HISTORICAL PERSPECTIVES ON FINANCIAL CRISIS, BANKS, 
AND REGULATION

Crisis and The Development of Economic Institutions: 
Some Microeconomic Evidence†

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How do economic institutions develop? Much of the recent literature has emphasized the long arc of history. The nature of early legal systems (e.g., La Porta et al. 1998); constitutions (North and Weingast 1989); colonial origins (e.g., Acemoglu, Johnson, and Robinson 2001); or technologies of production (Marx 1848 and Engerman and Sokoloff 2003) can all influence the development of economic institutions and subsequent growth. Of course, these views do not suggest that history is destiny. After all, these theories are predicated on strong initial social upheavals that establish colonies, constitutions, or legal systems, or initial radical innovations that change the technology of production significantly. So these theories suggest some degree of persistence, but subsequent upheavals could change the underlying factors that determine economic institutions.

In this paper, we provide suggestive evidence that large economic upheavals, such as financial crises, can affect economic institutions, and influence the subsequent political economy of economic development. Specifically, we study the banking structure in different towns in the United States, after the Great Depression led to a massive cull of the banks. We show that across nearly 2,000 towns in the United States, those towns that suffered greater national bank failures during the 1930s tended to have significantly fewer banks well up until the 1994 Riegle-Neal Act permitted greater banking competition. This stylized fact is consistent with a crisis-driven increase in concentration of the banking sector, which allowed incumbents to shape the subsequent development of the local banking sector.

A number of other factors could explain this persistence, including lower demand for finance in the towns most affected by the Depression. However, we find that for towns located in states that deregulated their banking system in the 1970s and 1980s, the correlation between the Depression-era failures and the subsequent number of banks weakens considerably in the years immediately after the state began permitting intra-state branching. That is, regulations limiting branching and the spread of banking, strengthened in the wake of the Great Depression, might have been a key source of power and rents for those incumbents that survived the failures of the 1930s. And, local incumbents might have successfully blocked entry in these towns for many decades until the state-led and then federal dismantling of these regulations. In Section I, we briefly describe the context of our study. Section II discusses some stylized facts.

I. The Context

There is substantial evidence that political economy forces might determine financial development in the United States. As an example, in Rajan and Ramcharan (2011), we explore how the structure of banking across counties in the United States in the early part of the twentieth
century was driven by the distribution of land within the county. We find that in counties in which agricultural land holdings were more concentrated, there were significantly fewer banks per capita, even correcting for state level effects. Of course, land concentration can be endogenous. Noting that patterns of rainfall affect the optimal crops and the optimal economic size of land holdings, with more rainfall favoring more plantation-style crops and therefore concentrated land holding, we instrument land concentration with rainfall. The results continue to hold. Moreover, credit appears to have been costlier, and access to it more limited, in concentrated counties. We also find that proxies for loan losses were lower in counties that had more concentrated land holdings, suggesting that the greater riskiness of the underlying pool of borrowers cannot explain our results.

Of course, this evidence does not point directly to a political channel of influence. In Rajan and Ramcharan (forthcoming), we examine congressional voting on the McFadden Act of 1927 for this. The McFadden Act attempted to level the playing field between state and national banks by forcing states to accord largely the same branching rights to national banks as to state banks (Preston 1927). It was widely expected that if the McFadden Act allowed national banks liberal branching powers, then subsequent to the passage of the act, national banks would unite with large state banks to push for branching in all states. Thus, landed elites in nonbranching states could be expected to be even more opposed to the McFadden Act than were landed elites in branching states, especially because the latter’s rents would already have been diminished by state bank branching.

Examining the initial congressional roll call data, controlling for state fixed effects (which allow us to absorb state differences in regulations, among other factors), we find that congressmen from districts with more concentrated land holdings were far more likely to oppose the McFadden Act. The results are stronger still when we instrument land concentration with rainfall in the area. This evidence is consistent with the Marxian or Engerman and Sokoloff (2003) view that technology (of farm production) determines constituencies (landed elite) who then influence the setting up of economic institutions (banks). Let us now turn to whether upheavals, such as the Great Depression, can affect the nature of constituencies, and thus their influence over economic institutions.

II. Some Stylized Facts

In this section we study the relationship between the log number of banks, both state and national, headquartered in a town and the log number of national bank failures between 1930–1936. We observe the log number of banks in a town for various years, beginning in 1966, the first year for which the summary of deposits data are available. For each year that we observe the log number of banks in a town, we regress this variable on the log number of national bank failures between 1930–1936. Because the number of failures inside a town during the Depression might be related to the nature of the local banking market before the Depression, we control for the log number of banks headquartered in the town in 1929, along with the log of total deposits and the log of total assets; apart from the failures variable, we do not distinguish between state and national banks. All regressions also include state fixed effects.

Figure 1 reports the regression coefficient and the 95 percent confidence band—dashed lines—for the log number of national bank failures estimated for each of the cross-section regressions between 1966 and 2005. In the 1966 cross-section, the correlation between the number of banks and national bank failures in the 1930s is economically and statistically significant. It suggests that a 10 percent increase in the number of national bank failures during the Depression is associated with 1.2 percent fewer banks some 30 years later. Alternatively, a town that had a one standard deviation increase in failures from the mean (1.85 compared to 1) had about 10 percent fewer banks in 1966. However, this correlation declines steadily thereafter, becoming insignificant by the late 1990s and is about two-thirds smaller compared with the coefficient obtained using the 1966 cross-section. A qualitatively similar pattern emerges if we use the log assets of those national banks that eventually failed, observed in 1929, as a measure of banking sector distress during the Depression (available from authors).

Persistently weak economic conditions in areas with a large number of bank failures could explain the evidence in Figure 1. We thus turn to the timing of bank branching deregulation across states to help gauge the importance of the
political economy hypothesis in explaining persistence. Before the Depression, only 12 states allowed some form of intra-state bank branching. In the remaining states that prohibited bank branching, banks could not easily enter local markets. Some states, for example, forbade multibank holding companies, making it difficult for banks to operate in different locations, even if these separate offices were not integrated, and operated independently with respect to deposits and regulatory requirements. Others allowed branching, but only through mergers or acquisitions that converted the acquired bank into a subsidiary. Beginning in the 1970s, however, the remaining 38 states began to deregulate, permitting intra-state branch banking.

We would expect that if incumbents used their influence to limit bank entry after the Depression, then their influence on the number of banks inside a town should wane after a state deregulates. That is, the power of the number of national bank failures during the Depression to explain the subsequent number of banks should decline sharply after banking deregulation. In contrast, if the relationship between bank failures and the subsequent number of banks is driven mostly by local economic conditions, then it should not be affected by the timing of deregulation.

To test this hypothesis, we combine our town-level data into a single panel (1966–2006) and interact the bank failures variable with an indicator that equals 1 for the years in which the state permits bank branching and zero otherwise. The panel also includes state and year fixed effects. The results are striking. The log number of failed banks is negative and significant, and suggests that a 10 percent increase in the number of failed banks is associated with a 1.6 percent decline in the number of banks in those years before deregulation. However, the interaction term between the failed banks variable and the deregulation indicator is positive, large, and statistically significant. This interaction term implies that in the years after deregulation, bank entry might have been higher in those areas most affected by the Depression. That is, state-wide branching deregulation may have attenuated the power of local incumbents to preserve the status quo, permitting increased entry especially in those towns with greater Depression era failures.

Table 1—Deregulation and Persistence

<table>
<thead>
<tr>
<th>Variables</th>
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<tr>
<td>log number of failed national banks, 1930–1936</td>
<td>−0.164***</td>
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<tr>
<td>log number of failed national banks, 1930–1936 × period after branching deregulation</td>
<td>0.208***</td>
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Observations 74,546

Notes: The dependent variable in this table is the log number of banks, observed in an annual panel from 1966–2005. The other controls include the log total deposits, and assets in the town, observed in 1929, as well as the log number of banks, again observed in 1929. The indicator variable “period after branching deregulation” equals one in the years that the state permits bank branching and zero otherwise. The panel also includes state and year fixed effects, and standard errors (in parentheses) are clustered at the state level.

*** Significant at the 1 percent level.
** Significant at the 5 percent level.
* Significant at the 10 percent level.
REFERENCES


