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European Banks and their Impact on the Banking Industry in Chile and Brazil: 1862–1913

Ignacio Briones and André Villela

with comments by Forrest Capie and by Patrick Honohan

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Editorial

On the 30th of September and the 1st of October 2005 the first Economic History Panel: Past, Present, and Policy, co-sponsored and hosted by Oesterreichische Nationalbank was held in Vienna. The Economic History Panel is a project that is jointly sponsored by the Institut d'Etudes Politiques de Paris and the Center for Economic Policy Research in London. Its motivation is the considerable advances that Economic History has achieved in the past, and the growing recognition of its contribution to shape policy responses and to inspire new theoretical research.

The first meeting on the topic "International Financial Integration: The Role of Intermediaries" was jointly organized by Marc Flandreau (Sciences Po, Paris and CEPR) and Eduard Hochreiter (Oesterreichische Nationalbank). Academic economists and central bank researchers presented and discussed current research and tried to review and assess the historical role of financial intermediaries in shaping the patterns of financial globalization. A number of papers and the contributions by the discussants presented at this panel are being made available to a broader audience in the Working Paper series of the Oesterreichische Nationalbank. A selection of these papers will also be published in the *European Review of Economic History*. This volume contains the second of these papers. The first one was issued as OeNB Working Paper No. 107. In addition to the paper by Ignacio Briones and André Villela the Working Paper also contains the contributions of the designated discussants Forrest Capie and Patrick Honohan.

January 4, 2006

EUROPEAN BANKS AND THEIR IMPACT ON THE BANKING INDUSTRY IN CHILE AND BRAZIL: 1862-1913

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Introduction

The period from the 1870s to 1914 witnessed the increasing integration of the major Latin American economies to the great wave of globalization that swept the world. Growing flows of merchandise, capital and labor linked Argentina, Brazil, Chile, Colombia, Peru and Mexico (just to mention the largest Latin American economies) to Europe and, to a lesser extent, the United States. Facilitating these flows – in particular, flows of goods, services and capital – were banks organized in the main capital markets of the day (namely, London, Paris, Berlin and New York) and with offices in the major commercial centers of Latin America. From places like Buenos Aires, Lima, Santiago and Rio de Janeiro (mostly) British and German commercial banks helped finance the exports of commodities such as grain, beef, nitrates, copper and coffee to markets in Europe and the United States while, at the same time, their parent banks gave support for the exportation of manufactures to the Latin American "periphery".

Foreign banks occupied an important place in the fledgling markets of Latin America. Their share of the banking industry, of course, varied from country to country but in all cases European banks helped integrate local economies even further into an international division of labor in which Latin America (alongside Africa and Asia) acted as a supplier of raw materials to the industrializing economies, while importing from the "center" increasing quantities of manufactured goods. This "perverse" role of foreign banks – namely, that of reinforcing the primary product exporting nature of Latin American economies – did not help them win the sympathy of later commentators (as a cursory look at most textbooks on the subject would reveal). Yet, how did contemporaries see these banks? What were the perceived impacts of foreign banks on the local banking sector? Were there marked differences in the behavior of local versus foreign banks? Are there any indications of a trend towards "best practice" amongst local banks in the wake of the entry of foreign competitors?

The answer to the first question is fairly straightforward: nineteenth-century Brazilians, Chileans, Argentines etc. often disliked foreign banks. Their complaints – and one has to remember that it was mostly the members of the local commercial and agricultural elite who made themselves heard – were voiced in the press and in parliamentary debates and, despite regional subtleties, they all seemed to converge on a few points, to wit: recrimination of foreign banks' refusal to lend against rural property; their aversion to engaging in soft loans (which, at the time, would have taken the form of advancing "accommodation credit") and

their excessive focus on speculation in the exchange-rate market (and the gains arising thereof).

As to the second set of questions, touching on the *impacts* of foreign bank participation in the major markets of Latin America in the late 1800s/early 1900s, we believe it has not received the attention it deserves in the literature.[1] This fact is particularly frustrating as it deprives modern analysts of an historical "laboratory" they can draw on to assess the possible impacts of the *current* wave of foreign bank penetration in the continent, in the wake of overall liberalization of the economies of Latin America. Given the lack of a systematic body of research on the effects of foreign bank activity during the first great wave of globalization which preceded World War I, in the present paper we shall attempt to begin filling this gap by analyzing the cases of Chile and Brazil.

Our analysis will be based on both aggregate and micro (bank balance sheet and, whenever available, income statement) data for selected years leading up to 1913. Right from the start, two methodological points are in order: i. the shortness of the period under consideration deprives us of a sufficient number of observations for regression-type analyses along the lines of modern research on the subject; and ii. while for Chile it is possible to obtain yearly balance sheets, in the case of Brazil we can count only on some point estimates. Still, it is hoped that the estimation of basic banking indicators, against the background of general trends in overall banking activity in both countries, will provide us with some useful indications as to possible behavioral differences between different groups of banks. The insights derived from this should benefit further from the comparison (both across time periods and between countries) of the Chilean and Brazilian experiences.

The remainder of the paper is organized as follows. Section 2 discusses the results of recent research on the significance of the *current* penetration of foreign banks[2] in emerging markets, particularly in Latin America. This analysis will be usefull in drawing possible hypotheses that might be then tested in the context of the historical data for Chile and Brazil. Section 3 presents an historical overview of foreign bank penetration in both countries. The core of the paper is presented in section 4, when we test for differences in the financial behavior of foreign banks as well as for their impact on the native banking industry. Section 5 sums-up our main findings, draws possible policy implications from the historical experiences and indicates paths for future research.

1. Lessons from the Present

<u>*Reasons for foreign penetration*</u>

The reasons behind the recent trend towards greater participation of foreign banks in emerging market banking systems appear to result from a combination of both "push" and "pull" factors. Among the former, one could point to the restructuring of the banking industry in developed countries, as was recently the case within the EMU.[3] Given the greater

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[1] Notable exceptions are Triner (2000; 2002) for the case of Brazil.

[2] Unless indicated otherwise in the present paper "banks" will be taken to refer to <u>retail</u> banks.

[3] This determinant seems to have been particularly true in the case of the Spanish banks, which have led the recent penetration of the Latin American market. After a process leading to increased concentration of the local banking sector, the major players – namely, Banco Santander Central Hispanico and Banco Bilbao Vizcaya – diversified their holdings by investing heavily in the acquisition of some of the largest banks in Argentina, Brazil, Chile and Mexico (Guillén and Tchoegl 2000).

competitive pressure faced in crowded mature markets, the major "push" factor behind the increasing presence of overseas banks in developing markets is simply the search for higher returns. An additional push factor is associated with the growth of foreign trade, with a number of studies having found a positive and significant correlation between banking FDI and the extent of integration between home and host countries (Ball and Tschoegl, 1982; Goldberg and Johnson, 1990; Grosse and Goldberg, 1991). Although the direction of the causality relationship is somewhat unclear, recent research supports the view that foreign banks tend to follow their customers abroad (Clarke *et al.* 2001). Finally, it should be noted that, at present, internationalization involves global banks seeking to expand their activities through the acquisition of stakes in local institutions, which leads them to cater to a broader, local client base.

The reason for the growing globalization of the banking sector has to do also with "pull" factors in the host countries, which influence the profitability prospects of foreign banks. In fact, a number of recent studies provide support for the hypothesis that foreign banks are attracted by profitable opportunities in the host country, where a lack of competition prevailed before their entry (Claessens *et al.*, 2001). According to Focarelli and Pozzolo (2000), foreign banks are more prone to enter into those countries that present better prospects for economic growth. They also tend to invest in countries with fewer regulatory restrictions. For Latin America as a whole, pull factors have taken the shape of greater integration, privatization and liberalization, all of which, together with the need to recapitalize the local banking sectors in the wake of crises, have made foreign entry more likely (Crystal *et al.*, 2002).

Arguments in favor and against foreign entry

Goldberg *et al*. (2000) summarize the main arguments found in the recent literature in favor and against foreign bank penetration. Pro-entry arguments are primarily threefold. First, foreign presence is said to increase the amount of funding available to domestic projects by facilitating capital inflows, as well as contributing to financial strength by means of increasing the stability of available lending. Second, there is a competition argument: foreign banks can improve the quality, pricing and viability of financial services directly or through competition with local banks. Finally, foreign entry has the potential to improve the financial system infrastructure by means of the introduction of "best practice" financial and regulatory procedures as well as the importation of improved managerial techniques.

On the negative side, main arguments *against* opening domestic financial systems to foreign participation include: the charge that foreign banks constitute a potential avenue for capital flight in times of crisis; that these banks "cherry-pick" the most lucrative domestic markets or customers; the emphasis on the "strategic" nature of the financial services industry (which, presumably, should be kept in national hands); concerns over the challenges to local supervision posed by the entry of highly complex financial institutions based in a number of jurisdictions .

Recent research has attempted to evaluate to what extent the aforementioned arguments prove true in practice. We briefly describe the main findings of this research separating the conclusions for developing countries as a whole from the ones obtained for Latin America.

General empirical findings from developing markets

Testing for differences in the behavior of domestic and foreign banks has been the main line of empirical research. In this connection, one of the most influential studies on this topic (Claessens *et al.* 2001) used bank-level accounting data from 80 countries in order to i. assess whether there are noticeable differences between foreign and domestic banks in terms of a few financial indicators, such as interest margins, taxes paid, overhead expenses, loan loss provisioning, and profitability; and ii. estimate how foreign bank presence has affected local banking markets. The authors find that foreign banks tend to have higher interest margins, profitability, and tax payments than domestic banks in developing markets. An additional result from their research is that the number of entrants matters more than their market share, in a possible indication that foreign banks *"(...) affect local bank competition upon entry rather than after they have gained substantial market share."*

Differences in behavior between foreign, private domestic and government banks, and their impact on the nature and success of banking, are at the center of the contribution by Mian (2003). Using panel data for over 1,600 banks in emerging market economies between 1992 and 1999, his results indicate that local banks, although being the same size as foreign banks, tend to be more aggressive in their lending than rivals, hold more assets in the form of loans and significantly less liquid assets than foreign banks. Relying more on "soft information" than their foreign counterparts, they lend out more and at higher interest rates (Mian 2003, p. 15). Foreign banks, on the other hand, "(...) *earn more through service fees, reflecting their high-end clientele*" (Ibid.). Overall profitability, though, is equivalent in both types of organization.

Regarding the contribution of foreign banks to financial stability, the evidence is mixed. On the one hand, some important cross country studies indicate that, on average, foreign entry has provided more financial stability (Demirgüc-Kunt, Levine and Min 1998; Levine 1999) and lower probability of financial crisis (Demirgüç-Kunt and Detragiache, 1998). On the other, other studies find no evidence that foreign entry has been stabilizing but, if anything, pointing tentatively in the other direction (Morgan and Strahan 2003).

Findings from the recent Latin American experience

Several studies have extended the previous analysis specifically for the experience of Latin American countries during the past decade. In general, the observed differences between local and foreign banks are even less clear in this case.

Using bank ratings and financial statements by means of the so-called CAMEL framework[4] Crystal *et al*. (2001; 2002) show that foreign and private domestic banks displayed broad similarities in financial condition and performance. Nevertheless, foreign banks showed higher average loan growth, a more aggressive response to asset-quality deterioration and greater loss-absorption capacity (Crystal *et al.* 2002, p.1). Regarding managerial practices, the authors show that foreign banks appear to contribute to the overall soundness of local banking via more aggressive screaning and management techniques. Calomiris and Powell (2001) found the same type of evidence when analyzing the case of Argentina during the 1990's.

[4] This consists of individual assessments of five aspects of a bank's financial condition and performance, namely, **C**apital adequacy, **A**sset Quality, **M**anagement, **E**arnings and **L**iquidity (Crystal *et al*. 2001, p. 6).

Studying the Mexican and Argentinean experiences during the 1990s, Dages *et al.* (2000) show that foreign banks exhibited stronger loan growth and had lower associated volatility, thus contributing to greater stability in overall financial system credit. In both countries *"(...) foreign banks displayed notable credit growth during recent crisis periods and thereafter"* (Ibid.). Still – and given that private domestic and foreign-owned banks were found to behave similarly in terms of cyclical fluctuations and loan portfolios – the authors are led to conclude that their findings *"(...) suggest that bank health, and not ownership per se, has been the critical element in the growth, volatility, and cyclicality of bank credit"* (Ibid., p. 19; emphasis added).

Peek and Rosengren (2000) have focused on the extent to which foreign banks are prone to "cut and run". Studying the case of countries having experienced financial crises recently (Argentina, Brazil and Mexico), they conclude that foreign banks have increased their participation in local markets despite the recurrent economic problems faced by those countries.

Levy-Yeyati and Micco (2003) obtained very different results in a recent study of eight Latin American countries between 1994 and 2002. The authors find that foreign banks in the region are associated with higher insolvency risk due to higher leverage ratios and more volatile returns. Moreover, they find that foreign entry weakened banking competition but, surprisingly, that the latter induced lower levels of risk for the bank industry as a whole.

While most of the recent research has identified positive effects in the recent trend towards greater penetration of foreign banks in developing country markets, two recent contributions that deal specifically with the Brazilian experience offer a more guarded assessment of the phenomenon.

While pointing out that foreign banks have had a positive impact on the Brazilian market by way of forcing local private banks to increase their efficiency and improve overall performance, Paula (2002) shows that foreign banks are not necessarily more efficient than host-country banks. Indeed, selected performance and efficiency indicators for 1999 and 2000 show private domestic banks ahead of their foreign competitors. On the other hand, Carvalho (2001) shows that, on average, foreign banks rely to a greater extent on financial operations with government securities than on credit, compared to their domestic (private) counterparts. Service fees tend to comprise a *smaller* share of foreign banks' operational revenues than local banks', which suggests that the former have not necessarily exerted a "modernizing" influence on the market. This pattern (or lack of) also holds true when comparing interest rates charged on selected classes of credit: the data indicate that bank ownership is not correlated with the cost of credit in Brazil.

Summing up the argument so far, in general current research appears to confirm the widespread view that foreign bank entry into emerging country markets tends to have positive effects, in the shape of bringing greater stability and, via the exercise of competitive pressures, efficiency gains. Still, the wording employed by some authors (e.g. Crystal *et al.* 2001, p. 47) indicates that the results are not as robust as they may seem. Moreover, these empirical findings appear to be even less clear when focusing in the more specific case of Latin American countries, especially when looking at differences in the financial and risk behavior of foreign and native banks. The latter suggests that the very aggregate nature of the tests may conceal important nuances that individual country studies can help to bring to light. The recent Brazilian experience – where highly competitive and increasingly efficient domestic banks dominate the market for retail banking and where foreign competitors tend to

adapt their behavior to local banks, and not the other way around – serves to show that there may be, if not exceptions, at least important variations to the general theme.

What "lessons", then, does the present hold for the past? In other words, based on the current wave of globalization of retail banking and its attendant impacts on host country markets, can we expect to find the same (positive) efficiency gains in the "periphery" of the XIXth century? Were there indeed noticeable behavioral differences between local and foreign banks? Did the activities of (mostly) British and German banks in Chile and Brazil bring greater stability to these markets? In view of their unquestionable superiority in terms of contemporary banking techniques did the activities of foreign banks give rise to a process of local "convergence" towards best practice? After a brief history of foreign banks in late XIXth-century/early XXth-century Chile and Brazil, which we present in section 3, section 4 will attempt to answer some of these questions.

2. The Historical Experience

The British were the first to establish foreign banks in Latin America. The timing of the arrival of these banks during the 1860s owed more to conditions in Britain than to events in Latin America, although their main motivation rested in their desire to finance a share of the growing trade between that region and Europe. The first wave came during the stock company boom leading up to the Overend Gurney crisis of 1866 and was made possible by the Companies Acts of 1858-62, which extended the privilege of incorporation with limited liability to banks (Cottrell 1991, p. 26; Jones 1993, p. 23). The London and River Plate Bank (1862) led the way, soon followed by the London and Brazilian Bank (1862), the British Bank of South America (1863), the English Bank of Rio de Janeiro and the London Bank of Mexico and South America (1863-4). These banks were later joined by the Anglo-South American Bank (1907), itself the result of the amalgamation of (British) institutions founded earlier in Argentina.[5]

From 1870 to 1910 the combined assets of the four major Anglo-Latin American banks (i.e., the London and River Plate, London and Brazilian, British Bank of South America and Anglo-South American) had grown from just under £ 9 million to more than £ 66 million.[6] During this period they spread their operations over a wide territory through their branch networks. In the case of the two Brazilian banks (the British Bank of South America and the London and Brazilian Bank), their network grew southwards into the River Plate, and westwards into Chile, whilst the London and River Plate Bank countered this expansion by moving into Brazil and Chile (Jones 1977, p. 23). In all by 1913 their combined network comprised 65 branches, thus distributed.

[5] Throughout banks will be referred to as British on the grounds that they were registered in London, although often shareholders of such companies were not themselves British. For example, in 1865 Portuguese and Brazilian citizens held more than 40% of the share capital of the English Bank of Rio de Janeiro (Jones 1977, p. 22).

[6] Jones (1977), Tables I.1 and I.3, based on data in Lough (1915).

Table 1
Branch Offices of the Major Anglo-Latin American Banks, 1913

Country/bank	London & Brazilian	British Bank of S.A.	Anglo-South American	London & River Plate	Total
Argentina	2	2	7	13	24
Uruguay	1	1	1	4	7
Brazil	11	3	-	9	23
Chile	-	-	10	1	11
TOTAL	14	6	18	27	65

Source: Adapted from Table I.2 in Jones (1977), p. 24.

Continental banks followed the British lead into Latin America with some lag. German (for example, the Deutsche Überseeische Bank (1886), Brasilianische Bank für Deutschland (1887), and the Bank für Chile und Deutschland (1895)) and, to a lesser extent, French (Banque Française pour l'Amerique du Sud and the Banque Argentine et Française) outfits predominated, although a number of banks with connections in Italy, Holland, Belgium and Switzerland set up business in the region as well (Glade 1986, p. 45). In 1913 their share of the local banking market (measured as a percentage of total deposits) varied from nil in Ecuador, Colombia and Venezuela to as much as 46% in Brazil; elsewhere, their market share was also noteworthy, and ranged from ¼ to 1/3 of total deposits (e.g., 17% in Bolivia, 26% in Peru, 28% in Chile and Argentina and 33% in Uruguay).[7]

In what follows, we present a more detailed overview of the evolution of the banking system and the history of foreign banks' penetration in Chile and Brazil.

2.1 Chile

The local banking industry during the formative years

The history of the formal banking industry in Chile began with the approval of a General Banking Law in 1860. The law was designed by the French economist Jean Gustave Courcelle Seneuil, one of the most prominent advocates of the free banking school at the time.[8] The aim of the law was to develop a banking system in which private banks would be in charge of supplying the economy with convertible notes. Apart from being restricted to issue notes in amounts up to 150% of their paid in capital or required to publish monthly balances sheets, no other important restrictions, including capital requirements or minimum specie reserves, were set by this law.

In 1878 a banking run against the major bank (The Banco Nacional de Chile)[9] forced the government to declare the temporary suspension of convertibility. Although banks were not restrained from continuing issuing notes, starting in 1880 the State began to issue its own inconvertible and legal tender notes and rapidly became the major issuer. In practice, the latter resulted in maintaining inconvertibility until 1895. That year Chile adhered to the gold standard and it became mandatory that both State and banknotes should be redeemed in gold

[7] Topik (1979).

[8] Hired in 1855 by the Chilean Government as Finance Minister Adviser and Professor of Political Economy at the Universidad de Chile.

[9] This bank accounted for nearly half of total deposits and bank note issuance.

by December 1897 at the latest. Credibility problems and financial difficulties resulting from a severe monetary contraction led to a new banking run in 1898. Once again, declaring the inconvertibility of all notes solved the crisis. However, this time private banks were definitely forbidden from issuing notes, thus granting to the State the monopoly of note issuance and inaugurating a new monetary regime.

The new monetary regime and the crisis of 1907-08

After the failed attempt at adhering to the Gold Standard (1895-98) the monetary regime prevailing in Chile was one of paper money overexpansion resulting in increasing inflation and in a systematic depreciation of the local currency.[10] During the early days, overissue was accompanied by economic expansion and rapid credit increase,[11] thus rendering the banking industry potentially more fragile. Moreover, clear signs of a stock market bubble appeared,[12] with some banks holding large positions (at the credit level or as stockholders) in companies that proved to be unsuccessful. In 1907 a severe financial crisis arose with domestic stock prices collapsing[13] and banks facing liquidity problems. Three banks failed in 1907, including the 7th biggest bank (the Banco Mobiliario). Additionally, in 1908 the largest nitrate company, the Spanish La Granja & Co. announced it was on the verge of bankruptcy, but was rescued by a £500.000 government loan through the Banco de Chile.[14]

In 1907, bankers' complaints about the scarcity of State notes during the crisis were not answered by simply issuing more notes, as often done in the past,[15] but by the creation of a new institution, the *Oficina de Emission*. Its mission was to issue Treasury notes upon request of any bank if and only if the latter was able to deposit its equivalent in gold in the National Treasury vaults in Santiago or London at a rate of 18 pence per Peso. As pointed out by Subercaseaux (1922, p. 137),[16] the latter marked a return to orthodox monetary principles. Besides, in apparent recognition of the lack of banking legislation, the government commissioned a study for a new banking legislation to former deputy and Secretary to the Treasury Mr. Agustin Ross but nothing came out at the end.

The post crisis period and new banking problems, circa 1911

Once the financial distress of 1907/08 was over, bank credit began to expand significantly once again, with loans growing from nearly $410million in 1908 to $780 million in 1910. Towards the end of 1911, the first signs of a new banking crisis appeared. In 1912, banks approached the government for help, and requested new issues of paper money. But the government answered by issuing State notes and giving them to banks upon request only if

[10] The value of the Chilean Peso felt from 17 pence in 1900 to 10 pence in 1913.

[11] Bank loans augmented by a factor of almost four between 1900 and 1907.

[12] A growing number of new companies were created (mainly in the mining and agriculture sectors), passing from 81 entities quoted in Santiago Stock Exchange in 1897 to 140 in 1904. Stock market capitalization grew for more than 100% (in real terms) between 1897 and 1904. See Briones (2001).

[13] The latter was reinforced by the collapse of the New York Stock Exchange in March 1907.

[14] This bank has traditionally maintained a privileged relation with the government, thus becoming a quasi State Bank.

[15] For example, in June 1906 the government issued $40MM, half of which to be lent to the banking system.

[16] Subercaseaux was a distinguished professor of political economy as well as the Chilean Finance Ministry in 1907, 1919 and 1923.

they were able to deposit its equivalent in gold in London or Santiago at a rate of 12 pence per peso. This measure introduced some flexibility for banks when compared to the prevailing conversion rate of 18 pence.[17] Nevertheless, a few contemporary observers like Subercaseaux (1922, p. 140) argued that the measure tended to benefit foreign banks that had access to European credit markets. According to Conoboy (1976, pp. 253-254), by the end of 1913, some $34 million in currency notes were issued against the deposit of gold by banks, $33 million were deposited in London while only $1.3 million in Santiago. Moreover, $12 million were accounted for by the Banco de Chile and less than $1 million by other native banks. The remainder was issued through foreign banks, especially the three German banks existing in Chile at the time.

Even if a formal domestic banking industry began to develop in the 1860's, foreign presence in Chile arose only in the 1890's, several years after Brazil. The history of foreign banks in Chile before WWI is the history of British and German banks. In the eve of WWI, five foreign banks - two British and three German - out of a total of 29 banks were operating in Chile.

The British banks

Starting in 1888, with the creation of the Bank of Tarapacá and London, British banks were the first to be established in Chile. The bank was organized in London by Mr. John Thomas North and British capitalists interested in performing credit operations for Chile's expanding nitrate industry. The bank changed its name to Banco de Tarapacá and Argentina in 1900 when it took over the Anglo-Argentine Bank. In 1906 the Bank's name changed again, to Anglo-South American Bank. The bank had its head offices in London and besides Chile, branches in Germany, Argentina and Uruguay.

The second British bank in Chile was the London and River Plate Bank. First established in Argentina (1862) and having its head offices in London, this bank expanded its operations to Brazil (1891) and then to Chile in 1906.

The German banks

Following the Bank of Tarapacá and London, the first German banks were established in the 1890's. In October 1895 the Disconto Gesellschaft, jointly with the Norddeusche Bank, founded the Bank für Chile und Deutschland (Banco de Chile y Alemania). The bank had its head offices in Hamburg, and was the sole foreign bank having branches exclusively in Chile. Only a few months later, in January 1896, the Deutsche Überseeische Bank (Banco Alemán Transatlántico) opened a branch in Chile. This bank was a separate entity created by the Deutsche Bank in 1893, had its head offices in Berlin[18] and was branched in several other Latin American countries.[19] It was the largest German bank in Chile. In 1910, a third German bank, the Deutsche-Südamerikanische Bank (Banco Germánico de América del Sur), extended its operations to Chile. The bank was dependent of the Dresdner Bank and the

[17] Especially considering that banks were allowed to fully recover their gold deposits (i.e. at 12 pence per peso) as soon as State notes were returned.

[18] First established as the Deutsche Überseebank in Argentina in 1886; reorganized in 1893 as the Deutsche Überseeische Bank (Young 1992, Table I, p. 34).

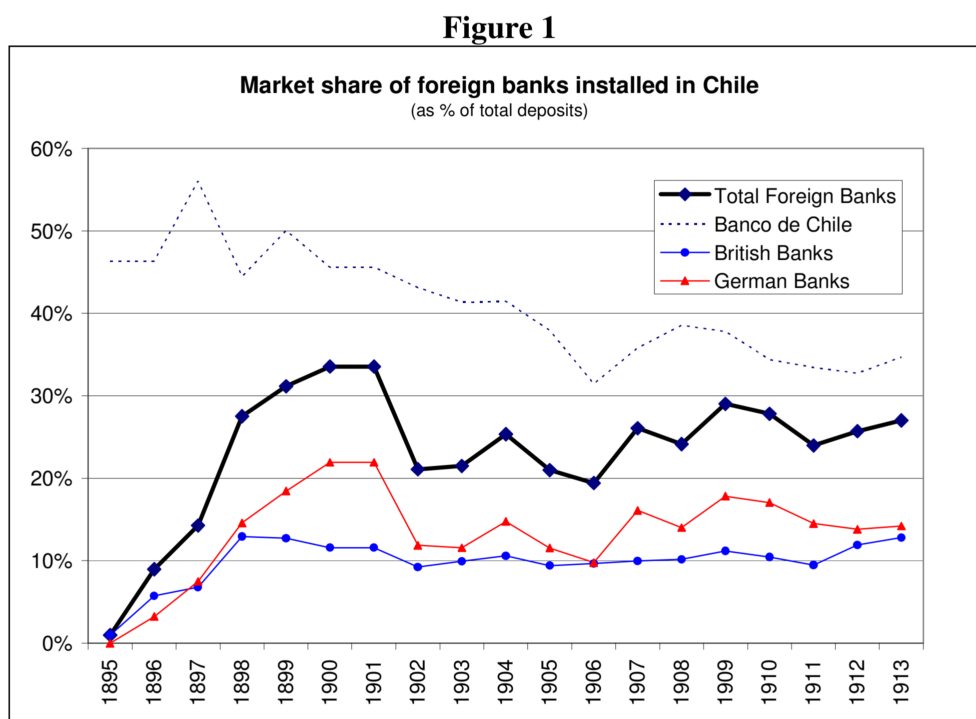
[19] In addition to the Chilean offices and to two branches located in Madrid and Barcelona, circa 1913 the Deutsche Überseeische Bank had branches in Argentina, Brazil, Perú, Bolivia and Uruguay (Hurley 1914, p. 20).

National Bank für Deutschland, with head offices in Berlin and branches in other Latin American countries.[20]

Relative size of the foreign banks in Chile

Foreign banks installed in Chile had a rapid success in penetrating the local market. As presented in Figure 1, they accounted for nearly 30% of total deposits as early as 1900 (stabilizing afterwards) with British and German banks having a roughly similar market share. Moreover, foreign presence was associated with a decline in the market share of Chile's major bank, the Banco de Chile.

Figure 1



Source: Authors based on individual balance sheets

Measured by total deposits, in 1913 the Anglo-South American Bank was the third largest bank in Chile (out of 29), lagging behind the native Banco Español de Chile but far from the Banco de Chile.[21] The Banco Alemán Transatlántico, the Banco de Chile y Alemania and the Banco de Londres y Río de la Plata were the 4th, 5th and 6th largest banks respectively.[22] On average, deposits held by a "typical" foreign bank were 70% bigger than their Chilean typical counterpart.[23]

[20] In addition to its Chilean branches of Santiago and Valparaíso, established in 1910, the bank opened offices in Buenos Aires (1906), Mexico City (1907) and Rio de Janeiro (1911).

[21] While this bank, which used to have close relationships with the government, accounted for nearly 50% of the market in 1900, its market share diminished to 33% by 1913.

[22] The Banco Germánico de America del Sur was the 13th largest bank in Chile.

[23] This is the average size of a Chilean bank excluding the Banco de Chile (which had the largest market share) from the sample.

Foreign banks and the legal environment in Chile

One important feature of both British and German banks was that rather than being established as simple branches of their parent institutions they were settled as subsidiaries[24]. Following a common practice in other Latin American countries, instead of demanding authorization to the Chilean government to create an overseas branch, foreign banks set up entirely new companies with their own specific capital. This meant that even if relying in the prestige of their parent banks and reporting to them, in case of local bankruptcy, their failure would not compromise the capital of their parent institutions (Young 1992, p. 33; Hurley 1914, p. 54; Subercaseaux 1922, p. 130).

Moreover, in Chile's case foreign banks were neither ruled by the banking law of 1860 regulating local banks nor by the Commercial Code of 1865, which governed domestic and foreign companies in general (Subercaseaux 1922, p. 129). This fact induced contemporary observers to point out that foreign banks were in a privileged position over local institutions.[25] Whether the latter was a real privilege for foreign banks is doubtful. Remember that the general banking law of 1860 neither constrained local banks to hold a minimum amount of capital nor restricted the kind of operations banks could undertake. Certainly, one important provision of the Law was the duty to publish monthly balance sheets, but in practice foreign bank balance sheets were published regularly in the newspapers as well. In this sense, it is more likely that this apparent different legal treatment was a non-binding constraint on local banks. Perhaps the only real advantage for foreign banks was that while local companies were subjected to pay taxes on the values of their shares quoted in the local stock exchange, foreign concerns were not quoted and thus paid no taxes.[26]

Operations and managerial practices of the main foreign banks

The financing of foreign trade appears to have been the main "pull" factor attracting foreign banks to Chile. Indeed, there exists a clear correlation between the importance of British and German banks and the share of Chile's international trade held by Britain (40%, on average, between 1890 and 1910) and Germany (20%). When financing overseas commercial operations the usual mechanism employed by foreign banks was the purchase or acceptance of bills of exchange drawn by an exporter on his consignee overseas (Young 1992, p. 40). Even a critic of the foreign banks like Subercaseaux (1922, p. 134) recognised that both German and British banks rendered very valuable services in the development of commercial negotiations. Besides, German banks favored the development of certain German companies organized in Chile (Ibid, p. 134) while British banks contributed to the financing of public works undertaken by British capital (Joslin 1963, pp. 196-7). They also managed various credit operations with the Government of Chile such as domestic bonds placed in the German or the London market.

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[24] Highlighting the same important point when referring to the overseas German banks, Young (1992, p. 33) refers to them as *daughter banks*.

[25] For example, the newspaper La Unión, of Valparaíso (27 July 1893), asserted that *"In Chile foreign companies find themselves in a privileged position in relation to national companies in all senses: they are not obliged to constitute any capital, nor to accumulate reserve funds, nor to make, nor to publish balances, not even to pay taxes"*. Quoted in Conoboy (1976), p. 256.

[26] As mentioned in the previous section, a tax on foreign bank capital was introduced in 1910 in an attempt to correct this difference.

Apart from these distinctive features, the main operations performed by foreign banks in Chile were not very different from the ones undertaken by native banks, namely receiving deposits and undertaking loan and discount operations. Indeed, balance sheet data indicate that the share of the deposits and loans over total assets of foreign banks was not very different form their Chilean counterparts.

While foreign banks probably did not differ significantly from native banks in the kind of banking operations they performed, many contemporary observers noticed that foreign banks established in Latin America had sounder managerial and monitoring practices. According to Hurley (1914) foreign banks supplied their home offices in Europe with the credit rating and characteristics of local firms and individuals. This is why he claims *"Latin American business men calling upon banks at Hamburg have been astonished at the familiarity of bank officials with the character of their business"* (p.11).

In the case of Chile, even skeptics about the contribution of foreign banks highlighted that foreign banks were very well managed (Ross 1910; Espinoza 1909). According to Subercaseaux (1922, p. 134) foreign banks *"have placed at the head of their administration thoroughly very competent men, who have seen to it that their functions are well performed; and in this way they have not only given the country the benefit of a good banking service, but at the same time have set good example for the national banks, the administration of which has not always been equally commendable"*. Confirming this point, Joslin (1963, p.196) cites the example of the Anglo South American Bank during the financial crisis of 1907 in Chile. "*The Anglo South American bank was fairly free from major trouble in the stock exchange boom, as Head Office had forbidden its managers to get entangled with the risky business of lending with shares as collateral without exacting a very wide margin of safety"*.[27]

2.2 Brazil

The imperial period, c.1877-1889

The Brazilian banking system evolved over the second half of the XIXth century to comprise a number of institutions, including savings banks (*caixas econômicas*), mortgage banks, private banks and the (usually) larger joint-stock commercial banks. The latter two carried out the bulk of financial transactions, such as exchange operations, bill discounting, advancement of loans and deposit taking.

These institutions, in connection with commercial houses and factors, helped finance the expansion of Brazil's slave-based coffee economy. Coffee factors granted credit to inland planters and helped move their crops to the ports, where, after selection and classification of the beans, (mostly) foreign-owned commercial houses saw to the shipment of the bags to Europe and the United States. The financial dimension of this process – consisting of flows of cash, advancement of credit and bill discounting – involved both foreign and Brazilian joint-stock banks, private banks, commercial houses, coffee factors and, ultimately, the

[27] Despite the recognition of their sound managerial practices or the role accomplished by foreign banks in facilitating commercial relations, many observers were critical of them. The main concern was related to the paid in capital these banks effectively introduced to Chile (Subercaseaux 1922, p. 131). In a similar fashion, objections were directed at the role of foreign banks in causing the flight of capital from the country during the crisis of 1907 through their practice of bringing little capital to Chile and remitting deposits back home (Ross 1910, p. 237). In the National Congress, criticism of the foreign banks after this crisis concentrated particularly on the three German banks.

planters, and formed the basis of Brazil's capital market until well into the XIXth century (Sweigart, 1987).

Operational rules and the finer details of the organization of financial institutions were laid down in the Commercial Code of 1850, with subsequent changes in corporate law mainly affecting joint-stock banks. The latter, after obtaining government approval of their statutes (just like any other joint-stock company) were left free to operate pretty much at will. Later in the century commercial banks were required to publish in the press a summarized balance sheet showing all business done by them. Apart from this, government exercised no supervisory role and had no interference in their operations (Hurley 1914, p. 43).

As of 1850 there were only three commercial banks operating in the Empire,[28] rising to 17 in 1877 and 26 in 1888, as the Republic set in.[29] Their combined assets of 500,000 *contos de réis* (£ 56 million) in 1889 were equivalent to a quarter of total estimated GDP, compared to 15,000 *contos* (£ 1,8 million, or 4% of GDP) four decades earlier. Deposits, in turn, amounted to 220,000 *contos* (£ 24,7 million) in 1889, with just over 25% held in the largest bank, the privately owned Banco do Brasil (Goldsmith 1986, p. 41).

The first foreign banks to set up operations in Brazil were British: the London and Brazilian Bank (LBB) was founded in London in 1862, going on to open a branch in Rio in February 1863.[30] Shortly afterwards it was joined by the Brazilian and Portuguese Bank (1864), which, three years later, changed its name to English Bank of Rio de Janeiro (EBRJ).[31] Although it would develop into the largest of the foreign banks operating in Brazil, the LBB experienced stagnant business for most of the first decade of its operations. Having survived two of the major financial crises that swept the Empire, in 1864 and 1875, a reformed bank (the New London and Brazilian Bank) opened branches in several important commercial centers in Brazil, thus increasingly engaging in the financing of the coffee and rubber trades. Foreign expansion was also part of its strategy: it first opened a branch in Montevideo, followed by Buenos Aires and Rosario. Its competitor, the EBRJ opted for a more conservative discount policy and relied more than the LBB on the exchange business. As early as 1867 the English Bank opened its first branch, in Recife and in the late 1870s it took part in the issues of several railway companies. Throughout, the EBRJ continued its expansion, opening up branches in other Brazilian cities and in the River Plate region (Joslin 1966, chapters 4 and 8).

Just before the end of the imperial period, British banks were faced with the first serious challenge to their position in Brazil, in the shape of a new German competitor, the Brasilianische Bank für Deutschland.[32] Founded in 1887 by one of the Berlin *grossbanken*, the Disconto-Gesellschaft (in conjunction with the Norddeutsche Bank), the Brasilianische had its main office in Hamburg and a capital of 10 million marks, for the promotion of

[28] The Brazilian Empire spanned most of the XIXth century, being replaced by the Republic in November 1889.

[29] Figures in Goldsmith (1986) and Topik (1987).

[30] In 1923 it would join forces with the largest British Bank in the region (the London and River Plate Bank), giving rise to the Bank of London and South America (BOLSA).

[31] This made Brazil the only country in Latin America where two British banks operated side by side in the 1860s (Joslin 1966, p. 60).

[32] This was not the first German bank to open a branch in Brazil. A Deutsche Brasilianische Bank was counted among the numerous failures in the aftermath of the 1875 financial crisis.

commercial links between Germany and Brazil (Riesser 1911, p. 440).[33] The Rio office of the Brasilianische was followed by offices in São Paulo (1888) and in the port city of Santos (1905).

German overseas banks differed from their British rivals on two main aspects: i. they were set up by the leading banks at home to act as their representatives in the host country markets; and ii. they went beyond the financing of foreign trade and, instead, engaged activelly in the business of issuing investments and, specially, government loans, which had become more frequent in the 1880s (Young 1991, pp. 88-9). Accordingly, in 1889 the Brasilianische took part as an intermediary in the issue of bonds of the Oeste de Minas Railway Co and, four year laters, it participated, at the invitation of the Rothschilds, in their first of a host of issues of Brazilian government loans (Young 1990, pp. 28-9).

The Brazilian banking system remained concentrated in the capital (Rio de Janeiro) all through the XIXth century. In 1889, the city's 23 banks accounted for 93% of the capital and reserves (and 90% of deposits) of the 35 banks that formed the system. Of the remaining 12 provincial institutions at the time, those four based in São Paulo were responsible for a further 5% of combined capital and reserves. Concentration by size was also a feature of the Brazilian banking system. Indeed, in 1889 the seven largest banks accounted for three quarters of total paid-in capital and reserves in the system (Goldsmith 1986, p. 42).

The republican period: 1889-1913

The Republican government that came to power in November 1889 gave further impetus to a banking reform introduced a year before, as the Empire drew to an end. Pressed by the continuing demand for monetary expansion in the wake of the abolition of slavery (1888) and the massive inflow of European immigrants, the new administration was forced to act quickly and new banking and corporate legislation was passed. In essence, it extended the rights to note issue to several private institutions,[34] and relaxed the requirements for the formation of limited-liability joint-stock companies. The result was a speculative bubble known as the *Encilhamento*, which saw the number of banks in Rio de Janeiro alone jump to 68. The volume of bank deposits in the country, in turn, increased 77% and 44% during 1890 and 1891, respectively, and came to account for three-quarters of the money supply, compared to about one-half two years before (Triner 2000, p. 44).

With a lag of about one year inflationary chaos and exchange-rate collapse came to testify to the speculative excesses of the *Encilhamento*. Widespread bank failure followed, with the volume of demand deposits dropping by more than 50% in real terms between their peak in the third quarter of 1891 and the third quarter of 1893.[35] The extent of the monetary crunch guaranteed that the Brazilian economy would remain stagnant for the rest of the 1890s. Successful stabilization would only be achieved at the turn of the century, following further (and severe) fiscal and monetary contraction implemented at the behest of foreign creditors

[33] The German Empire ranked fourth in the destinations of Brazil's exports in 1872. By 1901 it was second only to the United States. German exports to Brazil took a little longer to edge up to second place (1903). Trade data in IBGE (1987).

[34] Plurality of note issue was short-lived and in December 1890 the government granted the newly-created Banco da República dos Estados Unidos do Brasil a monopoly of note issue, later transferred to an offshoot of that bank.

[35] Calculated from monetary data in Peláez e Suzigan (1976, Table A.3), deflated by the wholesale price index in Catão (1992).

who, years earlier, had agreed to reschedule Brazil's mounting foreign debt. Deflation ushered a second wave of bank failures, which left Rio with only 10 commercial banks remaining in 1905 – a sharp drop from the 68 existing banks in 1891 (Triner 2000, p. 47).

Recovery from the trough proceeded in two stages. From 1902 to 1906, while government finances and Brazil's international standing improved dramatically, the coffee and banking sectors lagged behind. Then, in 1906, three inter-related events combined to reorient both domestic and international finance and usher in a new era in the development of Brazil's banking system: coffee price support schemes, the implementation of the gold standard, and the reorganization of the failed Banco da República into the (fourth) government-controlled Banco do Brasil (Triner 2000, p. 48). Together, a fixed rate of exchange, a stable (and then growing) international price for coffee and the monetary expansion which accompanied increasing surpluses in Brazil's balance of payments all contributed to the economic success of a tropical Belle Époque. In this atmosphere of economic growth amid price and exchange-rate stability, commercial banks felt confident to expand their activities and for the first time since the *Encilhamento* deposits of private-sector banks accounted for an increasing share of total money supply (Triner 2000, p. 50).

The improved macroeconomic and business environment served as an incentive for a second wave of foreign bank penetration of the Brazilian market. With the exception of the London and River Plate Bank (which, moving north from Argentina, opened its first Brazilian branch during the frantic days of the *Encilhamento*, in 1891), the other successful arrivals took place from 1906 onwards. These included Argentinian, French, Belgian and, specially, two new German banks, the Deutsche Sudamerikanische Bank and the most successful German bank in Latin America, the Banco Alemão Transatlântico (the local designation of the Deutsche Überseeiche Bank), both in 1911.[36]

This new phase of banking growth amid increasing foreign participation lasted until 1912,[37] when a reversal of Brazil's favorable balance of payments position, in both trade and capital accounts, caused problems in the local operation of the gold standard and, ultimately, the eventual abandonment of convertibility a year later (Fritsch 1988). In a marked change from earlier commitment to gradual monetary expansion the Treasury engaged (for the first time since 1891) in the issue of unbacked notes and consciously supported the development of the domestic banking system by means of substantial loans to local banks (Triner 2000, p. 52).

By 1913, total assets in Brazil's banking system has been estimated at 1,5 times (in real, inflation-adjusted, terms) the figure for 1889, although as a percentage of GDP it might have been smaller at the eve of World War I than at the start of the Republican regime (Goldsmith 1986, p. 96). The 12 foreign banks[38] operating in Brazil at the time held a substantial share of

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[36] Although they were clearly the main foreign threat to British bank supremacy in the region, German banks were definitely smaller than their rivals. In the Brazilian market, for example, both paid-in capital + reserves and deposits of the London and Brazilian bank were twice as large as those held by the largest German bank, the Brasilianische (Young 1991, p. 81).

[37] Overall, deposits grew more than three-fold between 1906 and 1913 and short-term credit multiplied by a factor of four (Triner 2000, Table A.2).

[38] By their order of entry in the Brazilian market: London and Brazilian Bank (1862), British Bank of South America (1863), Brasilianische Bank für Deutschland (1888), London and River Plate Bank (1891), Banco Español del Rio de la Plata (1907), Banque Française et Italienne pour l'Amérique du Sud (1910), Banque Brésilienne Italo-Belge (1911), Deutsche Sudamerikanische Bank (1911), Banco Alemão Transatlântico (1912), Banque Française pour le Brésil et l'Amérique du Sud (1912), Banco Nacional Ultramarino (1912) and Crédit

deposits[39] and cash and their combined loans exceeded the amount advanced in that year by the Banco do Brasil (Table 2).[40]

Table 2

The Brazilian Banking System in 1912

(share ot total, in %)

Operation / Type of Bank	Foreign Banks	Banco do Brasil	Local Private Banks
Deposits	35	50	15
Discounts	37	44	19
Cash	39	40	21
Loans	56	19	25
TOTAL	100	100	100

Source: Topik (1979), Table 2, p. 408.

At the time, the considerable share of the Brazilian market held by foreign banks was not in itself a contentious issue. Indeed – and apart from the fact that, contrary to the expectations of some, foreign banks did *not* introduce large amounts of capital in the region (and, instead, relied mostly on local sources of funds) – critics took issue mostly with the *direction* in which these funds were lent. In the end, contemporary (and a few later) critics openly attacked what was then seen as foreign banks' excessively conservative principles. These emphasized high cash reserves and the need for self-liquidating loans. In practice, Head Office insisted with local managers that discounts should be

> "(...) confined to paper with not more than three months to run , bearing two good names and a guarantee from a third party. The renewal of bills beyond their normal tenure was prohibited. Under no circumstances were advances to be made against growing crops, and if goods were pledged as security, no advance was to exceed two-thirds of their market value (...). Equally stringent regulations applied to the exchange business. Limits were set for the purchase of paper on particular houses (...). To safeguard both discounts and the purchase of exchange, the management were bidden to obtain bills of lading for goods shipped."[41]

It does not come as a surprise, then, that these practices aroused the opposition of powerful interests in the region, such as those of speculative businessmen and financiers, landowners (who had only their property to offer as security) and, at least during the early years of foreign bank penetration in Latin America, the government as well (Jones 1977, pp. 38-9).[42]

Foncier du Brésil et de l'Amérique du Sud (1913). This list, of course, does not exhaust the whole set of foreign banks that had operations in Brazil in the 1877-1913 period, but rather those which were in business as of 1913.

[39] Foreign banks' share of total deposits in Brazil reached a peak of approx. 50% at the start of the XXth century and hovered around 35% until the early 1920s. From them on it declined steadily, in parallel with the advance of local competitors. In the present (late XXth century) context of financial liberalization in Brazil, foreign banks hold no more than a fifth of total deposits, which suggests that the heyday of their relative importance in the country's financial system had indeed been in the initial decades of the century.

[40] Note that data in Table 2, from a different source than above, refers to 1912.

[41] Joslin (1963, pp. 67-8).

[42] A telling example of contemporary resentment of foreign banks' general business practices can be seen in the 1898 annual report by the Brazilian Minister of Finance, Bernardino de Campos, where he points to the fact that despite their holding 40% of deposits in Rio, foreign banks had not granted a single loan to agriculture and held a mere 550 *contos* in mortgages. Brazilian banks, on the other had, the minister noted, held 105,000 contos in short-term loans to the agricultural sector and had advanced 117,000 *contos* against mortgages (Topik 1979, p. 401).

Speculation in the exchange market was the other *bête noire* of contemporary (and present day)[43] critics of foreign banks. Indeed, exchange operations provided the bulk of British banks' revenues in Brazil. They conducted a large portion of their business by simply exchanging currencies (which involved no risk of credit exposure) and, in doing so, profited both from the fees they charged and from potential arbitrage (Triner 2002, p. 7).[44]

Whether either the criticisms or the sound managerial practices invoked for foreign banks proved to be valid or not depends to a great extent in checking for quantitative differences between the financial statements of foreign and native banks. Along with possible differences in *behavior*, calculation of some basic indicators should enable us to test for potential *impacts* of foreign bank entry into local banking markets in Brazil and Chile, and compare the results with the findings of the modern theoretical and empirical literature discussed earlier. The next session of the paper addresses these issues, after a brief discussion of the data and sources.

3. Do Foreign and Native Banks Behave Differently? The Historical Record

Based on balance sheet data the aim of this section is to look for differences in the financial behaviour between foreign and native banks. The kind of questions we try to answer here are as follows. Were foreign banks less capitalized than their native counterparts as it has been often argued? What was the attitude towards risk in terms of the proportion of liquid assets they held as compared to local banks? Which was the response of foreign banks during times of crisis as compared to domestic banks? Did foreign banks exert an influence in improving the basic financial indicators of the native banks? What about the effects of foreign entry in terms of competition and profits of the banking industry?

3.1 Chile

<u>The data</u>

Based on year-to-year balance sheet data for all existing banks (both native and foreign) we collected directly from primary sources, the analysis focuses primarily on the period 1896-1913, the period in which foreign banks largely penetrated into the local market.[45] We also include financial information of the native banks for the previous years (1860-1895) in order to check for the possible impact of foreign banks in affecting the general financial pattern of the local banking industry.

Balance sheet data was extracted directly from the official banking records published periodically in the Chilean official gazette, the *Diario Oficial*. While covering all the existing banks this information has several limitations. On the liabilities side, before 1909, balance sheets did not disaggregate for time deposits, short-term deposits and current account. Regarding loans, balance sheets did not provide detail on overdrafts, short and long term

[43] See, for example, Levy (1972, pp. 45-6).

[44] This state of affairs would not change substantially even after 1900, when the Brazilian government declared "speculative" foreign exchange transactions (i.e., those unrelated to specific commercial operations) illegal, as British banks found little difficulty in matching the purchase and sale of bills of exchange (Triner 2002).

[45] Setting 1895 as a starting point obeys two main reasons. i. while the first foreign bank in Chile was established in 1888, its first available balance sheet is from June 1895; and ii. as of 1896 we can count on balance sheets of the two German banks created in 1895 and 1896.

loans, thus only presenting the total amount (even after 1909). The latter has a direct implication when trying to measure liquidity and the attitude of banks towards risk.

Sometimes, especially in the case of the largest banks, a relevant component of their balance sheets was associated with "safekeeping assets". These were assets received only for safekeeping purposes. Indeed, the amount presented by banks in the asset side was exactly offset in the liability side in a similar account. Since they can neither be considered properly as banking earning assets nor available in case of necessity of the bank, we deliberately exclude these assets from both sides of the balance sheet.

In relation to profits, native banks presented their results to the public while foreign banks would seldom do it. Moreover - and because of their geographic diversification - foreign bank profits were presented at a consolidated level but not on a country-by-country basis. This shortcoming precludes any comparison between native and foreign banks as regards profitability.

A final point concerns the kind of statistical tests we can carry out. Because of the limited number of observations (spanning the 1895 to 1913 period, on a yearly basis), we are unable to conduct the standard statistical tests in order to check for significant differences between foreign and native banks.

Selected financial indicators

We start by defining financial ratios, which provide us with a general picture of banks' balance sheet structure. First we compute the ratio of loans to total assets and deposits to total assets. The latter allows us to figure to what extent banks relied on deposits as a source of funds. Moreover, we compute the growing rate of both loans and deposits for native and foreign banks. This information is particularly useful in assessing whether foreign banks could have had a stabilizing role during periods of financing distress (1898-99 and 1907-8).

Following Crystal *et al.* (2001), we next turn to define financial indicators in line with those used in the so-called CAMEL approach. Unfortunately, the limits of the information presented in the financial statements do not allow us to cover some important points. First, we are forced to exclude the asset quality dimension. Indeed, the balance sheets do not provide information about critical variables of this dimension, such as the amount of non-performing loans, provisions or loan recovery. Similarly, since we lack data on foreign bank earnings we are not able to establish rigorous comparisons, at least from a quantitative perspective. Although we have provided qualitative evidence in this respect, the same kind of limitation applies when trying to evaluate managerial dimensions.

Taking into account these provisons, the financial indicators we chose are limited to two main dimensions, namely, capital adequacy and liquidity.

Capital adequacy: for each bank, we measure the ratio of its total capital to total assets as well as the ratio of total capital to deposits.

Typically, bank capital was presented divided between many different accounts. The most important by far was paid in capital. All existing banks, both native and foreign, presented this account. Often, banks (specially the native ones) also presented other capital accounts such as reserve funds and dividend funds. In computing the total capital of a bank we include all these capital accounts.

Liquidity: we compute the ratio of liquid assets to total assets, liquid assets to deposits and, when available, both the ratio of liquid assets and cash to short term deposits. Liquid assets are defined as cash plus checks and deposits available in other banks. Cash is the sum of reserves in specie and notes.

Results

We start by looking at the general balance sheet structure of foreign and native banks as presented in Table 3.

Table 3

Balance Sheet Structure (as % of Total Assets)

	Liquid assets		***Loans***		***Total deposits***	
	Native	Foreign	Native	Foreign	Native	Foreign
1895	14%	25%	74%	74%	60%	31%
1896	12%	27%	71%	73%	55%	48%
1897	11%	21%	71%	79%	55%	49%
1898	17%	21%	64%	78%	54%	70%
1899	19%	17%	64%	79%	44%	72%
1900	19%	13%	73%	76%	63%	74%
1901	19%	13%	73%	76%	63%	74%
1902	14%	12%	78%	88%	67%	58%
1903	14%	10%	75%	90%	67%	61%
1904	15%	9%	74%	90%	65%	65%
1905	16%	14%	73%	85%	75%	75%
1906	12%	15%	72%	65%	66%	53%
1907	15%	14%	79%	86%	70%	62%
1908	13%	20%	62%	63%	67%	56%
1909	13%	17%	77%	73%	60%	54%
1910	9%	11%	86%	78%	51%	43%
1911	13%	10%	79%	73%	64%	51%
1912	14%	13%	73%	59%	58%	46%
1913	14%	10%	69%	64%	54%	48%
AVG	**14%**	**15%**	**73%**	**76%**	**61%**	**57%**

Source: own calculations based on balance sheet data.

For the 1895-1913 period, Table 3 indicates the absence of major differences between the balance sheet structure of native and foreign banks. On average, the share of liquid assets maintained was around 15% for both types of banks. In the early days, until 1900, foreign banks appeared to have held more liquid assets than their native counterparts but the latter is not true afterwards.

Loans were by far the most significant asset for both native and foreign banks, representing nearly ¾ of the total. Except for the period 1902-1905, when loans took up around 90% of the assets of foreign banks, no different pattern existed between foreign and domestic banks.

In a similar fashion, both groups of banks exhibited a relatively equal ratio of deposits to total assets. Nevertheless, from 1905 on, the ratio is nearly 20% lower in the case of foreign banks, thus suggesting that foreign banks relied less on deposits as a source of funds. The latter also implies that loans were a larger multiple of total deposits in the case of foreign banks (on average, 1.4 times compared to 1.2 times).

In Table 4 we present the financial indicators related to the capital adequacy of banks. On average there appears to be no noticeable differences between the share of total assets represented by the capital of both types of banks (29% for native and 27% for foreign). Nevertheless, it should be noted that after the 1907 financial crisis the figure for foreign banks is significantly lower, reaching values of 1/3 of the ratio exhibited by local banks. When looking at the second financial indicator (capital/deposits), foreign banks tend to exhibit less capital backing their deposits. Once again, the latter is even more evident after the crisis of 1907-8. While in 1913 the capital of native banks covered almost 2/3 of their deposits, the comparable figure for foreign banks was only 1/5.

Table 4

Capital Adequacy Indicators of Chilean Banks, 1895-1913

	Capital/Assets		***Capital/ Deposits***	
	Native	Foreign	Native	Foreign
1895	23%	67%		
1896	31%	52%	56%	108%
1897	33%	51%	59%	105%
1898	31%	27%	57%	39%
1899	27%	27%	62%	38%
1900	33%	24%	52%	32%
1901	33%	24%	52%	32%
1902	29%	26%	44%	46%
1903	29%	28%	43%	46%
1904	27%	30%	42%	46%
1905	23%	38%	30%	50%
1906	29%	27%	45%	52%
1907	27%	20%	39%	32%
1908	29%	15%	43%	27%
1909	34%	14%	57%	26%
1910	20%	11%	40%	26%
1911	30%	9%	46%	18%
1912	31%	9%	54%	20%
1913	31%	10%	57%	20%
AVG	**29%**	**27%**	**49%**	**42%**

Source: own calculations based on balance sheet data.

The final set of indicators we analyze is related to banking liquidity and, to some extent, to the risk profile each bank decided to take. Since counting on liquid assets is more relevant the higher the share of short-term liabilities a bank has, ideally one is interested in measuring the ratio of liquid assets to liquid short term liabilities. Unfortunately, as mentioned, because of the kind of information presented in the balance sheets, in Table 5 we are able to calculate this indicator only after 1908.

Table 5

Liquidity Indicators of Chilean Banks, 1896-1913

	Liquid assets / deposits		*Liquid assets / Short term deposits*		**Cash / short term deposits**	
	Native	Foreign	Native	Foreign	Native	Foreign
1896	17%	57%				
1897	17%	43%				
1898	27%	30%				
1899	42%	23%				
1900	29%	18%				
1901	29%	18%				
1902	22%	21%				
1903	21%	16%				
1904	23%	14%				
1905	22%	19%				
1906	19%	28%				
1907	22%	22%				
1908	19%	35%				
1909	23%	31%	40%	61%	28%	48%
1910	18%	26%	31%	48%	22%	31%
1911	21%	19%	35%	36%	22%	24%
1912	24%	29%	41%	47%	26%	27%
1913	26%	21%	43%	33%	25%	18%
AVG	**23%**	**26%**	**38%**	**45%**	**24%**	**29%**

Source: own calculations based on balance sheet data

When looking at the share of total deposits backed by liquid assets, once again there appear to be no important differences between native and foreign banks (23% and 26% respectively). The result is slightly different when computing liquid assets and cash held by banks in relation to their short-term liabilities. After 1908, foreign banks appear to have relatively larger amounts of liquid assets than native banks. Furthermore, if one excludes the largest native bank (the Banco de Chile) from the sample of domestic banks, and thus compares foreign banks with the "typical" Chilean banks,[46] the aforementioned figure is amplified. Indeed, from 1909 to 1913, a typical Chilean bank held liquid assets and cash equivalent to only 28% and 17%, respectively, of their short-term deposits. From 1896 to 1913, the share of total deposits covered by liquid assets for this specific group of native banks was 20% as compared with the ratio of 26% exhibited by foreign banks.

Credit expansion

A remaining question concerns the pattern of credit expansion for both groups of banks. Our data shows that the rate of expansion for loans and deposits was relatively similar in both groups of banks. Indeed, between 1900[47] and 1913, the average annual rate of growth of deposits and loans was, respectively, 12.5% and 11.5% in the case of native banks and 11%

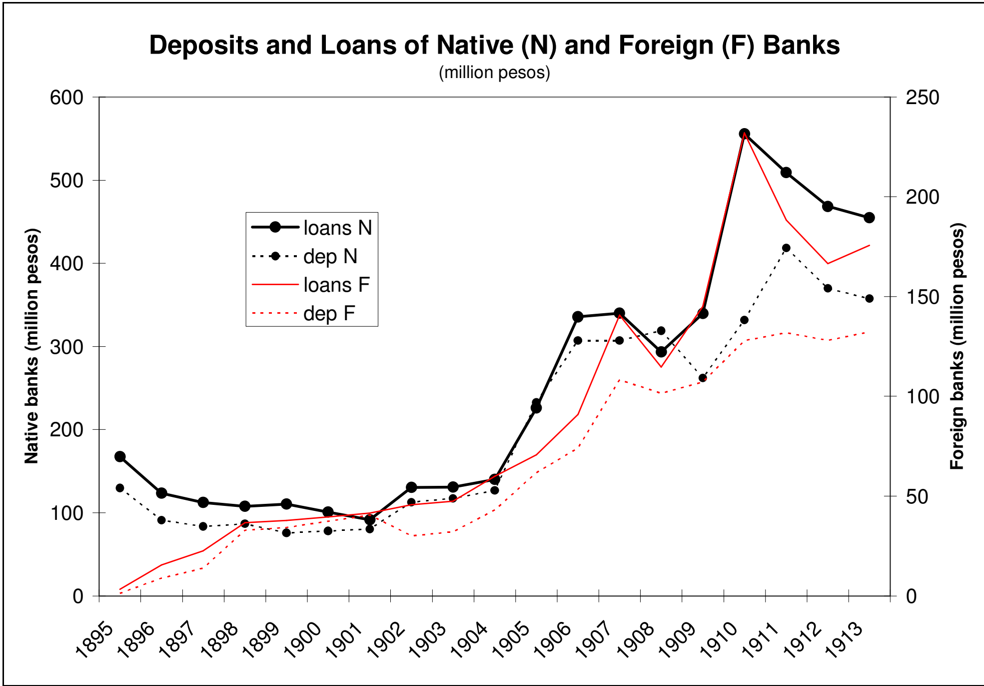
[46] The market share of these "remaining" native banks was relatively similar to that of foreign banks, ranging from 25% to 30%.

[47] We take 1900 instead of 1895-96 in order to avoid the scale problem related to the fact that deposits and loans were close to zero in 1895-96 (because the most important foreign banks did not exist before).

and 12.5% for foreign banks. In this respect, a pertinent issue is to check for credit growth in the years surrounding episodes of financial distress (1898-99 and 1907-08).

During the years preceding 1898, while credit from domestic banks was declining, foreign banks were expanding their activities. This is why foreign banks reached their maximum historical market share (as measured by deposits) during these years. In this sense, one can argue that foreign banks could have played a stabilizing role during this period of financial distress. Nevertheless, as shown in Figure 2 the pattern of credit (and deposit) expansion for native and foreign banks is strikingly similar afterwards. Both groups of banks expanded their credit at the same rate during the "boom" years ending in the crisis of 1907-08 and both groups of banks contracted during the crisis. When the crisis was over, both types of banks expanded and contracted again when new difficulties began to appear by 1911.

Figure 2



Source: Authors based on individual balance sheets

Foreign banks and changes in the financial indicators of the native banks

Despite the similarities we detect between foreign and native banks in relation to their financial indicators, perhaps a more interesting question is to test whether those indicators for native banks were modified by the arrival of foreign banks. Here we compare the value of the financial indicators of native banks for the 1896-1913 period (when they co-existed with foreign banks) with the ones referring to the 1880-1895 period[48] (when only native banks existed). Table 6 summarizes the main average values we obtained.

[48] Setting 1878 as a starting point obeys two reasons. First, the native banking system was already sufficiently developed at this time. Second, 1878 is a natural turning point since on this year inconvertibility was declared. Inconvertibility would prevail until 1895 and be resumed again in 1898.

Table 6

Chilean Banks: Selected Financial Indicators, 1880/1913

	Liquid assets/ assets	Loans/ assets	Dep./ assets	Capital/ assets	Capital/ dep.	Liq assets/ dep.[49]	Profits/ capital	Profits/d ep
Average (1880-1895)	**13,6%**	**76,3%**	**62,3%**	**20,1%**	**32,5%**	**18,9%**	**13,2%**	**4,6%**
Average (1896-1913)	**14,4%**	**72,8%**	**61,0%**	**29,3%**	**48,8%**	**23,4%**	**10,7%**	**4,9%**
Difference (%)	**6%**	**-5%**	**-2%**	**45%**	**50%**	**24%**	**-19%**	**8%**

Source: Authors based on individual balance sheets

Regarding the general structure of native banks' balance sheets, namely the share of liquid assets, loans and deposits to total assets, we detect no major differences between the two periods. In contrast, when we look at capitalization we detect that native banks seems to hold more capital after the entry of foreign banks. Both measured as a fraction of total assets and as percentage of the total deposits, the paid-in capital of native banks increased substantially during the 1896-1913 period. Figures 3 and 4 present the time series for these two indicators.

Figure 3

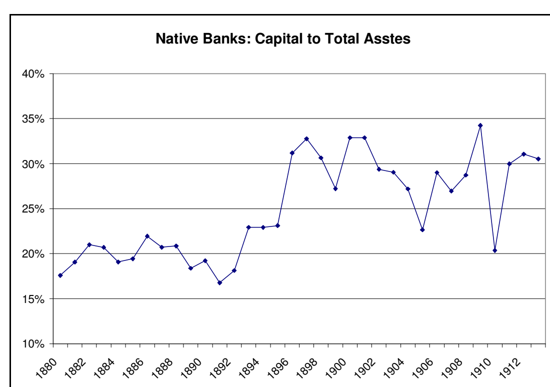
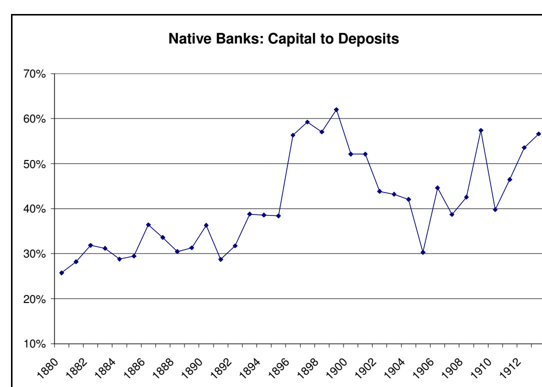


Figure 4



Source: Authors based on individual balance sheets

While the evidence is less clear in the case of liquid assets, when coexisting with foreign banks native banks seem to have held more liquid assets in proportion to their total deposits. Still, this result should be interpreted with care. First of all, during the whole 1880-1895 period, native banks issued notes. Since these notes were callable upon request, in our measure we included the amount of notes outstanding as being part of total deposits. Second, in 1898 and 1899, note-issuing banks were required by Law to hold larger amounts of specie in order to convert their notes, thus biasing upwards the average value for the 1896-1913 period (the ratio in 1899 was 42%).

Profits and competition

Finally, the data indicates that the profitability of the native banking sector declined after the entrance of foreign banks. While annual profits remained relatively stable as measured in

[49] Until 1898, we include the amount of notes outstanding of the issuing banks as part of total deposits. The reason is that, as for deposits, these notes are a callable liability.

relation to total deposits (4.6% vs 4.9%), they declined substantially when expressed as a share of banks capital (declining from 13.2% for the period 1880-1995 to 10.7% afterwards). The latter is a direct result of the increase in native bank capitalization noted previously. In Figures 5 and 6 we present the evolution of these two indicators.

Figure 5

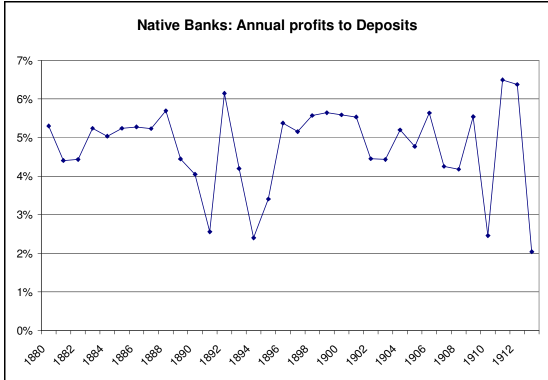
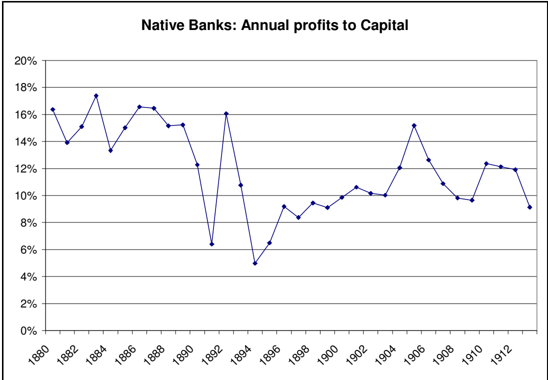


Figure 6

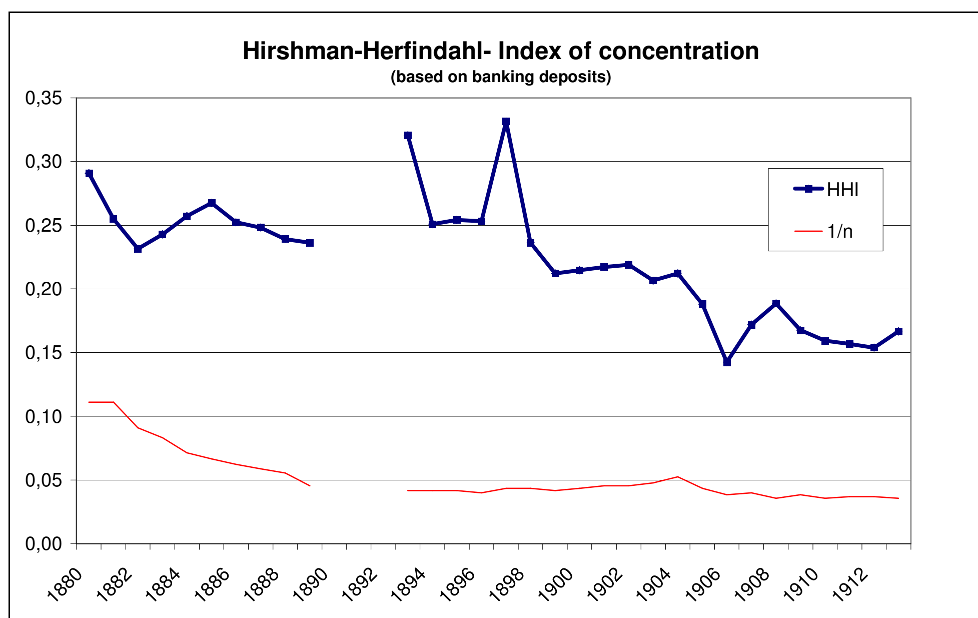


Source: Authors based on individual balance sheets

The reduction in the profitability of the native banks points in the direction of increasing competition after the entry of foreign banks. This point had already been made in connection with the declining market share of Chile's biggest bank (Banco de Chile) after 1900 (Figure 1). A more accurate indicator of such a measure of competition is provided by the Hirshman-Herfindah index of concentration (on deposits). Instead of taking only the major banks, this index has the advantage of including all existing banks in one single measure that calibrates for the relative weight of each bank.[50] As presented in Figure 7, this indicator exhibits an important decline after the penetration of foreign banks, thus suggesting that competition effectively increased.

[50] More precisely the index adds the square of the market shares of each single bank. The latter means the index gives heavier weight to bigger banks and vice-versa. In a highly competitive environment with many banks (N) having similar market shares, the index takes a value of 1/N (value which tend to zero). On the contrary, with a single firm (this is the extreme case for a fully concentrated industry) the index takes a value of one. Thus, the closer to unit the index is the more concentrated the industry is. A common current practice is to consider that values lesser than 0,1 represent a competitive market. Between 0,1 and 0,18 the industry is considered as having a moderate degree of concentration. Above 0,18 the market is viewed as concentrated

Figure 7



Source: Authors based on individual balance sheets

Interestingly, this pattern of decreasing concentration had more to do with movements within the native industry than with foreign banks increasing in number or expanding their market share.[51] What really happened after 1900 is that the Banco de Chile, which, historically, held a dominant position (nearly 50% of total deposits) and maintained close relations with the State, began to lose its market share and privileges. But, why now and not before? All happened as if foreign banks were effective in breaking this dominant position. First, after the banking run of 1898, foreign banks were in a very solid financial position while the Banco de Chile was not. Second, foreign banks began to negotiate loans and performing a series of international financial operations for the Chilean Government, something that historically had been the exclusive monopoly of the Banco de Chile.

3.2 Brazil

<u>*The data*</u>

The Commercial Code of 1850 (Law no. 556, of 25 June) disciplined the organization of limited-liability joint-stock companies in Brazil. In the early years after promulgation of the Code, the services sector was quickest to adapt its needs to the possibilities opened by the corporate form of business. Yet it was not until 1860 that the imperial government passed specific legislation (Decree no. 2679, of 3 November) determining public (in the press) disclosure of financial statements by joint-stock companies.

Balance sheet information for the imperial and early Republican period is far less complete than for later years, when joint-stock banks and publicly-listed companies in general would usually publish in the local press, and on a monthly basis, a summarized balance sheet

[51] As previously mentioned, the market share of foreign banks remained relatively stable since 1900. Besides, from three foreign banks operating in Chile in 1900, only two entrants started their operations afterwards: the London and River Plate Bank, in 1907, and the Deutsch-Südamerikanische Bank, in 1911.

showing all business done by them. Additionally, from early twentieth century onwards, semi-annual income statements might also accompany balance sheets for July and December.

The task of obtaining comprehensive balance sheet data for nineteenth-century Brazil is made additionally difficult by the growth, after the 1870s, of banking markets outside Rio de Janeiro, in places like Santos, São Paulo, Recife, Salvador, Porto Alegre, and Belém. In practice, this meant that the effort of collecting raw data for banks operating in those localities would require us having access to copies of newspapers published in each of those cities during a period of approximately 30 years. Despite our best efforts – and the quality of the collection of provincial newspapers deposited in the Biblioteca Nacional in Rio de Janeiro – this task was readily abandoned in favor of working with balance sheets extracted from the major newspapers of the day (the *Jornal do Commercio* and *Gazeta da Tarde*, both from Rio, but which sometimes would publish balance sheets from companies based in the provinces). We complemented this information with material obtained, for a few years, in the provincial press (*O Estado de São Paulo*, *Diário de Pernambuco*, *Gazeta da Bahia*) and, most importantly, secondary material provided by the Report of the Ministry of Finance (*Relatório do Ministério da Fazenda*).

In the end, instead of having a neat, continuous, data series (as in the case for Chile) for late nineteenth-century Brazil we ended up with a few points in time, namely, 1878, 1888, and 1897. Still, these years offer the opportunity to examine more closely aspects of the development of the Brazilian banking industry and the role of foreign banks therein. Indeed, 1878 came just a few years after a major financial crisis engulfed several banks in the Empire, among which the heavyweight Mauá Bank and a German bank. Those which survived the turmoil in 1875 – including the two British banks then present in Brazil – would presumably be among the strongest players in the market.

Ten years later, as the Brazilian Empire drew to a close, banking reform was perceived by part of the political elite as a means to win over support for the monarchy and thus stave off the growing republican threat (which it did not). Legislation passed in mid-1889 – and which was, in general terms, continued in 1890, by the provisional government of the Republic – greatly facilitated incorporation, resulting in a bigger, but less stable, banking system. Once the initial bubble of the *Encilhamento* was over, two waves of bank failures, in the early 1890s and 1900s, rid the market of several of the more fragile banks. For this reason, 1888 may be seen as a watershed separating a banking system that had been expanding slowly (but surly) in the Empire and the boom and bust years of the first republican decade.

Finally, 1897 lies conveniently before the first and second wave of bank failures, and immediately before signature of the Funding Loand agreement – and the attendant fiscal and monetary crunch – made itself felt. On the down side, the information for this year – obtained from the *Relatório do Ministério da Fazenda* – refers to Rio-based banks only and which, at the time, held approximately 2/3 of total deposits in the country.[52]

For the early XXth century period, we have been able to count on balance sheet data kindly made available by researchers of the banking and corporate history of Brazil.[53] Once again, for reasons related to the inconsistency of the disclosure procedures of the joint-stock companies, we have been forced to work with three points in time, instead of the much-

[52] For a few aggregates, this information will be complemented by data on *paulista* banks, from Saes (1986).

[53] Gail Triner and Anne Hanley, respectively.

preferable data series. The years for which we have consolidated data are 1901, 1906 and 1913. As mentioned above, banks operating in December 1901 found themselves in the final stages of a severe economic contraction. Full recovery from deflation would come in 1906, when a new, stronger banking system emerges, in the wake of Brazil's adherence to monetary and exchange-rate stability under the gold standard and the formation of a new, government-controlled, Banco do Brasil (Triner 2000, pp. 74 ff.). Finally, 1913 marks not only the conventional end of the "long" XIXth century but also of a period of early consolidation of a "modern" banking system in Brazil, a trend which would survive the ravages brought by World War I (Ibid.).

In sum, in the case of Brazil we have been able to collect consolidated bank balance sheet data for six different points bounded by 1878 and 1913, from a variety of sources, and with increasing reliability as we approach the end of the period. The raw data, in turn, has been used to calculate a set of indicators summarized in Table 7 and discussed below.

Financial indicators

We begin by looking at the evolution of the market shares held by foreign and domestic banks in the 1878/1913 period. The share of total deposits held by foreign banks in Brazil ranged from a low of 7,8% in 1878 to a peak of just under 50% in 1901. Six years later foreign banks held approximately one-third of total deposits, and this market share remained roughly constant until 1913. This pattern of relative growth followed by decline masks an *absolute* increase in the number of foreign banks in the country, from just two in 1878 and 1888 (the London and Brazilian Bank and the English Bank of Rio de Janeiro) to five in 1901 and 1906 (including the London & River Plate Bank and the Brasilianische Bank für Deutchland), and, finally, 12 by 1913. Throughout the 1878/1913 years market concentration – as measured by the Hirschman-Herfindahl index – evolved in two stages: it increased between 1878 and 1888 (from .171 to .358) and declined afterwards, to .20 in 1898 and .106 at the eve of World War I. The first move derived from the growth of the Banco do Brasil and its dominance of the commercial banking market; the subsequent decline, in turn, owes to the entry of new players – both domestic and private – into an expanding market.

Table 7

Financial Ratios for Brazilian Banks, 1878/1913

variable/year	1878			1888			1897			1901			1906			1913		
	D	F	T	D	F	T	D	F	T	D	F	T	D	F	T	D	F	T
Market Share																		
% deposits	85,9	14,1	100,0	92,2	7,8	100,0	66,2	33,8	100,0	50,1	49,9	100,0	65,9	34,1	100,0	63,6	36,4	100,0
% assets	86,2	13,8	100,0	92,8	7,2	100,0	72,3	27,7	100,0	54,1	45,9	100,0	66,2	33,8	100,0	57,0	42,7	100,0
Leverage																		
short-term credit/deposits	159,3	215,5	167,3	97,6	130,9	100,2	139,9	107,9	129,1	81,3	54,2	68,0	89,5	72,5	83,7	108,5	113,7	110,4
total loans/deposits	168,6	215,5	175,2	134,8	130,9	134,5	187,7	107,9	160,7	90,8	54,2	72,8	90,5	72,5	84,4	109,5	113,7	111,1
Liquidity																		
cash/deposits	35,4	69,1	40,2	8,6	27,5	10,1	26,3	58,7	37,3	58,0	59,7	58,8	47,2	53,6	49,4	27,8	36,6	31,0
cash/assets	7,6	15,3	8,7	1,9	6,7	2,3	7,4	21,8	11,4	29,8	36,1	32,7	22,2	25,5	23,4	16,2	16,0	16,3
Lending Activity																		
short-term credit/assets	34,2	47,6	36,1	22,0	32,0	22,7	39,1	40,1	39,4	41,8	32,8	37,8	42,2	34,5	39,6	63,3	50,9	58,0
discounts as % of short-term credit	59,1	40,9	55,8	49,3	14,7	45,6	37,5	81,1	49,7	46,2	67,8	43,8	45,5	51,5	47,1	42,5	50,3	39,0
total loans/assets	36,3	47,6	37,8	30,4	32,0	30,5	52,5	40,1	49,0	46,0	32,8	40,5	42,6	34,5	39,9	63,9	50,9	58,4
deposits/assets	21,5	22,1	21,6	22,5	24,5	22,7	28,0	37,2	30,5	51,5	60,0	55,6	47,1	47,7	47,3	58,0	44,8	52,6

Source: calculated from consolidated bank balance sheet data.

Leverage

The second group of indicators in Table 7 measures the degree to which banks were leveraged, in terms of both short and longer-term credit. Looking at short-term credit first, the results reveal ratios generally in excess of 100% in the XIXth century, for both domestic and foreign banks. As expected, come the deflationary period centered in 1901, leverage declines dramatically for both groups of banks, and particularly so among domestic banks. Recovery accompanies the new, improved, macroeconomic environment inaugurated in 1906, when ratios once again exceed 100%. It is noteworthy that unlike previous points in time, as of 1913 there is very little difference in ratios according to type of bank, domestic or foreign, in a process of "convergence" that would continue into the following decades (Triner 2000).

Liquidity

The reserve ratio, calculated as the proportion of cash (which does not earn interest) to total deposits, measures the liquidity of banks' portfolios. A drop in this ratio therefore is an indication that banks felt confident in lending a greater proportion of their resources (and thus earning interest on those loans), while retaining their ability to redeem deposits. The initial fall in the reserve ratio between 1878 and 1888 is consistent with the upbeat business climate leading up to the *Encilhamento*. Beyond that, the spike in 1898 – when the ratios more than double for both domestic and foreign banks – is a clear indicator of the retrenchment in lending operations (and, consequently, the decision to hold a greater proportion of banks' assets as cash) which lasted until the first half of the 1900s. From 1906 onwards, as the banking sector entered a phase of "normalcy", liquidity ratios declined further and stabilized around 25%-35%.

Alternatively, when calculated as the cash/assets ratio, results also confirm the general pattern just described, that is, an initial drop in liquidity for both domestic and foreign banks between 1878 and 1888. Afterwards – and as financial conditions worsened – both types of banks became far more conservative (liquid), until greater stability once again led to decreasing cash holdings in the early XXth century. Throughout, foreign banks maintained a higher cash cushion than their domestic rivals, in line with what the literature suggests. Still, here too one finds signs of convergence between foreign and domestic players, as we approach the end of our period and liquidity ratios tend to be similar.

Balance sheet structure

The last subset of indicators allows us to test for differences in lending activity between the two types of banks, depending on the overall business climate. The first pair of ratios ("short-term credit/assets" and "discounts as a percentage of short-term credit") reveals that local banks systematically allocated a significant portion of their resources to operations other than bill-discounting and short-term lending via overdraft facilities. The results also show that in 1878 and 1888 short-term credit accounted for a greater proportion of the assets held by foreign banks than was the case among their domestic rivals. This pattern was reversed subsequently and local banks began displaying a more prudent behavior, in the shape of an increasing share of short-term credit operations in their portfolios.

The lending data reveal a few other points worth noting. First, and in spite of their proclaimed conservatism, foreign banks would often hold a substantial (and greater than local banks') proportion of their short-term assets in the form of guaranteed, overdraft current

accounts, rather than as (lower risk) discounts of commercial paper. Second, at the start of the period foreign banks dedicated more of their balance sheet to lending activities, a trend that would be reversed after 1888. Finally, foreign banks appear to have relied to a greater extent on deposit-based funding than their domestic counterparts, although this pattern would also change as we approach the end of our period.

Credit expansion

A look at the pattern of deposit *growth* (Table 8) sheds additional light on the question of differences of behavior between both groups of bank. In the late imperial period (that is, between 1878 and 1888), real deposit growth at local banks averaged 11,1% p.a., while the performance of the two British banks then in place stood at less than half that pace, at 4,5% p.a. During the subsequent boom and bust period of the 1890s, however, deposits at Brazilian banks actually *fell* by more than 15% in inflation-adjusted terms.[54] The six foreign banks then operation, meanwhile, increased their combined deposits by just over 20% p.a. between 1888 and 1897. Four years later – and following a streak of bank failures which greatly reduced the size of the Brazilian banking system[55] – both local and foreign banks had experienced real net deposit *loss*, varying from 67% in the case of local banks to 36% among the five foreign players. This marked difference in deposit loss, in turn, helps explain the peak in market share held by foreign institutions in 1901, at almost 50%.

Table 8
Brazil: Real Deposit and Loan Growth, by Type of Bank (1877/1913)
(in % p.a. in relation to previous point in the series)

	DEPOSITS		LOANS		No. of foreign banks
Year/type of bank	**Domestic**	**Foreign**	**Domestic**	**Foreign**	
1877					2
1888	11,1	4,5	8,8	nil	2
1897	-1,1	20,0	0,4	16,0	6
1901	-24,1	-10,6	-34,5	-22,4	6
1906	15,4	1,2	15,3	7,3	7
1913	14,0	15,6	17,5	23,3	12

Source: calculated from consolidated bank balance sheet data.

By 1906, total deposits held in domestic banks had regained part of their former volume, having increased by more than 15% p.a. since 1901. In the same period, deposit growth at foreign banks was organic at best (1,2% p.a.). From 1906 onwards what we see is spectacular deposit growth among both domestic (at 14% p.a.) and foreign (15,6% p.a.) banks, reflecting what Triner (2000) considers the early years of an increasingly sounder banking system.

[54] Estimates of deposit growth that include the year 1897 refer to total deposits held by banks based in Rio and in the province of São Paulo. Together, this represented at least 90% of nationwide total deposits at the time. Data for São Paulo in Saes (1986).

[55] Combined deposits fell by more than 55% in real terms.

Impact of Foreign Bank Entry

We can use data on deposit and loan growth together with some of the financial indicators in Table 7 to speculate about the impact of foreign bank entry into the Brazilian market in the late XIXth and early XXth centuries. Far from relying on any sophisticated technique – which the paucity of the data immediately rules out – we take, instead, two turning points indicating years in which the number of foreign banks increased (in relation to the immediately preceding year for which we have data) as benchmarks against which we compare a few indicators. This admitedly crude criterion yields 1897 and 1913 as the relevant years to gauge the impact of foreign bank entry into the Brazilian market.

Taking the 1888/1897 period first, we observe an increase in overall leverage of the banking sector, which runs counter to what one would expect in the adverse macroeconomic context of the first republican decade. Yet it is interesting to note that leverage among foreign banks actually *decreased* in this period, indicating that these banks exercised a "restraining" role in the market. Liquidity, on the other hand, increased among both domestic and foreign banks, with the former lagging behind, but in a sense, converging towards the sounder, less risky, behavior of foreign banks. This trend is also seen in the general increase in the short-term credit/assets ratio, which, again, seems to have been led by foreign banks. Indeed, in the end loan growth in the turbulent 1888-1897 period was accounted for basically by foreign banks, whose outstanding loans grew almost fourfold in real terms, while the portfolio of domestic banks as of 1897 remained at virtually the same level as in 1888.

When the second wave of foreign bank entry took place – in the years immediately after 1906 – its impact appears to have been less pronounced. Indeed, despite the absolute increase in the number of foreign banks (from seven to 12), their market share (measured as a percentage of total deposits) remained fairly constant, at approximately one-third of the total. In the boom years leading up to WWI both foreign and domestic banks became more leveraged and less liquid, although it would be hard to credit either group with a leading role. Still, when one looks at the importance of short-term credit operations we note among domestic banks convergence towards foreign bank standards, the same being true in respect to lending activity (as captured by the total loans/assets indicator).

The analysis carried out so far appears to confirm at least one basic insight of the modern literature on the role played by foreign banks in emerging markets, namely, that these banks did help lead the market towards sounder, less risky positions. This seems to have been especially true during the boom and bust decade from 1888 to 1897, when leverage, liquidity and lending activity indicators displayed by domestic banks converged towards foreign bank practice. During the second period examined above (1906-13) this leading role played by foreign banks is less visible. Indeed, the ratios indicated in Table 7 do not allow us to claim with certitude which group led the way towards sounder, less risky, practices, although it is clear that by the early XXth century differences in behavior between foreign and domestic banks become increasingly imperceptible.

A final question also raised by the literature reviewed above refers to the possible stabilizing role performed by foreign banks during financial crises or periods of distress. Again, examination of this point must be based on indirect, anecdotal evidence, instead of any firmer test. As mentioned before, one of the fallouts from the severe banking crisis that swept the Empire in 1875 was a German bank. In this it was accompanied, among others, by the Mauá Bank, which, although domestic in theory, had branches in South America and Europe (Portugal and England), as well as an extensive regional network. Failure of both banks

suggests that foreign institutions (or internationalized banks) were no less prone to suffer from financial crises than domestic banks.

As noted earlier, in the early XXth century – and amid stringent fiscal and monetary policies – the Brazilian banking sector underwent a further shake-up that resulted in a renewed period of bank failures. While not a single foreign bank actually shut its doors at the time, none entered the market either, at least until 1906, when the Banco Aliança (from Portugal) started operations in Rio. In a similar vein, the less than spectacular deposit growth experienced by foreign banks between 1901 and 1906 (1.2% p.a.) suggests that there was no "flight for safety" in the aftermath of the string of bank failures in 1901 (see Table 8). On the contrary, the figures show that the public felt confident in making deposits with local rather than foreign banks. The former, likewise, displayed much healthier loan *growth* in the period, which, at just over 15% p.a. in real terms, was twice as fast as loan growth among their foreign rivals. Again, this pattern suggests that domestic banks were more responsive to the general business climate than foreign players, which appear to have pursued a "wait and see"-type policy before embarking on a more vigorous lending drive.

Needless to say, the preceding analysis does not *prove* direct causation linking foreign bank entry and either changes in domestic bank behavior or resistence to crises, but coincidence at best. Furthermore, even if we can suggest correlation between both phenomena (that is, foreign penetration and changes in local bank behavior), this should not rule out the incidence of "exogenous" factors with a direct bearing on the issue of bank behavior. This point is particularly revelant in the latter (1906-13) period. As explained earlier, 1906 marks an important watershed in Brazilian economic and banking history, characterized by the emergence of a sounder banking system following exchange-rate stabilization under the gold standard, the introduction of price-support schemes for the coffee sector and the creation of a new, revigorated, Banco do Brasil, with the role of a quasi-central bank. It is highly likely therefore, that if eventual convergence towards best banking practice did take place it was greatly facilitated by these crucial (and exogenous) institutional changes.

3.3 Summing Up the Case Studies

From a comparative perspective, we can summarize the main results obtained from our quantitative and financial analysis of Chile and Brazil as follows.

<u>Market Share</u>: measured by deposits, in Chile, the market share held by foreign banks reached 27% in 1913, a proportion that could be considered "average". Brazil, on the other hand, displayed varying degrees of foreign bank entry. The market share held by foreign banks ranged from a low of 8% to a high of 50% in the late XIXth century. However, as we advance in the XXth century – and in the aftermath of a second wave of foreign bank entry in the Brazilian market – this share settled at around 1/3 of total deposits.[56]

<u>Balance Sheet Structure</u>: no noticeable differences between foreign and native banks in Chile. Several differences observed in Brazil.

- <u>liquid assets/total assets</u>: this indicator differed little between domestic and foreign banks in Chile, having averaged 14-15% between 1895 and 1913. In the case of

[56] It is interesting to note that greater foreign bank participation in pre-WWI Brazil compared to Chile is the reverse of what is observed in the early 21st century. This difference may reflect each country's different attitudes towards globalization then and now.

Brazil,[57] they varied greatly in the XIXth century and the ratio for foreign banks tended to be higher; in 1913 they were virtually equal and similar to Chile's at 16%.

- loans/total assets: no discernible difference in Chile, with ratios standing at 75-76%. For Brazil, loans comprised a far higher proportion of domestic banks' assets in 1913 (63.9%, against 50.9% in the case of foreign banks). This difference may be accounted for by the presence, among the assets belonging to foreign banks, of very high amounts of bonds held as guarantees for their loans.
- deposits/total assets: foreign banks in Chile appear to have behaved similarly than their domestic counterparts (57% vs. 61%, respectively). For Brazil, the observed differences were less pronounced then in the case of the two indicators above. Still, at 20-30%, ratios in XIXth-century Brazil were very low. A possible explanation for this was a greater reliance on the part of Brazilian banks then on their own capital as a source of funds. As we come to the end of our period (1913) the deposits/assets ratio reaches 58% for domestic banks and 44,8% in the case of the foreign banks, a proportion which is closer to the one verified in Chile.

Liquidity: between 1896 and 1913 the proportion of liquid assets (cash plus interbank deposits) to deposits in Chile averaged 23% in the case of domestic banks and 26% for foreign banks. The same ratio for Brazil (taking account of cash only) tended to be higher - except for 1888, when it stood at just 10%. This tendency displayed by banks operating in Brazil to prefer higher cash holdings may be attributable to the highly unstable macroeconomic environment of the 1890s and early 1900s, which is reflected on the results for 1897 and 1901. Furthermore, foreign banks systematically maintained a higher cash/deposits ratio than local banks, in conformity with what the literature would predict.

Capital Adequacy:[58] On average, we find no noticeable difference in behavior between domestic and foreign banks in Chile. However, one interesting point is that the capitalization pattern of native banks changed after the entry of foreign banks. Indeed, native banks were far less capitalized during the period where no foreign banks existed. The latter suggests that foreign entry exerted a positive competitive pressure on native banks, forcing them to hold more capital and being at least as capitalized as the "new" British and German banks. A puzzling question is why in the aftermath of the 1907-8 financial crisis foreign bank capitalization declined, while not in the case of native banks. Reputation provides a possible explanation. In addition to their international status, foreign banks were neither touched by the 1898-99 crisis nor during the 1907-08 episode. In the end, being perceived as sounder banks in the eyes of the public made it less necessary to hold heavy cushions of capital.

Patterns of Deposit and Loan Growth and Contribution to Stability: in Chile, domestic and foreign banks appear to have behaved indistinctively and, as a general rule, they followed a pro-cyclical pattern. However, foreign banks expanded during the severe financial downturn

[57] For Brazil we used the cash/assets ratio.

[58] We have not worked with estimates of capitalization of Brazilian banks on account of major deficiencies in the original balance sheet data. These were distorted due to the inclusion, in the liabilities side of the balance sheet, of equity (capital) at the original (book) value authorized by banks' statutes. As a rule, these figures not only exceeded actual paid-in capital but also differed from the "true", market value, of bank stock. In the end, therefore, capital figures (as declared in the balance sheets) tended to overestimate their true worth, thus causing *under*estimation of ratios that include data on capital in the denominator. For a discussion of the problems surrounding capital figures disclosed by Brazilian banks in the period, see Triner (2000), esp. pp. 197-8.

of 1898, thus playing an important stabilizing role.[59] The picture is more mixed in the Brazilian case. For example, during a period of overall economic growth (1878/1888) foreign banks were characterized by higher deposit expansion, with domestic banks displayed comparatively higher *loan* growth. This may indicate that depositors felt confident in trusting their money to the new entrants, while the latter still felt reluctant to expand their lending activity, as if they were still getting acquainted with the local market. In contrast, in the turbulent period that followed (1888/1901) deposits held in foreign banks more then trebled in real terms, while domestic banks saw real deposit holdings drop by 70%. This result is consistent with a "flight for safety" towards sounder banks. Finally, in the decade leading up to WWI domestic banks led the way in both deposit and loan growth, in a possible sign of conservativeness among foreign banks, which may have taken a "wait and see" stance before convincing themselves of the strength of the ongoing economic boom.

Competition: In both countries we observe that foreign penetration is associated with decreasing concentration in the banking industry (in Brazil this picture is true from 1888). Because of the relatively late appearance of foreign banks in Chile (relative to Brazil), Chile offers an interesting laboratory to test whether the profitability of native banks declined. We find that indeed this was the case, with native banks being more capitalized as well as holding more liquid assets than during their early years. This result is in line with what has been pointed out by the current literature.

4. Concluding Remarks and Suggestions for Future Research

The history of foreign banks in Chile and Brazil in the late XIXth century and early XXth century is the history of British and German banks. Their penetration in both countries was significant, and not neutral in terms of its impact on the Chilean and Brazilian banking industry.

In the main, we found that in both countries foreign banks appear to have had a positive effect at least in some of the dimensions identified by the current literature. However, the extent of this influence is different depending on the country. First, even if a formal banking industry emerged roughly simultaneously in both countries, foreign bank entry in Chile was a more recent phenomenon than in Brazil. Second, while from a financial point of view native and foreign banks in Chile behaved in a relatively similar fashion, in Brazil we observe differences, although a tendency towards convergence was observable by the eve of WWI. In particular, the *specific* conclusions we derive from the case studies of both countries in terms of the impact of foreign banks are as follows.

Chile

Foreign penetration in Chile was very rapid. As early as the first decade of their existence (during the 1890's) overseas banks reached an important and relatively stable market share of nearly 30%. Foreign commerce appears to have been the major "pull" factor attracting banks exclusively from the two most important Chilean trading partners: Britain and Germany. Domestic currency instability and the continuous depreciation of the Peso resulting from the abandonment of the Gold Standard in 1898 did not act as a deterrent to this tendency.

[59] This can also be seen as a strategic move. Foreign banks gained a lot from acting this way. They expanded their market share and they increased their reputation by means of being perceived as solid banks in a moment where the native industry was severely hit.

From a qualitative point of view, indirect evidence points in the direction of sound managerial and monitoring practices favoring foreign banks. Even contemporary observers who were critics of those banks recognized the quality of their administration and the good example they provided for native bankers. This qualitative evidence is coherent with the fact that none of the foreign banks existing in Chile was touched by the three banking crises that shook the market between 1895 and 1913.

When comparing the financial behavior of foreign and native banks we found no noticeable general differences as regards their balance sheet structure, capitalization and liquidity indicators. This result is in line with the main findings in Dages *et al.* (2000) when looking at the recent experience of Argentina and Mexico. However, we do not find clear differences in their pattern of credit expansion as these authors do. While foreign banks have probably played a stabilizing role when expanding during the banking crisis of 1898, both native and foreign banks followed a similar procyclical expansion pattern afterwards.

However, we detected that foreign presence in Chile was associated with local banks holding more capital and more liquid assets as compared with the period where no foreign banks existed. We interpret this as the result of increasing "new" competition induced by foreign banks, forcing the native industry to appear sounder in the eyes of the public.

The latter is in line with an observed decline in local banks' profitability (as measured by the profits/capital ratio) and clear signs of falling concentration within the industry. Interestingly, because foreign bank penetration in Chile was very rapid, this pattern of declining concentration is more associated with movements *within* the native banking sector, rather than with an increasing number of overseas actors (or an increase in their market share). In this sense, the Chilean case suggests that foreign banks played an indirect, although essential, role in increasing competition by means of breaking the dominant position (50% of the market) previously held by Chile's largest bank (Banco de Chile).

Brazil

Foreign banks entered the Brazilian market in two waves, namely, in the early 1860s and after 1906. The first entrants were British and their decision to open up offices in Brazil seems to have derived as much by "pull" factors (i.e., the growth of Brazil's export economy) as by a relaxation of corporate legislation at home. The second wave, in turn, was much more "multinational" in essence, with British banks being joined by competitors from other European nations, chief among which the German banks. This time around, "pull" factors seem to have prevailed, in the shape of price and exchange-rate stability following Brazil's adherence to the Gold Standard and a banking reform, which ushered a period of expansion led by a revamped Banco do Brasil.

The fragmentary nature of the balance sheet data that we have been able to collect for Brazil should caution us against attempting to reach firm conclusions as to behavioral differences between local and foreign banks and the possible impacts of the latter's entry into the Brazilian banking industry. Yet, based on a few selected data points, we are still able to construct a set of stylized facts that should serve as a first approximation to the topic.

First of all it must be said that the impact of foreign bank entry into the Brazilian market in the 1860s is hard to evaluate, given their marginal share of the industry. Still, it is noteworthy that the two British banks then in operation survived the 1864 crisis, in a possible indication of the comparative strength of foreign banks vis-à-vis local competitors. (Anedoctal evidence

as this constitutes a mere hypothesis, at best, especially in light of the failure of a German bank in the aftermath of a major financial crisis in 1875).

Second, as we approach the end of the nineteenth century and, particularly, in the wake of the boom and bust period of the *Encilhamento,* in the early 1890s, we perceive more clearly differences in behavior between local and foreign banks. Indeed, bank behavior during the crucial 1888/97 period appears to confirm the view that foreign banks exercised a stabilizing role in the market, as leverage, liquidity and lending activity indicators displayed by domestic banks converged towards the less risky practice of their foreign rivals. Still, domestic banks were particularly hit by the sheer devastation provoked by two successive periods of banking failures (in the mid-1890s and early 1900s), leading their foreign counterparts to encroach on their business and attain what probably amounts to their highest ever share of the Brazilian market (accounting for roughly 50% of total deposits).

Third, the pre-WWI boom, with the attendant entry of new players (both foreign and domestic) into the market, seems to have inaugurated a new era in Brazilian banking history. This time, institutional changes, which led to the creation of the 4th Banco do Brasil, in 1906, appear to have been the driving force behind the creation of a sounder banking environment, more in tune with the needs of the expanding economy. This time – if anything -, foreign banks appear to have *followed* in the steps of local (if government-supported) institutions, thus inaugurating a long period dominated by Brazilian banks.

Comparison of the histories of foreign bank entry in the Chilean and Brazilian markets has shown a marked difference in the two experiences. Indeed, whereas in Chile financial indicators for both types of banks appear to have differed very little over time, they displayed great variation in the Brazilian case. While the latter result may be in part due to the lack of a long, homogenous, yearly set of balance sheet data for Brazil, it may also be the case that particularities to each country had (and have) an important bearing on the final outcome of foreign bank entry. For instance, the peculiar, country-specific, nature of the *Encilhamento* period in Brazil – which paved the way for the creation of several weak (if not outright bogus) corporations, among which were dozens of new banks – most certainly imparted a crucial behavioral difference between both types of banks in Brazil which was not replicated in Chile.

The same might be said of the important reforms that took place in Brazil in 1906: creation of the Conversion Office, marking Brazil's adherence to the gold standard; the founding of a new, government-supported, Banco do Brasil, with quasi-central bank powers; and the implementation of the first coffee-valorization scheme. These reforms, according to Triner (2000), marked the beginning of "modern" Brazilian banking history, a history in which local banks played a leading role. Again, these are country-specific phenomena, which help to highlight the importance of the relevant institutional background when conducting comparative history. In other words, as in many other areas, here too history seems to matter.

Does this mean that historical studies should be made on a case-by-case basis? Not necessarily. The comparative approach allows both similarities and differences to come to light, a feature that, in itself, commends this type of approach to the issues raised in the literature. And what does our exercise in comparative history tell us about possible lines for future research? First, a similar approach to be applied to Argentina and Mexico – the other two major Latin American economies in which foreign banks had penetrated extensively in this period – is highly recommended as a means to broaden our knowledge of the impacts of foreign bank entry in the region.

A second obvious task involves broadening our set of balance sheet data for Brazil. The main shortcoming involves statistics for the last quarter of the nineteenth century, although, ideally, one should attempt to collect information for the period leading up to 1905, in order to link up with G. Triner's estimates (covering the 1906-1930 period). Given the difficulty of obtaining balance sheet data for all major commercial centers, perhaps a second-best alternative would be to concentrate on the banking markets of Rio de Janeiro and São Paulo, which held the bulk of deposits and assets in the system.

A third line of enquiry should focus on careful analysis of material held in the archives of major domestic and foreign banks then in operation. In particular, it would be interesting to have access to material describing bank loan policy, attitude toward risk etc. (the *means*), in order to improve our understanding of the financial indicators calculated from the balance sheets (the *results*). We are aware of the difficulty of having access to many of the surviving archives, but are nonetheless convinced of the rewards that this type of initiative would bring to the bold researcher.

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Discussion

Forrest Capie

Bank of England

Briones and Villela have embarked on an ambitious and worthwhile project – to add to what has been discovered about recent financial integration by considering what happened in the late nineteenth century experience. With that in view they pose a number of questions derived from the recent work on the subject: did foreign bank entry increase competition; did foreign banks then behave differently, generally; more specifically towards risk; were foreign banks better capitalized; was there any convergence in behaviour between domestic and foreign banks? The answer to some of these looks straightforward but to others is an empirical matter.

I shall be brief, simply posing one or two questions, expressing some reservations, and offering some suggestions.

1.

First, some questions on the data. I have grown accustomed to seeing eyes glaze over when any discussion of data reliability takes place. But a serious knowledge of how the data are generated by whom, and for what purpose, and hence what their weaknesses and their possible uses are, are among the important contributions that historians can make. They usually preach extreme caution. The failure to find certain results in empirical work is most often explained in terms other than data deficiency and yet there is a good chance that that is where some of the problem lies. Researchers will reply that they must make do with the best available, but that does not rule out the possibility of the problem lying in the data.

Having been trying to construct a number of series on profits and capital for British banks in the twentieth century I know how difficult the job can be. Published balance sheets do not always give a true picture. If it is difficult to construct these series for twentieth century Britain in spite of the fact that there has been a long tradition there of careful collection and long-established legislative requirements together with fairly good habits of compliance then how much more so for Latin America. Even today financial institutions seldom have any agreed archival principles and some major losses of important documents are always taking place. A century ago when many of the institutions we are studying now were being born they had more important things to think about than data preservation. Data survival is a serious problem under normal circumstances. For Latin America there are other hazards as one early pioneer quickly discovered: 'the archives have suffered from the ravages of termites, cockroaches, and other insects which are particularly active in this climate' David Joslin was told. (Joslin preface p.x) The authors must be congratulated on bringing together the data that they have, but the paper tells us too little about the data. We need to know more about the quality and possible weaknesses. In the absence of survival of primary material I appreciate that would be difficult. But is there qualitative evidence on topics such as hidden reserves and the like?

2.

My second point concerns the use of foreign banks' domestic performance as a benchmark. For example, when British banks are used it is necessary to be clear which kinds of banks. There were many different species and they behaved differently for good reasons. The banks that operated in Latin America were obviously overseas banks. They were not branches of British domestic banks – either retail or investment. They were established specifically to carry out banking in Latin America. The authors say they were subsidiaries - but of what? (p.9) Some more information on their precise constitution would be helpful. Therefore when

British practices are considered, and data used, like must be compared with like. The banks in Latin America were, the authors say, essentially concerned with financing trade. P.5 (At another point they say they were similar to the domestic banks. (p.8) We need to be sure.) If they were essentially concerned with financing trade, that makes them roughly comparable with British merchant banks. What would Figure 2 look like if that comparison were made? Aside from that, did they have any connection with existing British banks of whatever kind? If not who were the people involved? It matters for consideration of questions such as prudent behaviour, liquidity ratios, behaviour in crises. If they were simply starting from scratch were they not therefore very like their local domestic counterparts? That raises another question. If a British bank wished to open in Brazil how should they begin? There was a lot of experience of this domestically in Britain. That experience would have suggested they use local knowledge and buy an existing Brazilian bank and then impose their own standards on it. Were there any attempts at this? If not how much trained labour did they bid away from local banks?

But to come back to the comparisons that are being made. Figures in the paper used for the purpose of comparison relate to British retail banks. This looks to be inappropriate. Retail banks have completely different balance sheets from merchant banks. They must have; they do quite different things. Even here I need to point out, the data used are not only out of date but misleading. The data used are usually from Sheppard (1971). Sheppard did a splendid pioneering job but his data were shown to be defective more than twenty years ago. (see Capie and Webber) So, for example, the British cash/deposit ratio used here is shown as rising gently across the period when in fact it was falling. (p.10) (Incidentally, this distortion was a consequence of a publishing requirement.) If there were a case to be made for using British retail banks as a benchmark might it not be better to use an earlier period, say 1850 to1870, on the grounds that they were then at an earlier learning stage and their various ratios would have been different (higher)?

3.

On an entirely different point what was the role – either positive or negative – for central banks? It has been argued that central banks were established in the late nineteenth century in order to block the progress of globalisation/integration. Harold James, for example, describes the Reichsbank as a clear example of this. Its founding was prompted by the 1873 crisis, that was in turn said to be in part a consequence of capital flows. His argument has much to do with the danger of capital flows obstructing the primary task of a stable means of exchange. If globalisation proceeded at a satisfactory pace in Brazil and Chile perhaps it was because they were fortunate in not having central banks or anything that resembled them, to put up such obstacles. But that aside does this in some way affect the German bank role – either positively or negatively? If German banks were handicapped at home does it help explain why they appeared abroad and possibly how they behaved?

More importantly, when looking at key ratios it is surely important to take account of the role of the central bank as lender of last resort. There was one in Britain and to some extent in Germany. I have reservations on the latter. The Reichsbank was competing for commercial business with the big banks and hence unable to act as lender of last resort. Well-behaved banks can be confident of survival when there is a trusted lender of last resort. In the absence of such a lender well-behaved banks can fail. We would surely expect to find different (lower) cash, liquidity, and capital ratios where there is a lender of last resort.

4.

All that said the results found are not particularly out of line with expectations. When foreign banks enter the market, concentration falls and competition rises. Almost by definition that is true; although great care needs to be taken when reading levels of competition from concentration ratios. Might it be possible to look at spreads as a better indicator of changing levels of competition? On the question of better management might it be possible to compute

some expenses ratios? That is one of the simplest ways of looking at the question of management and gets around many of the common difficulties. On capital adequacy is there enough discussion of the quality of the assets? What about hidden reserves – a common British practice? Did foreign banks have readier access to more sophisticated capital markets and therefore operate with lower capital ratios? On liquidity ratios it can be argued either way.

Some smaller points would include: there is no mention of the real/nominal distinction for a period when there was a great deal of inflation in both these countries. To some extent ratios cope with this need, but not always. Sometimes figures are given without specifying real or nominal; should there be some discussion of financial development in Raymond Goldsmith's terms – financial intermediation ratios and the like?

But none of that should detract from the excellent pioneering work carried out by these scholars. They should be encouraged to continue.

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The World Bank[1] and CEPR

Ignacio and André open an interesting window on an earlier phase of foreign bank entry with a view to lengthening the available sample. They have collected a rich database, have lots of facts and findings, and I have learnt quite a lot from the paper. Actually the new period is also still rather short (apart from the two British banks that started in Brazil in 1860s, we're really looking at little more than two decades for the most part). And the number of banks is small, just four British banks and three German ones. Still, it's an interesting story not least when one recognizes that this handful of foreign banks grew to take one-third of Chile's deposit market by 1900 and almost a half of Brazil's market in the early 1900s before losing some of this share by 1913.

Nowadays, many countries are relying increasingly on foreign banks, with numerous examples in Central and Eastern Europe – where Austrian banks have been particularly active. Indeed, at the opening address to this conference, the President of the Austrian National Bank mentioned the importance of foreign revenues to the Austrian banking system.

What kinds of policy question would we like answers to from this kind of data. I stopped to write down a list before comparing it with what the authors have done. Here's my list:

Countercyclicality

(a) Do foreign banks act as a safe haven for deposit in times of host crisis (thereby moderating outflow of funds and preventing host banking weakness from destabilizing the macroeconomy)?

(b) Do foreign banks draw on external resources to augment local resources in a host downturn?

(c) Do foreign banks retrench in response to home country problems?

[1] The author's views do not necessarily represent those of the World Bank.

Efficiency, competition & access

(a) Does foreign bank entry improve (i) efficiency; (ii) competitive pricing?

(b) Do foreign banks lend to SMEs and throughout the country and at term; does their presence improve or disimprove availability?

Prudence and stability

Does foreign bank entry increase or reduce risk-taking by local banks ("gambling for survival" or "demonstration effect")

There is a clear but not perfect overlap between these topics and those discussed in the paper. Ignacio and André are also interested in these questions, though they group the elements a bit differently. This affects the conclusions they draw as does the precise way in which they handle the data[2] – leading them to a more positive assessment of the impact of foreign banks than the evidence they provide can really support.

Countercyclicality

The authors treat the first two questions here together. They are inclined to say "yes" to this composite question of stabilizing effect, at least during some of the major downturns, e.g. (quotes from page 19, first full para): "The latter implies that foreign banks played a stabilizing role during this period of financial distress (Chile before 1898)" and (bottom of page)"During this period foreign bank behavior was countercycylical (Brazil, 1895-1901)"

But I see the evidence somewhat differently, and conclude that there is insufficient indication of a strong "yes" to these questions, especially when we break them into the two components, and use *levels* rather than annual *rates of change* of the relevant variables. (Figures 1,2) This perspective shows that, although foreign banks did not exacerbate the cycles, their insulating effect was not large.

Thus, for (a), the safe-haven effect, we can see from Figure 1 that in Chile the deposit fall-off of 1909 is not much absorbed by switching to the foreign banks. In Brazil (Figure 2) there is a

degree of stability in the trend of foreign deposits in the face of the local banks' meltdown, but little of the deposit losses in the local banks were picked up by the foreign banks.

For (b), the indications are again not really favorable for any use by the foreign banks of external resources. Plotting foreign bank loan to deposit rates against the trend in local bank real deposits we find no correlation for either Chile or Brazil (Figures 4, 5) even in the years cited. Note also in the big Chile downturn of 1907-8, there was little help from the foreign banks.

Question (c), on whether foreign banks retrench in response to home country problems, is not really discussed in the paper. This would seem possible to do even within the sample period; the experience just after the end of the sample, i.e. during World War I, could obviously throw additional light on this question and I would encourage the authors to do so in future work.

Efficiency, competition & access

The data does not allow much to be said on efficiency. On competition, the authors argue (bottom of page 20) that foreign banks were effective in breaking the dominant position of the Banco de Chile in Chile. It is not clear to me that the plotted data shows this. In particular I regressed the market share of the Banco de Chile on that of the foreign banks and found that we cannot reject the hypothesis that the Banco de Chile's market share was totally unaffected by changes in foreign banks' market share (and that the market share of the 'other' local banks absorbed all of the growth in foreign share). Figure 5 shows that the Banco de Chile's declining market share really took hold only after the foreign banks' share had already peaked in 1900/1.

The profit data from Chile does tend to support the idea that profit margins were squeezed in the first few years of the foreign bank entry as the foreign bank share of the market rose sharply. But then the local banks seem to have recovered both share and profitability, so the effect is not clearly an enduring one.

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[2] Incidentally, I would encourage the authors to make more use of the panel nature of the data; there are just a couple of regressions in the appendix exploiting this richness.

Except in relation to term finance,[3] we are not told much about the sectoral, geographical or maturity structure of the foreign banks' activities – though scattered literary indications in the literature indicate that they were mainly focused on the export commodities.[4]

Prudence and stability

For this dimension the authors have a mixed response.[5] The authors say that prudence was increased in terms of a sustained jump in capital to assets ratio but only for Chile after 1896. They also note that prudence was increased for a while in terms of an increase in cash to deposits ratio but only for Brazil 1902-10. Given the chaotic monetary and banking conditions that prevailed from time to time in both countries during the period under review, it seems safe to say that, even if the foreign banks did bring in some new discipline, their entry wasn't fully effective in stabilizing things.

* * *

The authors conclude that that foreign banks have a positive effect on the banking industry of host countries. While I believe this to be generally true, I feel that the evidence provided here is not very supportive of a strong positive effect. Nevertheless – and this is important – there is clearly little or no indication of negative effects.

The stylized fact that indicators for foreign and local banks tended to converge is quite an interesting one. Was this all North-South technology transfer, or did the foreigners 'go native' as they would have said in those days?

One thing that the historical record can throw light on is the ultimate life-history of these entrants. Tschoegl (2005) has argued that, while some foreign banks will enter a market with

[3] Foreign banks did not lend at term in Brazil, whereas the local banks made some long-term loans before 1908 (Fig 5)

[4] Anglo-South American Bank: 1906. "Its main interest lay in Chile, in the nitrate industry, and later in the coffee and cocoa business." Cited in the archive entry for this bank at University College London (http://www.aim25.ac.uk/cgi-bin/search2?coll_id=1606&inst_id=13).

[5] They also look at a different and somewhat less interesting question: whether the foreign banks operated a safer banking business than the local banks (Did they hold more capital, more liquid assets? Did they have a different deposit to loan ratio?). Whether these indicators are good measures of the question is for me doubtful in this context. For example, as they remind us, at home German banks had a higher capital ratios than British (even though we know that the British banks were quite risk-averse at home), so the question they are asking could translate into: "were the foreign banks more German than British in their behavior". Indeed, there is very little in the paper about the differential behaviour of the British and German banks: did *they* behave the same as each other in the host environment, or more in line with their home market practices?

an open-ended horizon, and that foreign banks may, exploiting particular conditions, grow to account for a high share of the market, ultimately financial systems will show a tendency to return to predominantly domestic control through a process of market maturing which for which he employs the metaphor of ecological succession. What of these particular first-movers? Was their early flowering choked out by luxuriant local growth? It would be interesting to pursue the story further in time. The share of foreign banks in total system assets in Brazil was still 25 per cent in 1930 but fell to less 3 percent by 1960: this process of decay or prohibition is as interesting to explore as the expansion phase.

For example, by 1923 the four British banks had merged into two, one of which failed in the recession of the 1930s, the other (Lloyds) surviving with a significant market share for many decades, though it disposed of its operations in 2003.

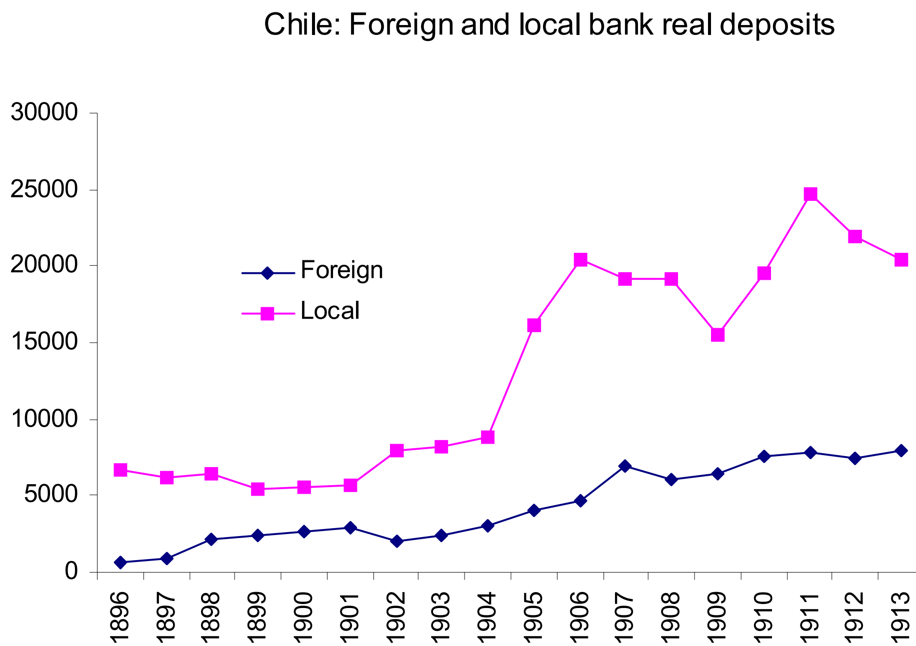
The three German banks in the study were established by ancestors of the surviving big-3 German "D" banks, Deutsche, Dresdner and Diskonto (which eventually lost its name following a merger with Commerz). I am not sure how well their South American operations survived the vicissitudes of the Twentieth Century, but I notice that Dresdner, the last major player in the region, has been downsizing drastically and has sold its Chilean and much of its Brazilian banking interests in the last year or so.

The foreigners did stay for decades, despite many pressures at home and in the host environment, but at the end of the day these particular foreign banks did not really stay the course.

Reference:

Tschoegl, Adrian (2005). "Financial Crises and the Presence of Foreign Banks." in Patrick Honohan and Luc Laeven, eds. *Systemic Financial Crises: Containment and Resolution* (Cambridge University Press).

Figure 1: *Foreign banks not large enough to absorb dips in the real value of local bank deposits (a): Chile*



(b) Brazil

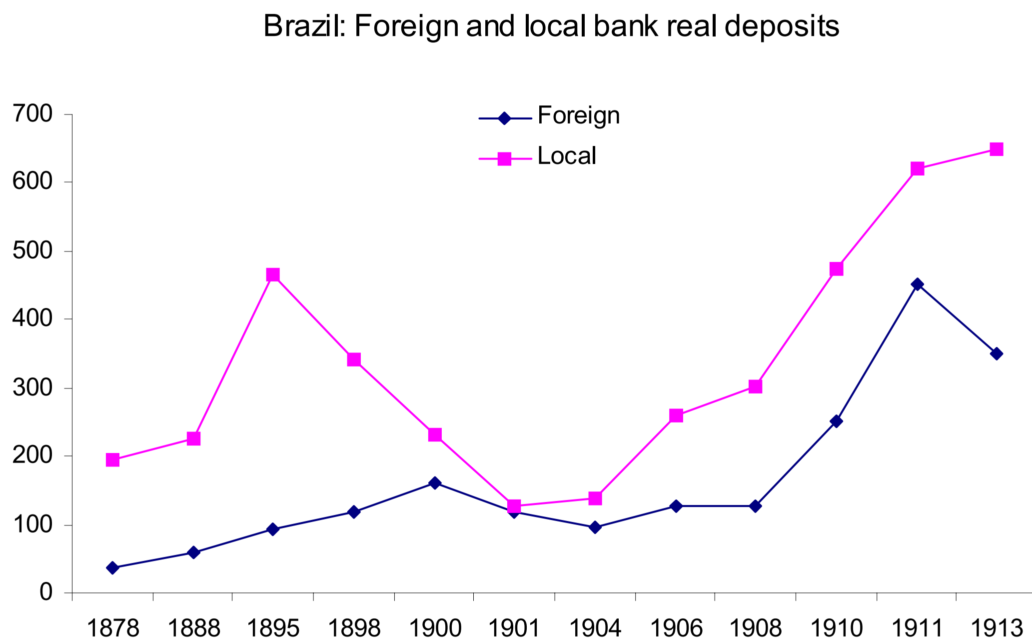
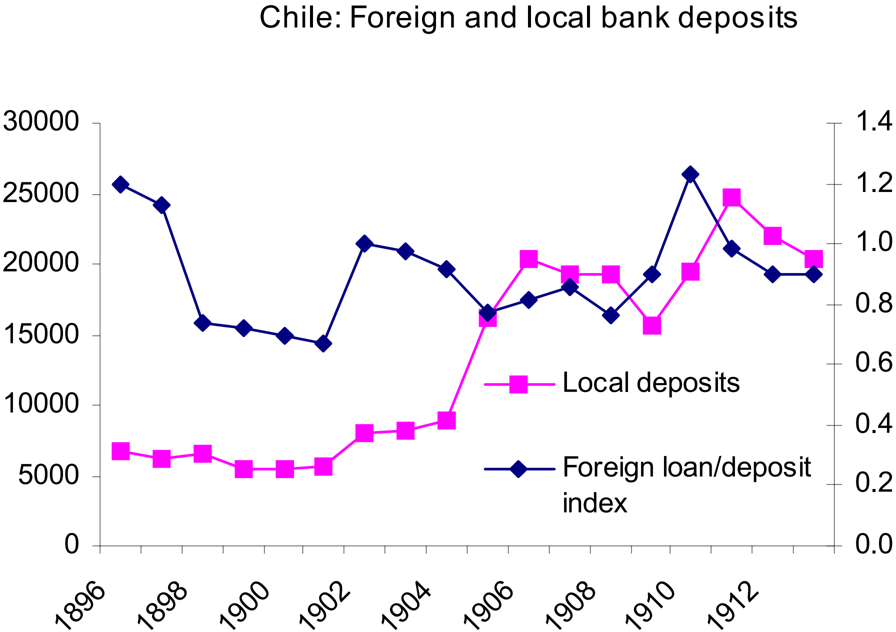


Figure 2: *Foreign banks' loan to deposit ratio does not rise when local banks' deposits fall*

(a) Chile



(b) Brazil

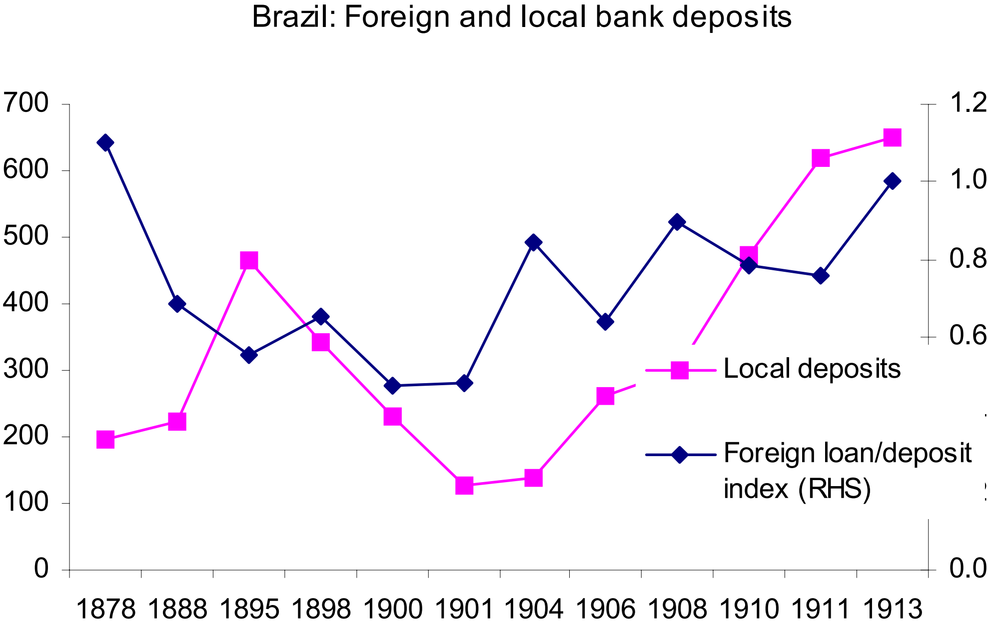
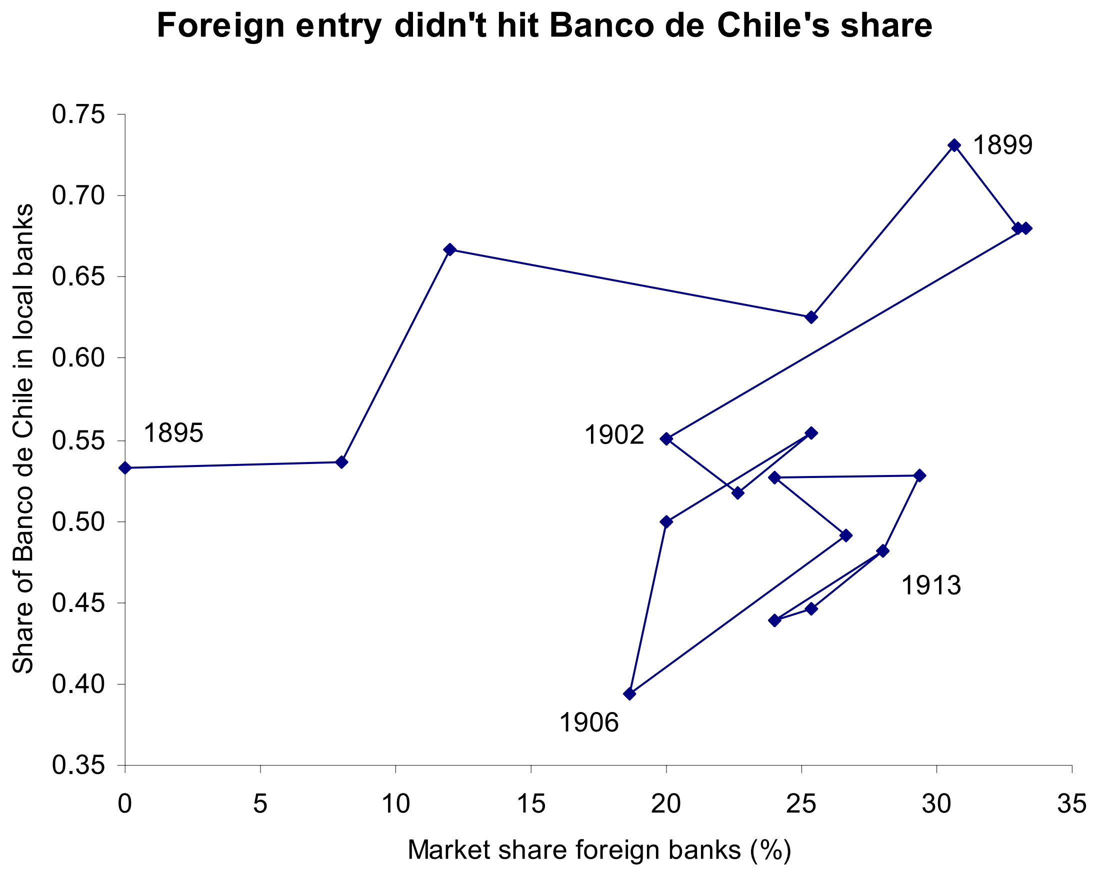


Figure 3: *Banco de Chile's market share grows when the foreign banks enter and gain initial market share 1895-1899; foreign banks' share declines or stagnates as Banco de Chile's share falls after 1901*



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