# The finance-trade-growth nexus and lessons from the past

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*How interconnected are finance, trade, and economic growth? This column looks to the past in search of an answer. Examining economies that traded across the Atlantic, it finds that finance and trade reinforced one another between 1880 and 1914 but these links were absent in the post-war period. Financial development has been strongly related to growth throughout the last 130 years, whereas trade had a direct effect on growth only after 1945.*

Developing and operating a financial system that fosters and sustains growth is one of today’s most pressing policy questions. The correlation between financial development and growth is well established (Levine 2005), and the roles of trade and export orientation in growth are likewise well accepted (e.g., Dollar 1992; Ben-David,1993; Edwards 1998). The finance and trade interaction, however, has been given scant attention as far as its impact on economic outcomes is concerned (e.g. Baltagi et al. 2009).

But there is nothing new about the finance-trade-growth nexus. Indeed, maybe we should look to the past to see into the future.

# New evidence from the first wave of globalisation: 1880-1914

Our recent NBER working paper on the topic finds that finance and trade reinforced each other in a group of now-developed “Atlantic” economies between 1880 and the eve of the First World War, but that these links vanished after the Second World War (Bordo and Rousseau 2011).[1](http://www.voxeu.org/index.php?q=node/6572#fn1) Financial development is strongly related to growth in these countries from 1880 to the present, while trade has a direct effect on growth only after 1945. Financial development also seems more closely related to economic fundamentals such as legal backgrounds and the political environment before 1914, while trade seems more closely linked in recent data.

One explanation that we propose for the power of trade to promote financial development before 1914 involves the breaking down of incumbencies that had for generations been able to capture rents by controlling the provision of finance. Rajan and Zingales (2003) make this very same point. Haber et al. (2003), in a study of the economy of Mexico from 1876 to 1929, also argue that the political instability that accompanies the decline of such incumbencies need not affect growth negatively as freer markets emerge to compensate for the fallout.

While problems of incumbencies are sometimes more clearly seen in developing countries today, we find it interesting that the histories of some of the world’s most advanced economies offer a wealth of salient examples. One case of a declining incumbency around the time of the First World War involves the US and the development of a domestic market in bankers’ acceptances (i.e., two-name paper). Before this, importers and exporters would be required to finance international trade with sterling bills (i.e., bankers’ acceptances) issued in London by British merchant banks. This allowed British merchant banks to dominate international commerce (with a supplementary role for banks in Paris and Berlin issuing bills in francs and marks). Indeed, the National Banking Acts in effect from 1864 until the founding of the Federal Reserve in 1914 did not allow America's national banks (with a very few exceptions) to issue bankers’ acceptances. A market in less-liquid single-name paper (i.e., commercial bills) financed domestic trade developed instead. This state of affairs reflected the ability of the national banks in the interior (i.e., the “incumbents”) to prevent the New York City banks from opening overseas branches and creating a market for bankers’ acceptances that would have increased their profitability (Broz 1997). When the Federal Reserve Act finally allowed national banks to deal in acceptances and the Federal Reserve Bank of New York helped to create an acceptance market through a wide variety of banks, mainly in New York City, it opened the door for US firms to finance international trade using less costly dollar bills of exchange rather than sterling bills, thereby promoting international trade (Bordo and Wheelock 2011, pages 9-10).

The rise of the dollar as a competitor to sterling in the 1920s also helped to break down the dominance of London, which was the “incumbent” of the time, as the main provider of global trade finance (Eichengreen 2011, chapter 2). The eventual rise to dominance of the dollar as an international currency after the First World War increased competition in the market for trade finance and may have contributed to the strong link between trade and finance that we find prior to 1929.

# Trade and finance after World War II

Why did the linkage between trade and finance weaken after 1945 for our now-industrialised economies? One explanation is also closely related to Rajan and Zingales (2003). In particular, as trade barriers are lifted and economies open, financial sectors surge to fund the wave of new economic activity. This surge in finance is essential as economies transition from states of lower growth to new higher-growth environments. Once the transition is complete, however, trade and finance may settle into a new equilibrium relationship where the interplay among them is driven more by real factors than mutually reinforcing effects.

We believe that the growing importance of trade for growth after 1945 is related to the signing of the General Agreement on Tariffs and Trade (GATT) by 23 countries in 1947 and its expansion in later rounds leading up to the establishment of the World Trade Organisation in 1995. With the GATT came rapid relaxations of tariffs and quantity restrictions on a wide range of traded commodities that began to re-establish international linkages that had been severed by the First World War and the high tariff barriers that followed it (Irwin 1995; Bordo et al. 1999). Another factor has been the growth and expansion of the European Economic Community (EEC) (i.e., the “common market”) from its beginning in 1957. With the EEC has come a new, second era of enhanced integration among the member nations, and this has continued with the establishment of the European Union. The gradual elimination of capital controls after 1973 complemented the opening up of international trade.

Despite our finding that legal systems and the political climate can explain patterns in financial development and trade, we are surprised that financial development mattered for growth and that trade mattered for financial development even at times when direct links from the deeper fundamentals seemed less strong. Consistent with Haber et al. (2003) and Bordo and Rousseau (2006), we see this as evidence that having a deep and well-developed financial sector and strong trading arrangements offers benefits for long-term growth even when institutional underpinnings are less robust. This is not to say that sound institutions are an unimportant ingredient in growth-enhancing financial and commercial sectors, but it does suggest that the study of traditional channels such as capital accumulation and the overcoming of indivisibilities in investment along with institutional origins will in the end help us to understand more fully how and why finance and trade matter for growth.

# Conclusion

Why look to the past for guidance on sustainable growth today? And why look to trade as central to the process? We believe that the answer lies in the ability of openness to bring about the growth-promoting rise of modern financial institutions and arrangements. When financial systems are grounded in the real activity that makes an individual economy an active participant in the world economy, we believe that the potential for robust growth is commensurately enhanced.

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# 1 The seventeen countries that we consider are Argentina, Australia, Brazil, Canada, Denmark, Finland, France, Germany, Italy, Japan, the Netherlands, Norway, Portugal, Spain, Sweden, the United Kingdom, and the United States. Though not all lie on the Atlantic coast, all were important parts of the late-nineteenth-century trading community than spanned the Atlantic and beyond.

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