. And although banks did diffuse in France in the nineteenth century, the process was supposedly slow and is claimed to have retarded economic development. However, in 1807, long before banks had begun to spread, the stock of mortgage debt in France still amounted to 10% of GDP, despite the damage done to credit markets by years of war and rapid inflation during the French Revolution. Relative to GDP, the stock of mortgage debt was comparable to the level in the United States after the shock of the Great Depression and World War II. And by 1840, mortgage debt originated outside of the banking system came to 27% of GDP, roughly the same level as total mortgage debt in the US in the 1950s.[4] If banks (and modern financial intermediaries in general) were essential, how could so much lending take place?

The data from France highlight a serious problem with the standard thesis. The problem, which is widespread, is that the official credit statistics scholars rely on usually underestimate the volume of traditional credit and therefore overestimate the role of banks. The root of the difficulty is that traditional credit intermediaries, unlike their modern counterparts, rarely face reporting requirements, and it is therefore difficult to estimate the volume of loans they make. The erroneous estimates in turn affect regressions that link lending to GDP growth. If the banks, for instance, are more efficient substitutes for the traditional lenders, then some of the credit that banks provide is simply replacing lending from traditional sources. True growth in total lending is therefore smaller than the figures derived from bank data would suggest, and GDP growth may be more sensitive to total lending than the regressions would suggest. The consequences would be different, however, if banks are not substitutes for traditional lenders. If the traditional intermediaries actually prosper when banks diffuse, because the banks and the traditional intermediaries are complements, then the actual growth of total lending is larger than the figures based on bank data indicate, and GDP growth may be less sensitive to total lending than the regressions imply. Neglecting traditional intermediaries may therefore exaggerate the role that credit markets play in economic growth, if banks are not substitutes for the traditional intermediaries. If, however, they are substitutes, then credit markets may be even more important than we expect in explaining economic growth.

Clearly one should measure the size of traditional lending; we do so in this article using an original panel dataset that we have assembled for France across the nineteenth century. Our data yield the first estimates of how a major fraction of traditional lending evolved across a long time period in an entire economy. Because collecting data on traditional credit intermediation is difficult, other estimates have either been snapshots at one time (Goldsmith, 1969) or have concerned only one city (Hoffman et al., 2000; Lindgren, 2002). We overcame the difficulties by relying on tax records from a stratified sample of French credit markets; the tax records in turn let measure the volume and stock of traditional lending in a major credit market, the market for mortgage loans, at four points between 1807 and 1899.

Beyond that, we also use our data to determine who was involved in this market and to estimate the impact that the most important form of financial deepening—the diffusion of banks—had on traditional intermediaries. Although our dataset does not allow us to directly test the effect that traditional lending had on economic growth, it does suggest that the modern intermediaries—banks—were not more efficient substitutes for the traditional intermediaries—notaries—in the mortgage market, which would point to financial development's have less of an effect on growth once traditional lending is taken into account. As late as 1899 traditional intermediaries were providing 83% of mortgage funding even though

[2] Postan, 1935; Gerschenkron, 1962; Davis and Gallman, 1978; Neal, 1994; Rousseau, 1999; Rousseau and Sylla, 2003, 2005, 2006; Sylla, 1999; Temin and Voth, 2006. Temin and Voth (2013) blame slow growth during the Industrial Revolution on interest rate ceilings and crowding out that hindered the development of British financial markets.

[3] The term "cost of credit intermediation" is taken from Bernanke (1983). It would include the costs of screening and monitoring borrowers and would be covered by recoveries from defaulting lenders and the spread between the cost of funds lent and the interest rate earned on loans.

[4] The stock of US mortgage debt was 11% of GDP in 1944 and averaged 31% in the 1950s according to the Federal Reserve bank data at http://www.federalreserve.gov/releases/z1/Current/data.htm.