

**British and Italian banks and small firms: a study of the  
Midlands and Piedmont 1945-1973.**

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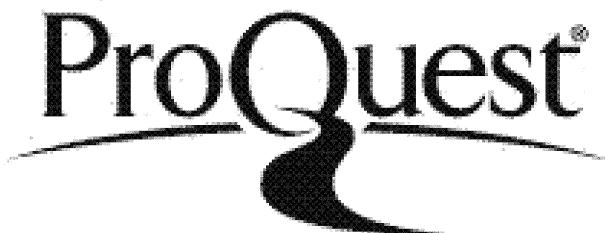


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## Abstract

The central contention of this thesis is that, in the post 1945 period, the British banking system limited the availability of finance to small firms. The concentrated and centralised nature of British banking induced financial repression as banks rationed credit to small firms, not purely in terms of interest rates, but also, and indeed mainly, in terms of supply. In a situation where banks enjoyed monopoly power over small and new firms, banks were unwilling to enter transactions with them as the cost of these transactions was high in relation to the returns, due to the centralised organisational structure of the banks. In the period previous to the one studied here, concentration had eliminated provincial banks, and the cartelized nature of British banking prevented the emergence of other local banks in the post-1945 period. These local banks would have had structures more suited to the reduction of information asymmetries, and therefore an interest in lending to small firms. The existence of a credit gap was exacerbated by credit restrictions devised by the British government in the post war period to control inflation and the balance of payments. These caused British banks to reduce the finance available to small firms. The argument presented here is that small firms in Britain suffered from credit restrictions more than they would have done if the banking system had been segmented, with other provincial banks available closer to local markets. The importance of local banks for the survival and development of small firms is illustrated by a comparison with the more differentiated Italian banking structure, in particular, the activity of two Piedmontese banks. In the chapters dedicated to Italian local banks, particular emphasis is given to their involvement with the regional economy and to the networks within the region

that facilitate the exchange of both formal and informal information between small firms and banks, thus reducing information asymmetries and facilitating transactions.

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## Introduction

One of the most frequently debated questions in economic history concerns the existence of a gap in the supply of finance to firms and whether banks can be partially blamed for this supply failure. Though this question has been addressed in depth for the period preceding the Second World War, few studies have focused on the years after 1945. In the main these have argued that high bank liquidity meant that demand for short term loans could be amply satisfied since this was, anyway, quite low, at least until the early 1970s. Moreover it has been argued that increased financial innovation improved the supply of funds to the economy as a whole and institutions such as the Industrial and Commercial Finance Corporation (ICFC) were set up with the intent of providing long term loans to small and medium sized firms<sup>1</sup>.

The literature agrees that small firms have suffered some degree of price discrimination when competing for bank loans due to higher perceived risk<sup>2</sup> but the research done up to date on bank lending to industry in the post-war period has concentrated on the relationship between banks and large firms revealing that British banks had no bias against this sector of the economy and that while most loans were, in theory, short term these were in fact rolled over to become medium or long term<sup>3</sup>.

This thesis aims to analyse the claim that British banks in the post-war period were efficient suppliers of finance to industry by looking more closely at the problems

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<sup>1</sup> F. Capie, M. Collins, Have the banks failed British industry?, (London, 1992).

<sup>2</sup> W.A. Thomas, The finance of British industry, 1918-1976, (London, 1978).

<sup>3</sup> D.M. Ross, 'The clearing banks and the finance of British industry, 1930-1959', PhD Thesis, London School of Economics and Political Science, 1989.

of small firms. The issue of whether small firms in Britain have suffered restrictions in the supply of credit is important in the context of the wider debate on the causes of Britain's relative economic decline. Though the connection is not explored in this thesis, it is interesting to note that at the same time as Britain experienced a decline in the number and importance of small firms (in terms of share of employment)<sup>4</sup> Britain's economic performance (in terms of GDP growth) lagged behind that of its main competitors between 1945 and 1973<sup>5</sup>.

The first chapter explores the main arguments in favour and against small firms. In recognition of the existence of a vast literature on the subject this chapter only attempts to identify the salient features of the debate and sufficient evidence is presented to show that small firms are important contributors to economic growth both in terms of employment and technological innovation. The chapter then explores the nature of information asymmetries in the relationship between banks and small firms and how these asymmetries can be reduced in the context of local economies. Finally the chapter presents the theoretical principles on which this work is based leading up to the hypothesis that the supply of finance to small firms in Britain was restricted due to the concentrated nature of British banking (and the absence of local banks), and the organisational structure of British banks.

Carrying on from there Chapter 2 describes the historical reasons for the concentration of British banking and analyses how the absence of competition shaped the commercial banks' attitude towards profit making and therefore their lending

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<sup>4</sup> W. Sengenberger, G.W. Loveman, M.J. Piore, The re-emergence of small enterprises, (Geneva, 1990).

<sup>5</sup> B.W.E. Alford, British economic performance, 1945-1975, (London, 1988).

decisions. Chapter 3 utilises archival evidence from three of the clearing banks, Midland, Lloyds and Barclays, to show how these banks organised their internal structure, and how information about customers was collected and processed<sup>6</sup>. The chapter focuses on the relationship between the Head Office of the banks and the provinces, in this case the Midlands.

Chapters 4 and 5 are also based on archival research and focus on the lending decisions made by these three banks in the light of the credit restrictions imposed on them by the government. These chapters test whether a bias was shown against small firms and whether this bias was due to the centralised structure of the banks.

Chapters 6, 7 and 8 are dedicated to Italian banking and to the activity of two regional banks in Piedmont. These chapters provide the 'counterfactual' evidence of a system segmented in the same way as the market and where local banks serve the needs of small provincial firms.

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<sup>6</sup> Research for this thesis has been restricted to the archives of these three banks because at the time when this research was started the archives of NatWest, that hold the material concerning the National Provincial bank and the Westminster bank, were not open to the public.

# Chapter One

## Small firms, networks and finance

### 1. Small firms

The view that the capitalist economy rests on the existence and dominance of large firms dates back at least to Karl Marx. He prophesied the corporate form of organisation leading to a: "constantly diminishing number of the magnates of capital, who usurp and monopolise all advantages of transformation". The limit was a state in which: "the entire social capital would be united, either in the hands of one single capitalist, or in those of one single corporation"<sup>1</sup>. Along the same lines Schumpeter wrote: "What we have got to accept is that the large-scale establishment has come to be the most powerful engine of progress"<sup>2</sup>. In 1956 Galbraith lamented that: "There is no more pleasant fiction than that technological change is the product of the matchless ingenuity of the small man forced by competition to employ his wits to better his neighbour. Unhappily, it is a fiction"<sup>3</sup>.

In the 1950s and 1960s the accepted doctrine on the development of the industrialised countries was that firm size mattered and these were the years Sabel and Piore have called the era of mass-production<sup>4</sup>. Firm size mattered because it seemed that economies of scale would be the decisive factor in dictating efficiency and large

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<sup>1</sup> K. Marx, Capital, (Chicago, 1912), I, p. 836.

<sup>2</sup> J.A. Schumpeter, Capitalism, Socialism and Democracy, (New York, 3rd edition, 1950), p. 106.

<sup>3</sup> J.K. Galbraith, American Capitalism: The concept of Countervailing Power, (Boston, revised edition, 1956), p. 86.

<sup>4</sup> M.J. Piore, C.F. Sabel, The Second Industrial Divide, (New York, 1984).

firms were seen as the generators of innovative activity and of economic growth.

However, the persistence of small firms, and in many countries their increasing importance in terms of employment, as shown in Table 1.1, has falsified Marx's prediction of a system dominated by one entity that could be easily eliminated by the forces of the proletariat and has shown that the economy is composed of more types of enterprise than Schumpeter had reckoned with.

Table 1.1: Employment share of manufacturing establishments employing less than 100 people<sup>5</sup>. (%)

<b>France</b>	<b>1954</b>	<b>1966</b>	<b>1974</b>	<b>1981</b>
(11-100)	36	36	34	35
<b>F.R. Germany</b>		<b>1963</b>	<b>1976</b>	
(1-100)		20	19.6	
<b>Italy</b>	<b>1951</b>	<b>1961</b>	<b>1971</b>	<b>1981</b>
(1-100)	67.2	61.6	69.3	72.4
<b>Japan</b>	<b>1957</b>	<b>1961</b>	<b>1971</b>	<b>1981</b>
(1-99)	58.6	52.7	51.8	55.6
<b>U.K.</b>	<b>1958</b>	<b>1963</b>	<b>1971</b>	<b>1981</b>
(1-99)	20	18	18	24

Note: The data are not comparable across countries, due to methodological differences.

Source: W. Sengenberger, G. W. Loveman, M. J. Piore, The Re-emergence of small enterprises, (Geneva, 1990). Table 7, p.72, for France; table 10, p.114 for Germany; table 7, p.148 for Italy; table 4, p.179 for Japan. For the U.K.: Census of Production, various years.

The literature on small firms is vast and the following pages will not attempt to cover it all. The number of books and articles written on the subject can be roughly divided in two camps, one where small firms play an important role in the economy and one

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<sup>5</sup> Ideally data on 'enterprises' should be presented as data on 'establishments' only indicate whether a plant is small or not, while not giving any information about ownership. Unfortunately enterprise data are not available across countries in the same way as data on establishments are. The problem will be addressed further when the comparison between Italy and Britain is made.

where the existence of small firms is a paradox, as they are considered to be operating at a suboptimal level.

According to the detractors of small firms, the size of the firms prevents them from achieving economies of scale and this should have a double effect: 1) deter the entry of firms in industries where economies of scale play an important part and 2) drive out those firms who operate below the minimum efficient scale<sup>6</sup>. The paradox lies in the fact that in spite of points 1 and 2 the number of small firms is not decreasing and many thrive in spite, or by virtue, of their size<sup>7</sup>. Furthermore, a number of studies have found that the entry of new firms into an industry is apparently not substantially deterred in industries where scale economies are important<sup>8</sup>. Before discussing the reasons why small firms are considered to be important elements in an economy, it is necessary to deal with the paradox highlighted above. If small firms are just anomalies that, for some unspecified reason, manage

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<sup>6</sup> L. Weiss, Structure, Conduct, and Performance, (New York, 1991), p. xiv.

<sup>7</sup> C.F. Pratten, Economies of Scale in Manufacturing Industry, (Cambridge, 1971). F.M. Scherer, 'The Determinants of Industry Plant Sizes in Six Nations', Review of Economics and Statistics, 55 (1973), pp. 135-145.

H.A. Simon, C.P. Bonini, 'The Size Distribution of Business Firms', American Economic Review, 48 (1958), pp. 607-617.

L. Weiss, 'The Survival Technique and the Extent of Suboptimal Capacity', Journal of Political Economy, 72 (1964), pp. 246-261.

<sup>8</sup> See for example: Z.J. Acs and D.B. Audretsch, Innovation and Small Firms, (Cambridge, 1990).

J.S. Austin, D.I. Rosenbaum, 'The Determinants of Entry and Exit Rates Into U.S. Manufacturing Industries', Review of Industrial Organisation, 5 (1990), pp. 211-223.

J. Cable and J. Schwalbach, 'International Comparisons of Entry and Exit' in P. Geroski and J. Schwalbach (eds.), Entry and Market Contestability: An International Comparison, (Oxford, 1991).

L. Beth and J.J. Siegfried, 'Entry and Exit in United States Manufacturing Industries from 1977 to 1982' in D. Audretsch and J.J. Siegfried (eds.), Empirical Studies in Industrial Organisation: Essays in Honour of Leonard W. Weiss, (Boston, 1992).

to survive in spite of their inefficient size, then it would make little sense to be investigating whether banks should be lending to them, as the answer would obviously be negative.

A recent econometric study has shown that the paradox ceases to exist if the selection process of new firms is analysed in dynamic terms instead of static ones. While an asymmetric firm-size distribution comprising mostly small firms may persist over time, the individual suboptimal scale firms will not operate for any length of time. Either they will succeed and grow, thereby reducing scale disadvantages, or they will face a diminished likelihood of survival<sup>9</sup>. Small firms will enter an industry at a suboptimal level because they do not know what the relative efficient size is but will soon discover what the optimal size is through the process of learning from their performance. Those entrepreneurs with talent will expand the scale of their business, while those with less ability will eventually exit the industry<sup>10</sup>. Though quite convincing in theory, this solution of the apparent paradox of the survival of small firms does not consider the fact that the majority of small firms do not increase their size whilst still managing to be successful<sup>11</sup>.

Network theory can be used to further our understanding of the existence, and success, of small firms by introducing the notion that the advantages of scale can be

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<sup>9</sup> D.B. Audretsch and T. Mahmood, Firm Selection and Industry Evolution: The Post-Entry Performance of New Firms, Discussion Paper FS IV 92-7, Research Unit Market Processes and Corporate Development, Wissenschaftszentrum Berlin für Sozialforschung GmbH, 1992.

<sup>10</sup> B. Jovanovic, 'Selection and Evolution of Industry', Econometrica, 50 (1982), pp. 649-670.

<sup>11</sup> D. J. Storey, S. Johnson, Job Creation in Small and Medium Sized Enterprises, Centre for Urban and Regional Development Studies, (University of Newcastle-upon-Tyne, 1987), vol. 1.

substituted by clusters of firms linked horizontally instead of vertically. Since network theory forms a crucial part of the backbone of this research, it will be presented in detail further on. The following sections will instead consider why small firms matter.

### 1.1 Why small firms matter

The literature on the topic of small firms has emphasised the fact that an industrial system made of a distribution of small, medium and large firms allows a more favourable distribution of economic power in society. In the long run excessive industrial concentration has unfavourable and destabilising effects. Small and medium sized firms play a positive part in the economy because they are an important source of new ideas and innovation while large firms can employ their considerable resources for large scale development. At the same time small firms are a good buffer to sharp fluctuations in employment.

Small firms are alleged to make at least four important contributions to the economy in general and industrial markets in particular. Firstly small firms play an important role in the process of technological change. Starting from the Schumpeterian tradition, Nelson and Winter argue that small firms make a significant entrepreneurial contribution and they are the source of considerable innovative activity<sup>12</sup>. Second, small firms are a source of regeneration and create market turbulence, thus providing

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<sup>12</sup> R. R. Nelson, S. G. Winter, An Evolutionary Theory of Economic Change, (Cambridge, Mass., 1982).

S. G. Winter, 'Schumpeterian Competition In Alternative Technological Regimes', Journal of Economic Behaviour and Organisation, 5 (1984).

an additional dimension of competition<sup>13</sup>. A third contribution, which relates to the first two, is that small firms are able to create new niches thus promoting competitiveness<sup>14</sup>. The negative correlation between industrial concentration and innovation has been recently highlighted while confirming that small firms, and new entrants, are important generators of innovation<sup>15</sup>. Finally small firms have generated, in recent years, the largest share of new jobs<sup>16</sup>.

It must be made clear from the onset that it is not claimed here that all small firms, in all sectors, can be defined as dynamic and innovative. In some sectors, like car manufacturing or oil refining, economies of scale require large scale operations, but small firms can still occupy niche markets that are too small for large scale producers and are characterised by demand not satisfied by mass produced goods, for example Sinclair calculators, or Aston Martin automobiles. Typically, though, small firms will have a more dynamic role in those sectors characterised by high rates of product innovation, competition on the basis of performance maximisation rather than price, loose entrepreneurial organisation and the use of general purpose manufacturing technology with relatively skilled labour<sup>17</sup>.

Detractors of small firms base many of their claims on the fact that over time

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<sup>13</sup> M. E. Beesley, R. T. Hamilton, 'Small Firms' Seedbed Role and the Concept of Turbulence', Journal of Industrial Economics, 33 (1984).

<sup>14</sup> W. A. Brock, D. S. Evans, The Economics of Small Business, (New York, 1986).

<sup>15</sup> P. Geroski, Market structure, corporate performance and innovative activity, (Oxford, 1994). In particular chapters 2 and 5.

<sup>16</sup> D. J. Storey, S. Johnson, Job Generation and Labour Market Changes, (London, 1987).

<sup>17</sup> Sabel, Piore, The Second Industrial Divide.

an increasing share of industrial output has generally been taken by the few largest firms in each sector<sup>18</sup>. Nevertheless this does not imply ever-increasing plant size. For example, in the United Kingdom the share of the one hundred largest enterprises in manufacturing net output and employment roughly doubled between the 1930s and the 1960s, but the share of the one hundred largest plants did not increase. This suggests that though the average size of plants has increased, the largest firms have increased their share in activity by building and acquiring more plants or establishments to a much greater extent than they have by concentrating in larger units<sup>19</sup>.

In the following pages evidence will be presented to support the view that small firms play an essential role in the economy, namely in two areas, technological innovation and employment opportunities, and are, therefore, well worth studying.

### 1.1.1 Small firms and innovation

One of the most comprehensive bodies of data on the issue of firm size and innovation is that contained in the innovation data bank at the Science Policy Research Unit at Sussex University. This data bank contains details of 2,154 innovations introduced by UK firms between 1948 and 1980, classified by the size of the innovating firm and that of the innovating unit (e.g. subsidiary, central laboratory, separate division) where these are different<sup>20</sup>.

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<sup>18</sup> R. Rothwell, W. Zegveld, Innovation and the Small and Medium Sized Firm, (London, 1982), Table 3.4.

<sup>19</sup> S. Prais, The Evolution of Giant Firms in Britain, (Cambridge, 1976).

<sup>20</sup> The SPRU database also contains data for the period 1980-1983 but these have not been included here as a recent study of the data has indicated that these may underestimate the total amount of innovative activity that occurred after 1980. Nevertheless the overall validity of the data have been confirmed in: Geroski, Market structure,

Table 1.2: Number of innovations by size of innovating unit, and by size of firm, for three time periods between 1945 and 1980 in the UK. The data are for important innovations introduced by UK firms.

- Innovation by size of innovating unit

	1-199		200-499		500-999		1000-9999		10000+		Total
	No.	%	No.	%	No.	%	No.	%	No.	%	
1945-59	103	19.5	76	14.4	56	10.6	213	40.3	81	15.3	529
1960-69	153	18.2	120	14.3	97	11.6	351	41.8	118	14.1	839
1970-80	241	30.7	109	13.9	113	14.4	255	32.4	68	8.7	786
Total	497	23.1	305	14.2	266	12.3	819	38	267	12.4	2154

- Innovation by size of firm

	1-199		200-499		500-999		1000-9999		10000+		Total
	No.	%	No.	%	No.	%	No.	%	No.	%	
1945-59	63	11.9	37	7	27	5.1	162	30.6	240	45.4	529
1960-69	101	12	50	6	43	5.1	210	25	435	51.8	839
1970-80	132	16.8	59	7.5	23	2.9	119	15.1	453	57.6	786
Total	296	13.7	146	6.8	93	4.3	491	22.8	1128	52.4	2154

Source: SPRU innovation data bank, 1981.

In this table a small firm is one employing less than 200 people and a medium sized one is one with less than 500 but more than 200 employees.

Looking first at innovation by size of firm Table 1.2 shows how in the first two periods the share in innovations of small and medium sized firms remained constant, as did that for firms in the size bracket 500-999. At the same time the share of firms in the size range 1000-9999 decreased by about 5 per cent. Between 1970 and 1980 small firms and firms in the largest size category increased their share by about 5 per cent, the share of firms in the 200-499 group increased only slightly whereas the shares of firms in the two categories 500-999 and 1000-9999 decreased significantly. Thus between 1945 and 1970 small and medium sized firms performed well, compared

to the other size groups, as their share of innovation remained just under 20 per cent of the total number of innovations and increased to nearly 25 per cent in the last period.

Looking at innovation by size of innovating unit between 1945 and 1969 the small and medium sized units' share of innovations remained more or less stable, at about 33 per cent as did the shares enjoyed by the other size categories. Between 1970 and 1980 small and medium size units increased their share of innovations to about 45 per cent of the total, while the shares of the two top size categories declined considerably. Furthermore, while the total number of innovations declined from 839 in the 1960-9 period to 786 in the 1970-80 period, the actual number produced by the smaller units increased.

A study similar to the one done by SPRU but including also the innovative activity of firms in the US, West Germany, Japan and France between 1953 and 1973 showed that, averaged over all countries, small firms contributed about one third of all innovations, the majority share being taken by large firms. Small firms' contribution was highest in the US (35 per cent) and France (31 per cent), followed by West Germany (26 per cent) and the UK (23 per cent). Small firms in Japan played only a minor role as producers of innovations (4 per cent)<sup>21</sup>.

The literature has identified five factors favouring the innovative advantage of large firms. The first argument is that innovative activity requires a high fixed cost;

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<sup>21</sup> National Science Foundation, Indicators of International Trends in Technological Innovation, NSF-6889, (Washington, D.C., 1976). Unfortunately no similar study has been done for Italy.

R&D typically involves a "lumpy" process that yields scale economies<sup>22</sup>. Furthermore, only firms that are large enough to achieve, at least for a time, market power, will choose innovation as a means for profit maximisation<sup>23</sup>. The cost of R&D implies a high degree of risk and large firms enjoy an advantage over small firms as they can minimise risk by diversifying in simultaneous research projects<sup>24</sup>. Scherer has noted that size can also increase economies of scale in promotion and distribution facilitating the distribution of new products, thus providing large firms with the potential for higher profits from innovation. Nonetheless it is Scherer who has summarised the advantages small firms have in contributing innovations. He argues that small firms do not suffer from bureaucracies that can hinder development, as the decision to innovate is made by relatively few people. More importantly Scherer points out that many advances in technology stem from the accumulation of small changes in individual components, materials and fabrication techniques. The sales potential of these cumulative changes is often too narrow to interest giant corporations<sup>25</sup>. Furthermore though large, monopolistic firms might have better resources to generate new innovations and may be in a better position to exploit them than other firms, innovative activity can be rent displacing and this would reduce the incentive of such firms to innovate. Conversely small firms have an incentive to use, and retain,

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<sup>22</sup> W.S. Comanor, 'Market Structure, Product Differentiation and Industrial Research', Quarterly Journal of Economics, 81 (1967).

<sup>23</sup> M.I. Kamien, N.L. Schwartz, 'Market Structure and Innovation: A Survey', The Journal of Economic Literature, 13 (1975).

<sup>24</sup> R.R. Nelson, 'The simple economics of basic scientific research', Journal of Political Economy, 67 (1959).

<sup>25</sup> F.M. Scherer, Industrial Market Structure and Economic Performance, (Boston, 3rd edition, 1990), p. 652.

innovation to increase their market share<sup>26</sup>.

If small firms are not considered in isolation but as units that operate together to create a "system of innovation"<sup>27</sup> then the understanding of the potential of small firms for innovation can be furthered. Within the system innovation is not only a cumulative process activated by one firm, but it stems also from the input from other firms, suppliers, users and institutions like universities, science parks and research centres. The various elements of the system contribute to the process of innovation by introducing different and complementary knowledge, concerning specific technologies involved in different moments of the cumulative process that will eventually lead to innovation<sup>28</sup>.

### 1.1.2 Small firms and the generation of jobs<sup>29</sup>

The second area where small firms are thought to hold a special position is in the generation of jobs. Possibly the greatest contribution to the debate on firm size and job generation is found in the work by Birch who examined employment change in 5.6 million business establishments in the manufacturing and service sector in the United States between 1969 and 1976, using a computerised data set from the U.S. credit-

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<sup>26</sup> Geroski, Market structure, pp. 149-150.

<sup>27</sup> F. Malerba (ed.), Sistemi innovativi regionali a confronto, (Milano, 1993), p. 13.

<sup>28</sup> Malerba, Sistemi regionali.

<sup>29</sup> The data presented in this section refer to the late 1960s and 1970s and have been gained from secondary literature. No data of this type are available for the period this research is concerned with, the 1950s and 1960s. Nevertheless the data presented here show that even in a period when the number of small firms was decreasing in the UK, these firms were important generators of jobs. Therefore these data allow us to make assumptions about the importance of small firms in the previous period.

rating firm of Dun and Bradstreet. His approach was dynamic as he looked at new openings plus expansions (equals gross new jobs) and closures plus contractions (equals gross job losses) from which he computed net job change.

Birch's main conclusions were that between 1969 and 1976 gross job loss through contraction and closure was about 8 per cent per annum; of gross job gains about 50 per cent derived from expansions of existing companies and about 50 per cent from new openings; of the 50 per cent of the jobs created by new openings, half were produced by independent, free-standing entrepreneurs, and half by multiplant corporations<sup>30</sup>.

Table 1.3: Percentages of net new jobs generated by size in the United States (1969-76)

Establishment size	0-20	21-50	51-100	101-500	500+	Total
All firms	66	11.2	4.3	5.2	13.3	100
All independent firms	51.6	4.4	0	-1.5	3.1	57.9
Manufacturing	360	61.7	-27.3	-163.4	-336.7	-106

Source: D.L. Birch, The Job Generation Process, Cambridge, Mass., MIT Centre for Policy Alternative, 1979.

Table 1.3 shows that during the period 1969-76, 66 per cent of net new jobs were created by firms employing less than 20 people, of which 51.8 per cent were created in independent firms. Furthermore in the manufacturing sector firms employing less than 50 people showed large net creation of jobs whereas the larger firms showed a substantial net job loss. Birch's results were carefully examined and criticised. In particular a study by Armington and Odle, using the same data set but for a different

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<sup>30</sup> D.L. Birch, The Job Generation Process, (Cambridge, Mass., 1979).

period, 1978-80, found that small firms were only creating jobs in proportion to their importance in the economy, which meant that firms with less than 100 workers were creating about 39 per cent of new jobs whilst providing 38 per cent of the labour force<sup>31</sup>. These results were subsequently challenged by Birch and McCracken by using exactly the same data used by Armington and Odle and concluding that firms with less than 100 workers created 70 per cent of all new jobs<sup>32</sup>. The great difference between the two results reflects the different approach between the two studies in compensating for the fact that the Dun and Bradstreet data base is not a random sample of firms in the USA. Storey concluded that though Birch probably overestimated the contribution of small firms to employment change, his research did demonstrate that small firms were creating jobs faster than any other size group of firms<sup>33</sup>.

These data have been compared by Storey with those calculated by Fothergill and Gudgin for the East Midlands between 1968 and 1975 following the same procedure used by Birch. Storey found that of the 55,600 total jobs created by openings in this period, about 42 per cent were created through openings of wholly new establishments. Storey also estimated that for the UK as a whole not more than 15 per cent of gross new manufacturing jobs per decade were created by wholly new establishments and that only small firms showed an aggregate tendency to increase

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<sup>31</sup> C. Armington, M. Odle, 'Small Business - How Many Jobs?', The Brookings Review, 1 (1982).

<sup>32</sup> D.L. Birch, S. McCracken, 'Small Business Share of Job Creation: Lessons learned from a Longitudinal File', MIT Program on Neighbourhood and Regional Change, (Cambridge, Mass., 1983).

<sup>33</sup> Storey, Johnson, Job Creation.

employment<sup>34</sup>.

These results have been confirmed by Storey in his review of studies on U.K. job generation in the manufacturing sector, between the late 1960s and late 1970s. These studies included two which cover the whole of the United Kingdom and nine regional ones. Despite the differences between the studies, all are consistent in showing that positive rates of job creation occurred in the smallest size groups of less than 20 employees, and to a lesser extent in firms with between 21 and 50 employees. The studies also confirm that the largest job losses were in the largest firms. On the basis of these studies Storey concluded that: "There can be now doubt that net job gains are found amongst small firms and that net job losses increase with firm size"<sup>35</sup>.

Storey and Johnson also conducted a study on job generation in the members states of the European community. On the basis of detailed country studies they were able to conclude that the net employment performance of small and medium sized firms was better than that of large firms. Storey and Jonson however also noted that the vast majority of SMEs either remained small or died and only a small majority created a vast number of new jobs. Similarly job loss was concentrated in relatively few large firms, and some medium-large and large firms created significant numbers of jobs<sup>36</sup>.

Reminiscent of Birch's results are those found by Contini and Revelli for Italy.

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<sup>34</sup> D. Storey, Job Generation and Small Firms Policy in Britain, Centre for Environmental Studies, (London, 1980) Research Series 11.

<sup>35</sup> Storey, Job Generation, p. 98. Emphasis in the original.

<sup>36</sup> Storey, Johnson, Job Creation.

Their work, based on social security data, shows that over the two periods 1978-80 and 1981-83, very small firms (those employing less than 20 people) vastly outperformed the overall average in terms of job creation: e.g. net total employment fell by 210,000 from 1981-83 while very small firms increased employment by 102,000. Employment in very small firms was also particularly fluid as turnover was quite high, with one out of 2.3 workers changing employers each year. The average for all firms was one out of every four workers<sup>37</sup>.

The evidence from the secondary literature presented in these pages would suggest that small firms can be important elements for the growth of any economy. Nevertheless in Britain, during the post-war period and up to the end of the 1970s, there was a reduction in the importance of small firms, both in terms of sheer numbers and share of employment. What is interesting is that the extent of this decline was, among the industrialised countries, peculiar to Britain. The following pages will be dedicated to a brief description of the failing fortunes of small firms in Britain since the interwar period. This will be compared with the case of Italy. The comparison will be taken a step further by an illustration of what happened to small firms in the Birmingham area and in Piedmont.

## 2. The decline of small firms in Britain

In 1971 the Bolton Committee published the results of the enquiry on the state of small firms in Britain. The Committee found that the number of small firms had declined sharply after 1935 and that the employment share of establishments with

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<sup>37</sup> B. Contini, R. Revelli, 'Natalita' e mortalita' delle imprese italiane: Risultati preliminari e nuove prospettive di ricerca', L'Industria, 100 (1986).

fewer than 200 employees had declined from about 44 per cent between 1924 and 1935 to 31 per cent in 1963. Similarly their share of net output had fallen from about 40 per cent to 27 per cent. In the case of small enterprises their employment share had fallen from 38 per cent in 1935 to only 20 per cent in 1963<sup>38</sup>. Though other countries showed a similar decline in the employment share of small manufacturing establishments between the 1950s and the middle 1960s, Britain's small manufacturing establishments share of employment was the lowest of the 13 advanced industrialised countries surveyed by the Bolton Committee<sup>39</sup>. The decline of small firms in manufacturing, in terms of employment and output, started during the interwar period but had stopped by the end of the 1970s, as suggested by Table 1.4 below.

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<sup>38</sup> PP 1971, Report of the Committee of Enquiry on Small Firms, Cmd 4811, pp. 58-9. Hereafter Bolton Committee.

<sup>39</sup> Bolton Committee, p. 70.

Table 1.4: Share of employment and net output in manufacturing by enterprise size.  
United Kingdom, 1930-1983.

Share of employment (%)						
	1-24	25-99	100-499	500-999	1000+	Total (000)
1930	12.8	16.1	32.7	38.4		5554
1948	9.9	16.9	32.2	13.5	27.5	7080
1954	8.4	15.7	32.4	13.1	30.4	7672
1963	8	12.2	30.7	14.2	34.9	7952
1970	7.3	11.1	27	13.9	40.6	8033
1974/5		19.7	25.3	13.3	41.8	7467
1983		26.2	27	13.3	33.5	5079
Share of net output (%)						
	1-24	25-99	100-499	500-999	1000+	Total (000)
1930	12.3	15.4	30.6	41.6		1191
1948	9.4	16.9	32.6	13.6	27.4	3954
1954	7.6	13.7	30.9	13.7	34.2	6235
1963	7.1	10.5	28.6	14.8	39	10820
1970		16.4	25.7	14.4	43.5	18531
1974/5		16.7	24.2	14.3	44.9	36948
1983		22.3	25.8	14.2	37.7	80804

Source: W. Sengerberger, G. Loveman, M.J. Piore (eds.), The re-emergence of small enterprises. Industrial restructuring in industrialised countries, Geneva, ILO, table 11, p. 239.

The employment share of small firms in Britain can be compared with that held by this sector in Italy, as shown in Table 1.5.

Table 1.5: Italy - Share of employment by enterprise size (%)

	1951	1961	1971	1981
Small	50.5	53.2	50.5	55.3
Small and Medium	67.4	72.0	69.2	73.9

Notes: Small: less than 100 employees (1951 and 1961, less than 101); Small and medium: less than 500 employees (1951 and 1961, less than 501)

Sources: Istituto Centrale di Statistica, Censimento generale dell'industria e del commercio, various years<sup>40</sup>.

Though Table 1.5 shows that the importance of small, and medium-sized firms, in terms of employment share, had diminished by 1971, their share of employment had increased again by 1981. Furthermore the table suggests how different the industrial structure of Italy is compared with that of Britain.

## 2.1 Small firms in the Midlands and Piedmont

Ideally the comparison between the two countries should be taken a step further by comparing the changes in the industrial structure of the Midlands with the changes that occur in Piedmont. The two areas are roughly comparable as both had been metal working industrial districts and both specialised, in the post-war period, in the mechanical engineering sector. Unfortunately data for manufacturing in the UK classified by size of firm and by region is available in the Census of Production only after 1971. Therefore data for the Birmingham area have been used. Furthermore these data refer to establishments, providing information on the changes in the size of plants

<sup>40</sup> In the case of Italy it would make little sense to show data for the pre-war period as it is only after the Second World War that Italy can be considered an industrialised country. For example: in 1951, 44% of the population was still employed in agriculture. V. Zamagni, Dalla periferia al centro, (Bologna, 1990), p. 425.

and not on the size of firms. Despite the limitations in the data, Table 1.6 shows that the Birmingham employment area experienced industrial concentration as the number of larger firms (those with more than 1000 employees) increased between 1949 and 1969, while the number of medium-sized and small firms decreased.

Table 1.6: Birmingham Employment Area - Number of plants by size

	1949	1959	1969
2000+	20	19	22
1000-1999	33	35	36
500-999	61	62	42
100-499	432	398	327
11-99	1723	1656	1632
Total	2269	2170	2059

Source: City of Birmingham, Abstract of Statistics, various years.

These changes can be compared with those that affected Piedmont over the same period.

Table 1.7: Piedmont - Number of enterprises by size

	1951	1961	1971
1-10	52326	47425	44468
11-100	3214	5114	6084
101-500	435	628	669
500>	99	115	130
Total	56074	53282	51351

Sources: same as Table 1.5

Table 1.7 shows that, in the case of Piedmont, only the artisan group of firms (1-10) decreased in number as the area became more specialised in the mechanical

engineering sector, moving away from more traditional sectors such as clothing, where artisan firms tended to cluster.

There are many possible reasons behind the decline, in terms of numbers and net output, of the small-medium sized firms in the manufacturing sector in Britain after 1945, as shown in Table 1.4. One possible reason might have been the lack of sources of finance.

### 3. Small firms and the supply of finance

A firm can be defined as small, for the purpose of economic investigation, according to a number of criteria. The most commonly used are quantitative and refer to the number of people employed, turnover, or capital. These definitions, though commonly used, suffer from the limitation of not relating to anything about the intrinsic character of a small firm. Furthermore these quantitative definitions are extremely relative: a software company employing 50 people might have a higher value of sales than a canning firm employing 500 people. These limitations notwithstanding it has been necessary, in the pages above and in those to come, to adopt other authors' units of measure (usually the number of people employed) for the purpose of quantification and comparison. But as this research is concerned with small firms and finance, the fundamental criterion that defines a small firm is one that relates to the firm's ability to access capital. Therefore a small firm is a firm where ownership and management are not separated, where owners are the only source of additional capital and loan capital is normally restricted to bank money secured by specific assets or an owner's personal guarantee. Based on these criteria what characterises a small firm is that all its capital resources are strictly limited, it is not quoted on the stock exchange, nor can

it place securities privately among institutional investors, nor can it raise loans abroad nor (usually) obtain bank finance without the personal guarantee of the owner<sup>41</sup>.

### 3.1. What a small firm needs finance for

A firm will need finance for different purposes depending on what life stage it is in. A new firm will need start up finance, even in the case of a business that begins its operations in a basement or garage, to buy equipment and working capital to buy supplies, as customers do not pay immediately. In this case the two most common sources of finance will be private, either from the owner, the family and friends, or redundancy money. The other source tends to be the owner's bank and takes the form of an increased overdraft or of a loan, secured by a house or other personal assets, such as stocks and shares.

During the normal course of events a small firm's biggest problem will be cash flow, as wages and suppliers have to be paid regularly, while customers do not pay at the moment of purchase. If normal shortages of cash coincide with another short term problem, like an illness or a temporary downturn in demand, the only possible source of finance is the bank.

The following stage is expansion, which might take the shape of a move to larger premises and/or the purchase of new or different machinery, for product or process innovation. There are two different interpretations of the innovative process that suggest differences in the type of capital required by small firms for innovation. Following the Schumpeterian concept of innovation, capital is seen as a fund which needs to be there to promote innovation. Technological change is seen as something

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<sup>41</sup> G. Bannock, The Economics of Small Firms, (Oxford, 1981), p. 28.

momentous that needs a considerable investment in capital. The Rosenbergian view of innovation, the small steps one<sup>41</sup> is also connected to the idea of innovation as a cumulative process, as presented in Section 1.1.1, is more concerned with liquidity, i.e. the liquidity of the firm at the moment of the decision to innovate. This will determine the extension and the articulation of the first steps towards change<sup>42</sup>. In both cases the most probable source of finance is a bank loan or in some cases a venture capital institution which will take a share of equity.

All this takes us back to the relationship between small firms and banks. If liquidity is the issue for innovation (or survival) then a small firm might decide to innovate or will be able to carry on production even during a period of low demand if it can negotiate an extension of its overdraft and, most importantly, if it knows that this will not be withdrawn during a bad general economic phase.

### 3.2 Small firms and the "Macmillan Gap"

The notion that small firms in Britain have suffered, and suffer still, from disadvantages in their relationship with the capital market has been popular for at least fifty years and has been discussed by the Macmillan (1931), Radcliffe (1959), Bolton (1971) and Wilson (1979) Committees<sup>43</sup>. These, and other writers, have discussed the notion that there might have been a gap in the provision of finance, in the sense that some types of firms, because of their size, might have suffered undue discrimination from banks and other sources of finance.

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<sup>42</sup> M. Amendola, J. Gaffard, The innovative choice, (London, 1988), pp. 40-43.

<sup>43</sup> Also refer to: Advisory Council on Science and Technology, The enterprise challenge: Overcoming barriers to growth in small firms, (London, 1990).

Briefly, these are the various guises this discrimination has taken:

- (i) A difficulty in raising small amounts of capital, usually equity. The Macmillan committee fixed on £200,000 as being the threshold figure in 1931.
- (ii) Prejudice from the capital market that might stem from poor credit assessment procedures, and which excludes those firms who need to raise only a small amount of money.
- (iii) Small firms may not have any difficulty in raising money but they are penalised, compared to large firms, in the interest rate they have to pay, or the security they have to provide because perceived as being more risky, and because they have little contracting power due to the fact that they cannot buy bulk finance from a number of sources.
- (v) Supply constraints might stem from the fact that the cost of assessing and monitoring small loans is too high in relation to the returns<sup>44</sup>.

The Wilson Committee when examining, in 1975, the accounts of three hundred incorporated small firms found that 65 per cent of cash raised was internally generated and that bank overdrafts represented 15 per cent of the total liabilities of small companies<sup>45</sup>. The Wilson Committee also claimed that small firms were charged a 2 per cent higher interest rate than that paid by large firms<sup>46</sup>. Furthermore British banks demanded a much higher level of security than did their European

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<sup>44</sup> J. Barber, J. S. Metcalfe, M. Porteous (eds.), The barriers to growth in small firms, (London, 1989), pp. 39-40.

<sup>45</sup> PP 1981, Committee to Review the Functioning of Financial Institutions, The Financing of Small Firms, Cmd 7503, Interim report, p. 8.

<sup>46</sup> At the beginning of the 1950s the interest rate charged to small firms was typically 4.5%-5%, 2 percent higher than the rate charged to "blue chip" customers. Barclays Bank Archive, Local Head Office Circulars, Acc. No. 29/740.

counterparts as 1:1 gearing ratios were quite common in Britain whereas European banks were prepared to accept 2:1 or even 3:1. Similarly the security ratios required, that of net assets to borrowing, were in the 2:1 to 4:1 range<sup>47</sup>. The argument put forward by the Committee to explain discrimination was that small firms were relatively risky<sup>48</sup> and that therefore it was to be expected that they would face higher interest rates or security conditions than did larger firms. Nevertheless they concluded that excessive bank caution led to smaller, and especially newer, small firms being rationed in the market for bank loans<sup>49</sup>.

The aim of this research is not to establish whether small firms were treated differently to large firms in terms of pricing or conditions. This sort of discrimination is to be expected since, as small firms face great difficulties in accessing the capital market and non-bank institutions supplying capital are few, banks enjoy a quasi-monopolistic position in their relationship with them. The business of banks is to make money and they will use their oligopolistic position as suppliers of finance to small firms by either restructuring loans as the marginal revenue decreases or by increasing the interest charges. Though the perils of monopoly are seemingly avoided by the presence of more than one bank, small firms will suffer if the banks operate a 'non poaching' policy and/or if there are high switching costs connected to changing bank. Therefore, for the purpose of this research price discrimination will be considered as

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<sup>47</sup> Committee to Review the Functioning of Financial Institutions, p. 23.

<sup>48</sup> A study done on businesses registered for VAT in 1973 found that only 43 per cent survived the next ten years and it is not unreasonable to suppose that the great majority of these firms must have been very small. See: P. Ganguly, 'Lifespan analysis of business in the UK, 1973-82', British Business, 12 August 1983.

<sup>49</sup> See also, M. Binks, 'Finance for expansion in the Small Firm', Lloyds Bank Review, 134 (1979).

a fact of life for small firms.

Instead this research aims to establish whether in the period after the Second World War small firms in Britain suffered restriction in the amount of credit available to them because the structure of British banks, and of British banking, made the cost of assessing and monitoring small loans too high in relation to the returns.

Before going into the detail of the relationship between small firms and banks the following section will analyse the environment and the institutions that can foster the growth of small firms. The study of the environment in which small firms exist is important because of the support it gives small firms in overcoming those limitations that are intrinsic to their size, limitations that can hinder their development. The following pages will also lay out the conceptual framework on which this research rests.

#### 4. Small firms and networks

Before describing the environment in which small firms exist it is necessary to define what a small firm is, or better still, what it is not, i.e. a large firm. A large firm is, among other things, a hierarchical organization developed to internalise processes which are otherwise too complex to control and organize. Instead the small firm is a firm which is not equipped with the structure large firms use to deal with the economic environment. Due to this absence of an internal organisational structure small firms cannot monitor the environment in a way that will allow them to formulate strategies and oppose competition in the same way as large firms do. Compared to small firms, large firms are better able to control the economic environment because

the complexity of their structure allows them to access information more easily.

In terms of objectives, small and large firms are not very different. Both share the same goals, whether this be maintaining and increasing their market share or making profits<sup>50</sup>. Differently from a large firm though, a small firm can do this only by exploiting niche markets and/or by adapting to fast changing markets, in the absence of economies of scale<sup>51</sup> and of a hierarchy of managers, a marketing structure and large R&D resources<sup>52</sup>. The pursuit of this strategy requires knowledge about market conditions, demand, technologies available and sources of finance but one of the small firm's biggest barrier to growth is the difficulty of acquiring information.

According to neoclassical economic theory prices should be the best mechanism for transmitting information<sup>53</sup>. The price system is, again in theory, the mechanism which allows the market to exist in a state of equilibrium<sup>54</sup>. Even uncertainty can be reduced to a condition where the equilibrium of the market is not disturbed by including the possible effect time has in changing prices<sup>55</sup>. In reality the price system is much more complex. Prices are multi-character as the price of the same item varies

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<sup>50</sup> G.B. Richardson, N. H. Leyland, 'The Growth of Firms', Oxford Economic Papers, 16 (1964), p. 2. And also E. Penrose, The Theory of the Growth of the Firm, (Oxford, 1966), pp. 28-30.

<sup>51</sup> Piore, Sabel, The second industrial divide.

<sup>52</sup> A. Chandler, Scale and Scope, (Cambridge, Mass., 1990).

<sup>53</sup> F. Hayek, Individualism and Economic order, (London, 1949), pp. 77-91.

<sup>54</sup> K. Arrow, G. Debreu, 'Existence of equilibrium for a competitive economy', Econometrica, 22 (1954).

<sup>55</sup> G. Debreu, Theory of value: An axiomatic Analysis of Economic Equilibrium, (New York, 1959), chapter 7, pp. 98-102.

according to the source of the information (for example: actual price, contract price, price offer, price prognosis), on the buyer (variations in the quantities bought can determine variations in prices), on time (information is often issued on both past and future prices, and this happens several times, with different time-lags, i.e. offers, prognoses, sources)<sup>56</sup>. Furthermore, information is often asymmetric, when the seller has more information than the buyer and the price provides no indication on whether the good is a 'lemon' or not<sup>57</sup>. The market presents too many imperfections for the small firm to be able to find the best price and prices are not sufficient transmitters of information as they do not even out the turbulence of the market.

Another difficulty arises when considering small firms and price theory. Sampling the market in order to acquire information about prices takes time and since time is limited the information acquired will be imperfect. To reduce the degree of imperfection the extent of the analysis will have to be increased, therefore increasing the cost of the information<sup>58</sup>. These costs can in part be avoided by substituting a formal organization for a series of impersonal specific contracts. This is (one of the reasons) why firms exist and increase their size<sup>59</sup>. The size of firms, and the groups of activities which is profitable to incorporate within a single firm, will be affected by

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<sup>56</sup> J. Kornai, Anti-Equilibrium. On economic system theory and the task of research, (London, 1971), pp. 67-69.

<sup>57</sup> G.A. Akerlof, 'The market for lemons: Qualitative uncertainty and the market mechanism', Quarterly Journal of Economics, 84 (1970), pp. 488-500. The problem of asymmetric information, and its implications for the relationship between small firms and banks, will be addressed in more depth further on in the chapter.

<sup>58</sup> C.A.F. Goodhart, Money, Information and Uncertainty, (London, 1989), p. 2.

<sup>59</sup> R.H. Coase, 'The Nature of the Firm', Economica, 4 (1937), pp. 386-405.

the efficiency with which a market operates<sup>60</sup>. As the turbulence of the market increases so does the complexity of the structure of the firm (until the cost of running the structure is greater than the cost of acquiring information). Therefore by looking at large firms and at the advantages of size vis-a-vis the environment it becomes clear that small firms, considered as single, isolated simple organizations, cannot survive the turbulence of the market, if we assume that access to information is a precondition for survival and success.<sup>61</sup>.

Small firms can survive and increase their market share if they exist in an environment where information can reach the small firm and information asymmetries can be reduced. This ideal-type structure is situated between the market (the neo-classical institution where information is communicated by the price mechanism) on one hand and the organizational hierarchy of the large firm (in which transactions are regulated by command and which has a structure capable of relying on non-price information) on the other.

This research is based on the assumption that the local economy is the structure where small firms can create, with all the other actors in the system, a network of economic relations regulated by mechanisms which are different from the rigid and ~~formal~~<sup>ones</sup> that dominate the market (the market of neo-classical theory where economic actors in perfect isolation receive perfect information by the price mechanism). These mechanisms allow the small firm to exist in an alternative organization to the vertically integrated one of the corporations one that is just as effective in controlling

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<sup>60</sup> B.J. Loasby, Choice, Complexity and Ignorance, (Cambridge, 1976), p. 68.

<sup>61</sup> G.B. Richardson, Information and Investment. A Study in the Working of the Competitive Economy, (Oxford, 1990).

the turbulence of the market and allowing the small firm to acquire, and exchange, information.

In order to define this rather vague concept called 'the local economy', a review of the literature on firms and location offers some interesting insights.

#### 4.1. From Industrial Districts to Network Theory

Alfred Marshall considered how firms (regardless of their size) could acquire high levels of efficiency thanks to the external economies achieved by concentrating in the same location those firms that participated in the same industry. These external economies concerned transaction and production costs and derived from the inter-relations that connect firms and the local population, i.e. the workers, their families, etc, with the local history and culture. External economies could be gained by gravitating towards sources of raw material, and by developing common pools of highly specialised factors of production, shared by many firms in the industry. For example, Marshall considered how the pottery industry developed in Staffordshire thanks to cheap coal and 'excellent' clay, while the success of the Sheffield cutlery trade was due to the good quality of the grit of which the grindstones used in workshops and factories were made<sup>62</sup>.

Another external economy enjoyed by the small firm was the pooling of specialised labour connected to the area not only by economic ties, but also by social ones. The connections created between 'neighbours' (to use Marshall's phraseology) allowed information about inventions and improvements in machinery, processes and organisation, to circulate between firms: "...if one man starts a new idea it is taken up

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<sup>62</sup> A. Marshall, Principles of Economics, (London, ninth edition, 1986).

by others and combined with suggestions of their own, and thus becomes the source of further new ideas"<sup>63</sup>. It is the territorial localisation of the economic and social relations that creates those economies external to the firm but internal to the area. The economies internalised in the area are the equivalent of the economies of scale enjoyed by large firms. The main difference is that the localised system does not need a hierarchy to organise the structure. The structure, thanks to its high degree of flexibility, balances itself adjusting to the changes which occur in the environment.

The "Marshallian Industrial District" as a concept has been developed further by some Italian literature which has concentrated mostly on the importance of the "localised thickening" of inter-industrial relationships which develop inside the locality where the firm operates. The actors inside this area are all seen as communicating not by virtue of standard market relations but because they belong to a complex and tangled web of external economies, of joint and associated costs, of historical and cultural vestiges. These are peculiar to the district and cannot be recreated<sup>64</sup>.

One of the most studied cases is the textile industrial district that developed within the area around the town of Prato in Tuscany after the Second World War. Before the war this area had been dominated by a few large scale, vertically

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<sup>63</sup> A. Marshall, Industry and Trade, (London, third edition, 1927), p. 287, and Marshall, Principles of economics, p. 225.

<sup>64</sup> G. Beccattini, 'Sectors and/or districts: some remarks on the conceptual foundations of industrial economics', in, E. Goodman (ed.), Small Firms and Industrial Districts in Italy, (London, 1989), p. 132.

M. Bellandi, 'La formulazione originaria', in G. Beccattini, Mercato e Forze locali: Il distretto industriale, (Bologna, 1987), pp. 49-65.

S. Brusco, 'The Emilian Model: Productive Decentralisation and Social Integration', Cambridge Journal of Economics, 6 (1982).

F. Pyke, G. Beccattini, W. Sengenberger, Industrial districts and inter-firm cooperation in Italy, (Geneva, 1990).

integrated, firms. Between 1945 and 1950 the high cost of purchasing new wool made these firms uncompetitive while smaller, artisan firms developed methods of production that allowed them to use recovered wool. Increasing competition from other countries further reduced the large firms' market while the small firms, by specialising in one phase of production, but functioning together as one unit, allowed the district to produce a number of different woollen products, whether in design or type of weave, increasing the possibility of rapid adaptation to qualitative changes in demand. In 1951 the firms employing less than 50 people accounted for 35% of total employment while firms employing more than 100 people accounted for 50%; by 1961 these shares had changed to 63 to 25 respectively. Exports from this area increased by 526% over the same period. The economic success of the district meant that the number of small firms grew as the labour force moved away from the large factories but not from the area. The competitive advantage of the district over the large firms was the existence of cooperation between thousands of specialised small firms all involved in the various stages of the production of one final product, including the firms that produced the necessary machinery. Cooperation was made possible by socio-cultural factors such as the feeling of belonging to the same community and the existence of kinship relations across firms<sup>65</sup>.

The concepts that underline the notion of the industrial district have been taken on by Stohr and those that have worked with him to develop a network theory to

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<sup>65</sup> G. Dei Ottati, Tra mercato e comunità': aspetti concettuali e ricerche empiriche sul distretto industriale, (Milano, 1995), chapters 4-5.

explain the persistence of localised economies in the context of national economies<sup>66</sup>.

Network theory sees the production system of the local economy (Marshall's industrial district) as a system of specialised enterprises linked to other enterprises (as customers, producers of inputs, goods or services), consumers and workers by a network of commodity, person and information flows. Network theory regards the regional economy as an institutional device, which mobilises resources and channels information from one actor to the other, increasing flexibility and reducing uncertainty. Participation in the network is seen as increasing the ability of small firms to innovate and successfully adjust to changing macroeconomic conditions<sup>67</sup> as the small firm gathers information not only from the economic network of enterprises to which it is connected, but also from the family and social network of the entrepreneur, and of his employees. In fact the small firm can be seen as suspended between the economic network of enterprises and the social network of the entrepreneur and his household<sup>68</sup>.

The localised economy exists in three dimensions of space: economic, geographical and sociocultural and all three dimensions co-exist. The economic space is that in which the actors carry on their transactions and which determines their performance. Infrastructure services and degree of urbanization in the geographical

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<sup>66</sup> W. Stohr, D. Taylor, Development from above or below? The dialectics of regional planning, (Chichester, 1981).

W. Stohr (ed.), Global challenge and local responses: Initiatives for economic regeneration in contemporary Europe, (London, 1990).

E. Bergman (ed.), Regions reconsidered: economic networks, innovation and local development in industrialised countries, (London, 1991).

<sup>67</sup> Bergman, Regions reconsidered, p. 5.

<sup>68</sup> P. Pedersen, 'A network approach to small enterprises', in Bergman (ed.), Regions reconsidered, p. 90.

space influence the behaviour and success of the actors. The sociocultural setting may influence the use of certain technologies or ways of producing goods and it also influences the process of socialization and culturalization. All three co-existing dimensions form an internalized system of values and behaviour, creating a sort of common personality among the actors<sup>69</sup>. This mesh of economic, geographical and sociocultural relations not only exists in space but it also exists in time. The temporal dimension of the network is essential to the stability of the localised economy. It is only thanks to a shared history that the elements of the network are bound together. History here is not only meant as a general social term but also in economic terms meaning that, inside the local economy, the temporal dimension is also expressed by the repetitive pattern of transactions.

All the factors which make up the localised economy have one common denominator: the factor of communication. This structure, which substitutes for both market and hierarchy, exists thanks to the fact that all the actors communicate socially through a 'specialised language'. This specialised language develops thanks to a learning process. Relying on what the actors have learnt about each other in the past, the speaker will use words confident of the fact that the listener will interpret them correctly. Both will rely on each other's correct use and understanding of the words used<sup>70</sup>.

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<sup>69</sup> D. Kaman, 'The distribution of dominance in networks and its spatial implications', in Bergman (ed.), Regions reconsidered, pp. 36-37.

<sup>70</sup> M. Polanyi, Personal knowledge. Towards a post-critical philosophy, (London, 1978), p. 206.

#### 4.2 Small firms, the local economy and information

In the following pages I shall apply some of the ideas about locality, developed from Marshall, the Italian literature and network theory, to show how the network can help small firms acquire information to survive and succeed.

The information firms need is: the capacity of the market, imports, exports; their competitors, i.e. how the industry is structured, how it changes, who is in, who is out; the prices of products; raw material, who supplies it, where it is; new processes, new products, new technology, patents; government actions and policies, new laws and regulations and, finally, sources of capital<sup>71</sup>.

Changes in the environment happen very rapidly, not only in the market but also among the institutional elements that influence the market (new laws, new government regulations, etc). The turbulence in the environment means that the amount of information the firm has to scan (to grow, be competitive and innovative) not only increases with time but also becomes more elaborate. By considering the above points and the fact that small firms are unable to generate information internally as large firms do, it appears clear that the "small" entrepreneur will have a very limited perception of the environment in which the firm operates if the only person he can rely on to collect information is himself and if the only resource he has is his own time. A study done on the business scanning practices in small firms shows that scanning is done mostly by one person, the owner of the company<sup>72</sup>. The main

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<sup>71</sup> J. Boswell, The rise and decline of small firms, (London, 1973).  
Piore, Sabel, The second industrial divide.  
E. Goodman (ed), Small firms and industrial districts in Italy, (London, 1989).  
W. Sengenberger, G. Loveman, M. Piore, The re-emergence of small enterprises, (Geneva, 1990).

<sup>72</sup> F.J. Aguilar, Scanning the business environment, (London, 1967).

formal source of information comes from published material<sup>73</sup>. The main informal source of information comes from outside personal contacts: "usually the spoken word, a private note, phone call, a tip-off, private opinion, a suspicion of a trend or a hunch"<sup>74</sup>. The study also shows that among the firms studied, small firm managers rely for 68 per cent of information on outside sources, whereas large firm managers rely on this type of source only for 22 per cent.<sup>75</sup> Another study shows that information inputs are facilitated by personal contacts and not by specialist journals<sup>76</sup>. In the absence of a structure built specifically to collect information, the possibility of relying on outside sources of information for knowledge about the environment becomes all important to the small firm. To facilitate communication these outside sources must be near the small firm. Proximity seems to be a very important factor for at least two reasons. The first reason is very practical, a close source is easier to contact, and it is easier to know of its existence. Small firms have a rather limited radius of action<sup>77</sup>. The second reason has a more social connotation,

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<sup>73</sup> In this case the time left at the owner's disposal to peruse the literature becomes an important variable in establishing how large his perception of the environment will be.

<sup>74</sup> Capital Planning Information, Information and the small manufacturing firm, (Edinburgh, 1982), p. 3.

<sup>75</sup> Aguilar, Scanning the business environment, p. 139.

<sup>76</sup> J. Goddard, 'Industrial innovation and regional economic development in Great Britain' in, F. Hamilton, G. Linge (eds.), Spatial analysis, Industry and Industrial Environment, (Chichester, 1983), III.

<sup>77</sup> A report done on information and the small firms, shows how a large percentage of the small firms in the sample did not use the Small Firms Agencies (agencies set up by the government in the 1970's on a regional basis) because even though the agencies were stationed regionally, the owners of the firms did not know what the agencies did, as the advertising (leaflets, posters) was not clear. There was also doubt among many

linked to the local nature of the agent and therefore to his belonging to a sort of extended family<sup>78</sup>. This makes it easier to establish trust relations, allowing the small firm to trust and rely on the information received<sup>79</sup>. The local economy, as defined in the preceding section is the place where the relation between the small firm and the sources of information is most easily established. These resources also play another very important role: that of transmitting information about the small firm to the environment since, unlike large firms, small firms are not very 'visible' in terms of profits made, and distributed, and of people employed. The issue of why 'visibility' is important for small firms will be discussed further on.

At this point it is necessary to establish the identity of the sources of information inside the localised economy. Four subcategories of sources can be distinguished: friends and family; actors related to locational factors; institutional actors and actors that are specific to the product-market combination<sup>80</sup>. All these sources are instrumental in conveying information about the external world to the small firm while at the same time passing on information about the small firm. The second group deals with locational factors like infrastructural services (waterworks, energy suppliers, railroad companies, etc). These informers about services can only act

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firms whether a service based 50 miles away, would have the necessary local knowledge to be really useful. See: Capital Planning Information, Information and the small manufacturing firm, p. 20.

<sup>78</sup> J. Boissevain, J.C. Mitchell (eds.), Network Analysis: Studies in Human Interaction, (Paris, 1973).

<sup>79</sup> Y. Ben-Porath, 'The F-Connection: Families, Friends, and Firms in the Organization of Exchange', Population and Development Review, 6 (1980).

<sup>80</sup> D. Kaman, 'The distribution of dominance in networks and its spatial implication', in Bergman (ed.), Regions reconsidered, p. 39.

if the small firms are clustered as these services will have their representatives only where there is a population of (small) firms to serve. The third category includes trade-union representatives, public administrators, lobbies and business organizations, like Chambers of Commerce<sup>81</sup> and industrial associations. This is the group that is most involved (in the sense that their involvement is more institutional) in the transmission of information. These are the gatekeepers of the network. The gatekeepers are in contact with the environment and actively provide relevant external information by translating it into the jargon used by the small firm<sup>82</sup>. The fourth category consists of suppliers and customers. The role of this group in conveying information about the market is essential. With suppliers and customers the small firm exchanges views on the section of the market nearest to it (the section the small firm perceives most easily) and receives, in exchanges the suppliers and customers own 'slice of vision' which, at the same time, is made up of their own suppliers and customers 'slice of vision'. The larger the number of interconnections, the higher the level of information exchange.

#### 4.3 Small firms, information and transactions

The previous section has suggested that small firms can gain information, and transmit information about themselves, within the local network thanks to the presence of local agents who act as transmitters. This section will explore this theme further by

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<sup>81</sup> W. Grant, Chambers of Commerce in the UK system of business representation, (Warwick, 1983).

S. Murray, Talking to local business: the involvement of Chambers of Commerce in local affairs, (Bristol, 1984).

<sup>82</sup> Kaman, 'The Distribution of dominance in networks', p. 48.

analysing the governance structures within the network that regulate transactions, making it possible for those who exchange information to trust each other and rely on the information received.

Every time an economic agent wants to enter into a transaction it needs information on the goods needed by the other party to the transaction and on the party's trustworthiness. Fixed transaction costs are the cost of information collection, the creation of provisions and guarantees for enforcement, negotiations, and marketing. These costs arise because parties to transactions are different individuals with imperfect information about each other, divergent motives and mutual suspicions and because expenditure of resources can reduce the gap in information and protect the parties against each other. Transaction costs tend to increase relative to the degree of imperfection of the market and of its consequent (in-)ability to convey information from one firm to the other in an efficient and rapid way.

The following pages will show that it is sensible to argue that the local network allows the repetition of transactions in such a way as to create a mechanism which is stronger in guarding against opportunism than competition. This mechanism is based on the creation, through repetition, of social contacts and privileged channels of communication.

The fact that economic agents operate inside a network of social relations creates a situation defined as "embeddedness of economic action and social structure"<sup>83</sup>. The embeddedness argument stresses the role played by personal relations in generating trust and discouraging malfeasance. The local economy is the

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<sup>83</sup> M. Granovetter, 'Economic action and social structure: The problem of embeddedness', American Journal of Sociology, 91 (1985).

place where embeddedness is most evident since most activities are characterised by social connections. This is the place where economic actors can rely most easily on the information from a trusted informant (trusted because dealings in the past have been free from opportunistic behaviour) to decide whether to deal with another operator. Once a relation is established this will become embedded as the operators start sharing a past together. This shared past is the most efficient controller of transaction costs as it is the cheapest source of information on the reliability of the parties concerned, furthermore if opportunistic behaviour has been absent in the past this will ensure trustworthiness and thus future transactions<sup>84</sup>. Some literature recognises the fact that many, if not most, economic exchanges are not regulated by contracts, or only in a perfunctory way, as in the case of legal sanctions or the effect of defective performances and therefore non-contractual relations take the place of contracts<sup>85</sup>. Non-contractual relations are effective because the two business units are connected at all levels by personal relations which, across the boundaries of the two organizations, exert pressures for conformity to expectations<sup>86</sup>. The example of salesmen and purchasing agents is pertinent. These two operators know each other well and their relationship goes back in time. Each one has something to give to the other which goes beyond the goods transacted. Salesman gossip about competitors, shortages and price increases to purchasing agents who treat them well. In the same way the

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<sup>84</sup> Granovetter, 'Economic action', p. 480.

<sup>85</sup> S. Macaulay, 'Non-contractual relations in Business: A preliminary study', American Sociological Review, 28 (1963), p. 60.

<sup>86</sup> E.H. Lorenz, 'Neither Friends nor Strangers: Informal Networks of Subcontracting in French Industry', in D. Gambetta (ed.), Trust, Making and Breaking Cooperative Relations, (Oxford, 1988).

buyer's engineering staff may work with the seller's engineers to solve problems jointly. All the actors involved in the transaction will want to continue successfully in business and will therefore avoid conduct which might interfere with attaining this goal<sup>87</sup>.

Oliver Williamson introduces the notion of "Relational Contracting" in his analysis of the governance structure that controls opportunism when recurring transactions of the mixed and highly idiosyncratic kind occur<sup>88</sup>. The nonstandardized nature of this type of transaction makes relying on market governance very risky. The idiosyncratic nature of the transaction locks together seller and buyer: the buyer will not look for other suppliers because these will have to incur high set up costs (therefore charging high prices), the seller will not be able to withhold supply and look for better opportunities as the product has been made to the specification of one customer. Recurring transactions of the idiosyncratic kind often occur in industrial districts among small firms 'locked' together by product interconnections. In the case where seller and buyer are connected by the characteristics of the product they are exchanging, the governance structure used to limit opportunism and reduce transaction costs is based on relational contracting. A formal contract regulating these factors would increase transaction costs. The regulation of opportunism comes from the fact that supplier and buyer will repeat their transactions through time adapting their contracts to unfolding events. As the transactions continue through time their contracts will be simplified as the individuals come to trust their institutional and personal

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<sup>87</sup> Macaulay, 'Non-contractual relations', p. 63.

<sup>88</sup> O. Williamson, 'Transaction cost economics: The governance of contractual economies', Journal of Law and Economics, 22 (1979), p. 248.

relations, believing personal integrity to be operative. All these elements will lead to the refusal of opportunistic behaviour<sup>89</sup>. This special governance structure supplants standard market-cum-classical contract exchange<sup>90</sup>. This regulating system is reinforced when the agreement between the parties is supported by extra-market relations that bind them together and make the contract self-reinforcing<sup>91</sup>. Williamson's point holds true mostly for small firms, for, as Veblen argues, "personal responsibility" is in great measure mitigated in large corporations due to the distance existing between the head of a large enterprise and the transactions<sup>92</sup>.

Both Granovetter and Williamson, in their different explanations of how transaction costs are reduced, introduce the element of communication. The fact that the actors involved in the transaction communicate, allows them to acquire information about each other in such a way as to reduce transaction costs. The place where this communication takes place most easily, therefore the place where transaction costs are most easily reduced for the small firm, is the local network. The network is created by proximity, shared culture, shared environment. These elements make sure that inside the network transactions can take place safely as trust cannot be betrayed without discrediting the players and putting them in the condition of being betrayed. Opportunistic behaviour is kept under control by the fact that the actors all know each other and the fact that the players might meet again makes it possible for cooperation

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<sup>89</sup> Williamson, 'Transaction cost economics', p. 240.

<sup>90</sup> Williamson, 'Transaction cost economics', p. 245.

<sup>91</sup> B. Johansson, 'Economic Networks and Self-Organization', in Bergman (ed.), Regions reconsidered, p. 24.

<sup>92</sup> Footnote in Williamson, 'Transaction cost economics', p. 245.

to emerge<sup>93</sup>. The future is important for the establishment of the conditions for cooperation, but also the past, as the history shared by the actors is important for the monitoring of actual behaviour<sup>94</sup>. Local networks are efficient systems for regulating deviant behaviour (in the sense of deviant from cooperation) as social relations strengthen those ties of loyalty and respect among the inhabitants of the area<sup>95</sup>. This is true specially for those transactions where the value of the goods transacted is ambiguous or uncertain. In a market integrated by strong community elements the economic actors will accept ambiguous transactions, trusting in the fact that in the longer term balance will be reached<sup>96</sup>.

Communication and social relations inside a regional economy allow transaction costs to be reduced and, therefore make it easier for firms to enter transactions. The loose governance structure of the transactions, based on cooperation, creates a situation where if disagreement emerges during the course of the transaction, it is more likely that the conflict will be solved through "voice" rather than "exit" mechanisms<sup>97</sup>.

As much as the network allows the small firm to acquire information it also provides other actors within the network with information about the small firms. In

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<sup>93</sup> R. Axelrod, The evolution of cooperation, (New York, 1984), p. 12.

<sup>94</sup> Axelrod, The evolution of cooperation, p. 182.

<sup>95</sup> G. Dei Ottati, 'Il mercato comunitario', in G. Beccattini, Mercato e forze locali. Il distretto industriale, (Bologna, 1987), pp. 124-125.

<sup>96</sup> These are those transactions the value of which can emerge only with time. J. Barney, W. Ouchi (eds.), Organizational economics: Towards a new paradigm for understanding and studying organizations, (San Francisco, 1986), pp. 360-363.

<sup>97</sup> A. Hirshmann, Exit, Voice and Loyalty, (Cambridge, Mass., 1970).

the following pages the concepts explored in the sections on information and transaction costs will be applied to the relationship between banks and small firms.

## 5. Networks and banks

In theory banks, as profit maximisers, aim at engaging in transactions which involve the lowest marginal cost possible relative to the price charged. Transaction costs connected to the business of lending money concern, in the first instance, the cost of gathering information about clients and their business to minimise the risk of default. After the loan has been granted the bank incurs other costs such as monitoring to minimise the risk of moral hazard and, in some cases, the necessity of enforcing contracts<sup>98</sup>. Bank lending is one of the cases where problems of asymmetric information are more likely to occur as the borrower possesses much more information about himself than the lender. Gathering information to reduce asymmetry is a time - and human resources - consuming activity and these costs can be reduced by imposing on customers the necessity to fulfil some formal requirement concerning, for example, their balance sheets and performance record. Not having much collateral and a limited cash flow, small firms have more difficulties in securing loans, or extensions of overdrafts, than large firms do, especially in the case of investment for innovation<sup>99</sup>. Information asymmetries could be reduced by additional knowledge of a more informal nature, about the trustworthiness of an applicant and the prospects of the business. Nevertheless, it can be hypothesised that for the bank the cost of acquiring information on the small firm beyond that which is formalised (collateral,

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<sup>98</sup> C.A.F. Goodhart, Money, Information and Uncertainty, (London, 1989), p. 2.

<sup>99</sup> Binks, 'Finance for expansion in the small firm'.

cash flow, track record, etc) might be too high in relation to the returns<sup>100</sup>. This high cost could lead to the transaction (the loan) not taking place. Or if it takes place, the cost for the small firm could be very high (being charged higher interest rates than those commanded by large firms, for example). The effect of this mechanism might become perverse in the sense that it either increases the firm's capital costs, or by restricting actual supply<sup>101</sup> it makes it less innovative, in both cases making it less competitive.

This thesis will show how in assessing non-formalised information, however, not all financial institutions have the same cost function. Those banks whose decision-making centres are physically closer to the small firm, such as Italian regional banks, can assess local knowledge more cheaply than those banks which use a branch network to transmit information from the periphery to the centre, as in the case of the British banks.

Before analysing how proximity helps local banks to reduce transaction costs it is useful to summarise the theoretical framework used to define a regional network as presented in the previous sections.

In the Italian case, the regional network has specific characteristics as the people that live in the same geographical area relate to each other in a way unique to the group they belong to. This is because they often share a local dialect; they share a common history, probably of municipal origin; they share the same set of cultural points of reference in the form of religion and belonging to the same ethnic group. By

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<sup>100</sup> J. Barber, J.S. Metcalfe, M. Porteous (eds.), The barriers to growth in small firms, (London, 1989), p. 39.

<sup>101</sup> J.E. Stiglitz, A. Weiss, 'Credit rationing in markets with imperfect competition', American Economic Review, 71 (1981) p. 395.

inhabiting the same area, they share physical proximity from a very early stage and experience collectively the changes to the social, economic and political fabric of the area, in other words they share in the making of the history of their locality; most importantly they also share the same economic environment, in terms of the experiences connected to the same industrial sector<sup>102</sup>.

The regional economic network is characterised by the fact that within it transactions are regulated both by market rules and by the existence of the specific relationships existing between the actors based on the five points listed above. The literature on this topic suggests that much of the success of the small firm sector in Italy can be attributed to the interconnections existing between firms that share the same locality and the same industrial sector. These connections allow the creation of external economies that include, for example, the dissemination of information and the regulation of transactions. Recent research has highlighted the role played by Italian local banks in the development of regional economies in the post 1945 period, based on the same framework used by network theorists<sup>103</sup>, establishing how the conditions that allow for inter-firm cooperation inside the district can be generalised to include other economic actors, such as local banks.

The historical reason for the existence of these banks was, in many cases, the explicit defence of local societies from the market<sup>104</sup>. Even if these banks have, over time, abandoned their original vocation, many preferential relationships with the local

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<sup>102</sup> G. Dei Ottati, Tra mercato e comunità: aspetti concettuali e ricerche empiriche sul distretto industriale, (Milano, 1995), chapter 2.

<sup>103</sup> Bagnasco, La costruzione sociale.

<sup>104</sup> A. Polisi, 'Prima della Banca d'Italia. Spinte unificanti e resistenze regionali', Meridiana, 14 (1992), p. 30.

economy and social environment have remained unchanged<sup>105</sup>. This relationship between financial intermediaries and firms has been shown to be mutually beneficial as a prosperous regional economy will transfer its funds to the local banks for reinvestment in a virtuous cycle where the lenders, being involved with the economy that supports them, get to know the characteristics and potential of local firms<sup>106</sup>. A local bank will give much greater weight to the personal qualities of the potential borrower than will a bank which is less well rooted in the local environment. The close connection between banks and firms also carries the risk of capture and of this cycle becoming vicious, as in the case of banks supporting businesses for reasons outside the scope of economic development. Not all is rosy within the network: if bank managers give credit to their friends without considering their creditworthiness, the economy of the district can be seriously endangered<sup>107</sup>.

## 5.1 Assessing

The first cost a bank encounters when deciding whether to grant a loan is that of collecting reliable information. Inside the local network there are participants who can provide information additional to that formalised in an application form by the firm. These informants can be organisations who are clients both of the bank and of the firm asking for a loan, associations like the local Chamber of Commerce or other financial

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<sup>105</sup> A. Michelson, 'Mercato informale del credito e piccola impresa', Quaderni di sociologia, 37 (1993), p. 106.

<sup>106</sup> S. Brusco, E. Righi, 'Local government, industrial policy and social consensus in Modena', Economy and Society, 18 (1989), p. 405.

<sup>107</sup> G. Beccattini, 'The Marshallian industrial district as a socio-economic notion', in F. Pyke, G. Beccattini, W. Sengenberger (eds.), Industrial Districts and Inter-firm Co-operation in Italy, (Geneva, 1990), p. 47.

institutions. The regional economy is singular compared to other business networks as the welfare of the individual participants depends on the welfare of the whole community. Therefore there is little incentive not to cooperate as withholding information or providing faulty information would reduce the welfare of the individual by reducing that of the community. Furthermore, as all the participants are locked together within the same economy and society, which in the case of the regional economy has tangible, geographical boundaries, opportunistic behaviour is likely to be punished in the future.

This mechanism of co-operation allows the bank to gain access to good quality information about the reputation of a firm and its activity. The information provided by these sources is particularly effective in the case of new firms searching for start-up capital as in their case the main asset of the firms is the reputation of the entrepreneurs. By belonging to a regional network these people are known to those with whom they have dealt in the past and thus can more easily become known to the bank. Clearly this mechanism does not work as well for entrepreneurs who are new to the district since it is the embeddedness of social relations that generates trust and helps to regulate transactions as described in section 3.3.. Therefore in the case of newcomers, banks can rely only on information provided by the firm if this has none of the social connections that other firms have built through time. These new entrants, though physically inside the region, will fall outside the network that would otherwise provide the bank with additional information.

## 5.2 Monitoring and enforcing

Monitoring the activity of customers is the other important element in the minimisation of risk. Banks generally gain knowledge of their customers' activity through long-standing business contacts and these allow contracts to become simplified through time, as the same customer approaches the same bank every time a loan is needed. These contacts and the knowledge derived from them make monitoring simpler, more effective and cheaper. If the social element is introduced in the analysis of the relationship between banks and firms then the transactions that take place between them can be defined as idiosyncratic, a highly individual exchange, especially in the case of local banks and local firms, as will become clearer when the Italian banking system is described. When seller and buyer are connected by the characteristics of the product they are exchanging, as in the case of a loan granted on the basis of knowledge that goes beyond that quantified by a balance sheet, the governance structure used to limit opportunism is that based on relational contracting where the relation existing between buyer and seller allows for monitoring without increasing transaction costs. Thanks to the embeddedness arguments discussed in an earlier section, the local bank can rely on the information it receives from the local informants (suppliers, customers, the "gatekeepers") about the firm applying for a loan. These informants can be trusted because malfeasance would make future cooperation difficult and all the players are better off cooperating as they will inevitably have to deal with each other again<sup>108</sup>. The social network creates ties that make monitoring easier as the firm's reputation, and thus its ability to enter contracts with future suppliers and customers, is at stake. For the same reason contracts will be respected

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<sup>108</sup> Axelrod, The Evolution of Cooperation, p. 173.

and enforcement will not be necessary. Inside the local economy the welfare of the community depends largely on individuals not taking undue risks, thus peer monitoring mechanisms can mitigate moral hazard<sup>109</sup>. In other words the network facilitates transactions between banks and local firms by making reliable information easily accessible.

### Conclusion

Section 2 of this chapter described the decline of small firms in Britain while comparing it with the endurance of this sector in Italy, while Section 3 suggested that the focus of this research is to establish whether small firms in Britain suffered from restrictions in the supply of finance

The hypothesis tested in this research is two pronged as it focuses on the structure of British banking and of British banks. It purports that the historical trend towards concentration experienced by British banking with the creation of a structure made up of a few large banks had two effects. The first prong of the hypothesis is that small firms suffered supply restrictions because concentration eliminated provincial banks which by being inside the local network, could use informal knowledge about prospective customers to reduce information asymmetries, thus increasing the likelihood of transactions taking place. The second prong of the hypothesis maintains that because the few large banks that took the place of the many small ones had centralised organisational structures placed outside the local network, this made it more

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<sup>109</sup> R. Arnott, J.E. Stiglitz, 'Moral Hazard and Non-Market Institutions: Dysfunctional Crowding Out or Peer Monitoring', American Economic Review, 81 (1991), p. 179.  
J.E. Stiglitz, 'Peer Monitoring and Credit Markets', World Bank Economic Review, 4 (1990).

difficult for small firms to access finance. The next chapters will show how centralisation induced the formalisation of information about applicants for loans thus increasing the information asymmetry between small firms and banks. Information asymmetry would induce the bank to reject the loan or price it very high, and in fact British banks chose to do the former. It is hypothesised that centralisation made the use of informal knowledge about applicants, to reduce asymmetries, too expensive to use in relation to the returns.

The approach taken in this thesis denies that the lending of the banks in the post-war period was demand driven. It is interesting to note that, whereas banking theory recognises the active role of banks in stimulating demand for credit<sup>110</sup>, banking historians in general discount the possibility of bank loans having been subject to supply constraints. Capie and Collins agree with Mayer, when discussing the activity of the banks during the 1950s and 60s that: "banks would be willing to lend more if only prospective borrowers could come forth"<sup>111</sup>. These authors attribute the low ratio of advances to total assets held by the banks from the end of the war until the mid 1960s not only to low demand but also to the fact that bank behaviour was subjugated to government finance, in the sense that banks were 'obliged' to hold a very large proportion of their assets in government securities while at the same time quantitative restrictions were placed on bank lending as part of the government's

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<sup>110</sup> R.S. Sayers, Modern Banking, (Oxford, 1958), chapter 7.

<sup>111</sup> F. Capie, M. Collins, Have the Banks Failed British Industry?, (London, 1992) p. 74.  
C. Mayer, 'Financial Systems and Corporate Investment', Oxford Review of Economic Policy, 3 (1987). M. Collins, Money and Banking in the UK. A History, (London, 1988), p. 420.

attempts at demand management<sup>112</sup>. This thesis will argue that not only did the structure of British banks reduce supply to small firms but also that during the period of credit restrictions the London-centric structure of British banking imposed a heavier burden on small firms than if there had still been local financial institutions.

To make this argument stronger the 'counterfactual' is presented under the guise of the comparison with the Italian case. The Italian chapters will show firstly how the structure of Italian banking reduced the impact of the monetary policies implemented in the post-war period on the small firms and secondly how banks within a local network can reduce information asymmetries.

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<sup>112</sup> Capie, Collins, Have the Banks Failed, pp. 67-69.

## Chapter Two

### The British banking system

As presented in the previous chapter one of the two prongs of the hypothesis this research wants to test<sup>15</sup> whether small firms in Britain suffered restrictions in the supply of finance because of the concentrated nature of British banking and the absence of local sources of credit. The first part of this chapter describes how and why banking in Britain came to be so concentrated whilst the second part analyses the shortage of alternatives to bank lending at a local level in the post-war period.

The aim of this chapter is also to show that banking concentration, and cartelization, were approved of by successive British governments in the belief that a banking system thus shaped would be better suited to serve the needs of an industrial structure geared towards large firms. Furthermore it will be shown how the absence of competition also shaped the commercial banks' attitude towards profits making them behave more like profit-satisficers than as profit-maximisers.

#### 1. Concentration in British banking

In the nineteenth century the market power of the British banks had been widely dispersed. The banking system comprised hundreds of small, local banks with few if any branches. In 1825 there were more than 600 banks while by 1913 this number had contracted to 70<sup>1</sup> and by the close of the First World War British banking was concentrated in the "Big Five": Midland, Lloyds, National Provincial, Barclays and

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<sup>1</sup> M. Collins, Money and banking in the UK: A history, (London, 1988), p. 54 and p. 78.

Westminster. These five banks alone held four-fifths of aggregate deposits in England and Wales. This expansion had been pursued through the opening of branches and the relentless amalgamation with other banks<sup>2</sup>. The merger movement which started in the late nineteenth century involved both banks and industry as the industrial structure of the country moved towards large scale organizations. Whereas recent studies have shown the closeness of the relationship between local banks and businesses in the second half of the nineteenth century<sup>3</sup>, businessmen seeking loans in the pre and post-First World War period had to negotiate loans with branch managers of a national concern<sup>4</sup>.

Following the wave of bank failures in 1825 and 1926, the banking system was reformed by removing the prohibition on the establishment of joint-stock banking companies (with unlimited liability) with more than six members, having the right to issue banknotes, within 65 miles of London. At the same time the Bank of England was given permission to open branches outside London. In 1833 non-issuing joint-

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<sup>2</sup> In 1875, English joint-stock banks had, on average, just eleven branches. This number had increased to 156 in 1913. F. Capie, M. Collins, Have the banks failed British industry?, (London, 1992), pp. 38-39.

<sup>3</sup> L. A. Newton, 'The finance of manufacturing industry in Sheffield c. 1850 to c. 1885', PhD Thesis, (University of Leicester, 1994). Other studies on the subject include: M. Collins, P. Hudson, 'Provincial bank lending: Yorkshire and Merseyside 1826-60', Bulletin of Economic Research, 31 (1979); P. Cottrell, Industrial finance 1830-1914: The finance and organisation of English manufacturing industry, (London, 1979); P. Hudson, The genesis of industrial capital: a study of the West Riding wool textile industry c. 1750-1850, (Cambridge, 1986).

<sup>4</sup> For the hypothesis that these branch managers had less power than formerly independent bankers and that this might have meant that loans to industry could have been given a lower priority because riskier than other forms of investment see: Y. Cassis, 'British Finance: success and controversy' in J.J. Van Helten, Y. Cassis (eds.), Capitalism in a Mature Economy, (London, 1990). See also D. Ziegler, Central bank, peripheral industry. The Bank of England in the provinces, 1826-1913, (Leicester, 1990).

stock banks were allowed into London. In the seven years following the reform eighty-seven joint-stock banks were formed. In 1844 there were 68 London banks (63 of which were private), and 373 provincial ones (272 private and 100 joint-stock). The first joint-stock banks were admitted to the London Clearing House (controlled by the private banks) in 1854 <sup>5</sup>.

In 1858 joint-stock banks could register as limited companies and the Companies Act of 1862, by unifying the legal regulations of all limited companies, facilitated the establishment and amalgamation of joint-stock banks. The obligation to publish balance sheets also increased the public's confidence in these banks, while decreasing the influence and popularity of private banks. In England and Wales in 1884 there were 65 London banks (35 private and 21 joint-stock), 6 London and provincial ones (all of which were joint-stock) and 263 provincial (172 private and 91 joint-stock). Although the private banks were still a majority, the joint-stock banks had a higher number of branches (1590 against 443)<sup>6</sup>.

The advantages of large scale made amalgamation between banks attractive. The existence of the clearing system based in London meant that provincial banks had to maintain an agent in the clearing centre, thus incurring higher costs than the London banks; extensive branch networks allowed surpluses from certain areas to be transferred to areas requiring credit; credit risk could be diffused over a larger area and operations standardised, thus reducing costs. Expansion was sought through

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<sup>5</sup> P.H. Matthews, The Bankers' Clearing House, (London, 1921), chapter 1.

<sup>6</sup> T. Balogh, Studies in Financial Organisation, (Cambridge, 1947), p. 7.

amalgamation and the opening of new branches<sup>7</sup>. Amalgamation allowed provincial banks to obtain a place in the Clearing House by absorbing a London bank which was already a member (as Midland and Lloyds did) and private banks to join forces against joint-stock ones (as in the case of Barclays). By 1912 the number of banks in England and Wales had been reduced to 57 and amalgamation started embracing larger banks after the number of small local banks had become negligible. The process of amalgamation is well represented by the case of the Midland bank. Between 1913 and 1918 it amalgamated the Sheffield and Hallamshire, the Lincoln and Lindsey, the Metropolitan Bank and the London Joint Stock Bank, thus becoming the largest bank in the world<sup>8</sup>.

Amalgamation between large banks created concerns about a strong money trust and of monopolistic behaviour. This danger prompted the creation by the Treasury of a Committee on Bank Amalgamation in 1918. The report of the Committee pointed out the various advantages of establishing large commercial banks. Economies of scale could be gained, risk could be spread and, most importantly, the conclusion was reached that:

"...large banks are better for traders, and particularly for large traders, than small banks because, with their large resources, they can safely make individual advances on a more generous scale. And ... banks must keep pace with the growth in size of business houses ... to enable them to deal with the demands of the after-the-war trade both at home and abroad"<sup>9</sup>.

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<sup>7</sup> The number of branches increased from 1195 in 1858 to 2113 in 1881 and 5797 by the end of 1913.

<sup>8</sup> Collins, Money and banking, p. 207. For further information on the merger movement see: F. Capie, G. Rodrick-Bali, 'Concentration in British banking 1830-1920', Business History, 24 (1984).

<sup>9</sup> PP 1918, Report of the Treasury Committee on Bank Amalgamation, Cmd 9052, point 6b.

Nonetheless the Committee agreed that the amalgamation of large banks would create a cartel that was undesirable both from a political and financial point of view. Thus the Committee recommended that all further amalgamation should be made dependent on the joint approval of the Treasury and the Board of Trade<sup>10</sup>. This recommendation was never turned into practice but was replaced by a private understanding between the banks and the government which allowed the continued absorption of small banks but did not permit the merging of any of the larger banks. In fact mergers were restricted to banks whose geographical coverage did not overlap<sup>11</sup>. After 1918 the five larger banks (Midland, Barclays, Lloyds, Westminster and National Provincial) continued their expansion through the amalgamation of a number of provincial banks, especially in Lancashire, Scotland and Ireland. By 1922 the number of banks had been reduced to 26 (10 joint-stock, 15 private and the Bank of England).

The events following the report of the Treasury's Committee on Bank Amalgamation could be plausibly interpreted as an agreement between bankers and the government in which the large banks, in exchange of the promise not to amalgamate among each other, were authorised to continue the process of taking over the smaller banks without any check<sup>12</sup>. This agreement would have suited both the banks and the

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<sup>10</sup> Balogh, Studies in financial organisation, p.10.

<sup>11</sup> P.L. Cottrell, B.L. Anderson (eds.), Money and Banking in England, (Vancouver, 1974), p. 316.

<sup>12</sup> Of the 12 members of the Committee, 6 were bankers, including Sir Richard Vassar-Smith, at the time chairman of Lloyds and President of the FBI, Sir John Purcell, chairman of the National Bank and Captain Keswick, chairman of the Directors of the HongKong and Shanghai Banking Corporation and, of course, Lord Cunliffe, the Governor of the Bank of England. The Committee interviewed 22 people, businessmen, economists (including Sidney Webb) the chairman of the Stock

government as it was clearly felt that for industry, and consequently banking, the way forward rested in large scale, while postponing the threat of the creation of a complete monopoly. Nevertheless, since the second half of the nineteenth century, the London Clearing Banks had already been operating, what was in effect a price cartel. The London Clearing Banks Committee fixed the rate on deposits in relation to Bank Rate, while they had a tacit agreement on advances and the poaching of customers, thus effectively abolishing competition. Collusion between the banks, the government and the Treasury to restrict competition has been explained on the grounds that the Treasury and the Bank of England would have found it easier to use interest rate policy if they had to deal only with a small number of cartelized banks. Furthermore, in return for restricting competition the banks would willingly purchase government securities<sup>13</sup>.

In 1938 the number of banks operating in England had decreased to 17. However, this figure is misleading. In fact, the Big Five controlled most of the remaining provincial banks and shared the market with three, smaller, joint-stock banks, Martins, the District and Glyn Mills, and with the only remaining private bank, Hoare.

By 1957 there were eleven members of the Committee of London Clearing banks. Barclays, Lloyds, Midland, National Provincial and Westminster had a national network of branches while District and Martins were much smaller and concentrated

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Exchange Committee and bankers. Of the 14 bankers interviewed only two represented provincial banks, the Bank of Liverpool and the District. Thus the Committee in fact represented only the interests of the large London banks.

See, PP 1918, Report of the Treasury Committee on Bank Amalgamation, Cmd. 9052.

<sup>13</sup> B. Griffiths, 'The development of restrictive practices in the UK monetary system', Manchester School, 41 (1973).

in Northern England. Williams Deacons (a Lancashire bank) and Glyn, Mills were owned by the Royal Bank of Scotland while Coutts was owned by the National Provincial. The National Bank, predominantly an Irish bank with few branches in London and England, was the last one of the London Clearers<sup>14</sup>. In the 1960s a new spate of mergers changed this structure. In 1962 the District and the National Provincial merged and in 1968 merged with the Westminster, creating the National Westminster. The National Bank was sold to the National Commercial Bank of Scotland in 1966. In 1968 the three LCBs, National, William Deacon's and Glyn, Mills came under common ownership, following the merger of the National Commercial and Royal Bank of Scotland. In 1969 the three LCBs were combined to form the new Williams and Glyns<sup>15</sup>. Barclays and Martins merged in 1968 after the Monopolies Commission had refused permission for a planned merger between Barclays, Martins and Lloyds. The Monopolies Commission refused the proposed larger merger because it was thought that the suggested benefits to the public interest would be little more than marginal and would be offset by the risk arising from the reduction in the number of sources of finance for medium-sized and small businesses, particularly as far as the fast-growing, innovating companies were concerned<sup>16</sup>. The Commission was also not convinced that there existed enough evidence to claim that there were economies of scale in British banking. Nevertheless no objection was raised

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<sup>14</sup> Collins, Money and banking, p. 398.

<sup>15</sup> Ibidem, p. 400.

<sup>16</sup> Monopolies Commission, Barclays Bank Ltd, Lloyds Bank Ltd, and Midlands Bank Ltd: A report on the proposed merger, (London, 1968), pp. 44-63.

against the takeover of Martins, the last independent regional bank, by Barclays<sup>17</sup>.

The amalgamations of the 1960s were approved partly because it was thought, by the Prices and Incomes Board, that they could reduce costs through the closing down of surplus offices. The size of the banks affected their ability to provide effective lending facilities on the very large scale required by large national and multinational companies and it was felt that small banks could be at a disadvantage in the provision of services with a high technology content like credit cards or the introduction of computerisation<sup>18</sup>. By the time of the Wilson Committee in 1977 there were only six London clearers left: Barclays, Lloyds, Midland, National Westminster, Coutts (owned by National Westminster) and Williams and Glyn (which belonged to the National and Commercial Banking Group in which Lloyds had a 16% stake). In 1978 Barclays and National Westminster were of a comparable size, accounting for 60% of total UK clearing banks liabilities, while Lloyds and Midland together accounted for less than 40% and Williams, Glyn for under 3%<sup>19</sup>.

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<sup>17</sup> One of the reasons why Martins sold out to Barclays was because it felt the cost of computerisation was too high for its scale. See M. Ackrill and L. Hannah, Barclays Bank, forthcoming. Between 1960 and 1965 the expenditure by the banks on capital equipment doubled and rose to nearly 8 million pounds in the latter year. Most of it going into the banks' investments in computers. Total expenditure on computer hardware and software over 1958 and 1968 has been estimated as in the region of 90-100 million pounds, mostly by the Big Five. See E. Nevin, E.W. David, The London Clearing Banks, (London, 1970), p. 209.

<sup>18</sup> National Board for Prices and Incomes, Report No. 34, Bank Charges, Cmd 3292, (London, 1967), p. 53.

<sup>19</sup> Collins, Money and Banking, p. 401.

## 2. A quiet life - the best of monopoly profits?

The amalgamation process described in these pages created, during the first part of the twentieth century, an oligopolistic banking system and, as the process continued in the period after the Second World War, the absence of competition became even more marked.

This thesis argues that banking concentration made small firms suffer constraints in the supply of finance not only because of the disappearance of local sources of finance but also because of the centralised structure of the banks. In another chapter I shall discuss how internal structure influenced lending, but here I need to justify a basic assumption behind my hypothesis, i.e. the reason why British banks chose not to satisfy demand from small firms.

In 1959 the Clearing banks told the Radcliffe Committee that they "could comfortably lend more on overdraft if only they could find more credit-worthy customers"<sup>20</sup>. The Committee's view was that the banks were underlent as the total of their advances was a function of the demand by customers who could satisfy the banks' very narrow criteria of credit-worthiness<sup>21</sup>. The bankers explicitly recognised that they were often refusing loans to customers who were credit-worthy at the interest rate charged<sup>22</sup>.

It is not surprising that the banks could be so exacting in their standards as to be 'underlent'. These were the most profitable years experienced by British bankers.

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<sup>20</sup> PP 1959, Committee on the Working of the Monetary System, Report, Cmn 827, pp. 48-49.

<sup>21</sup> Ibidem, p. 49.

<sup>22</sup> J. Thompson, 'Chairman's address' in Annual statement to Barclays Bank Ltd shareholders, (London, 1963).

Barclays' rate of profit on shareholders funds in the 1950s averaged ten percentage points above the prime discount rate, the highest level ever achieved by the bank. Though by 1958 Barclays was the biggest domestic bank and probably the most profitable, the profitability of the other Big Five was also very high<sup>23</sup>.

But were the banks behaving as profit-maximisers or could they have been even more profitable? Were they just profit-satisficing by rationing loans beyond the rational level described by economic theorists<sup>24</sup>? Another indication of the underlending of the banks comes from the levels of bad debt. In the case of Barclays Bank, average bad debt written off between 1946-1962 was 0.07% of outstanding advances. The bank was explicitly taking few risks because bad debt reserves were very low: while 2.5% of advances had been set aside as bad debt and doubtful debt reserve at the end of the war, by 1959 the reserves had fallen to 0.4% of advances<sup>25</sup>. In the Midland Bank, between 1942 and 1959 net new provisions for bad debt were necessary only in three years. During the 1960s net provisions were lower than 0.5% of total advances<sup>26</sup>, nothing like the figures of around 3% annually in some years in the 1930s and 1990s. In Chapter 4 archival material from the Bank of England will show that bad debt was declared to be very low also by the other London Clearing banks. Such low levels of bad debt were not justified by macroeconomic stability, as

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<sup>23</sup> M. Ackrill, L. Hannah, Barclays Bank, forthcoming, chapter 3.

<sup>24</sup> B. Greenwald, J.E. Stiglitz, 'Information, Finance and Markets: The architecture of allocative mechanisms' in V. Zamagni (ed.), Finance and the Enterprise, (San Diego, 1993).

<sup>25</sup> Ackrill, Hannah, Barclays, p. 265.

<sup>26</sup> Data courtesy of Edwin Green, Group Archivist, Midland Bank.

these levels were lower than the incidence of bankruptcy in the economy generally<sup>27</sup>.

The banks were being extremely risk adverse and could have lent more, especially to small firms since, as Chapter 4 will show, there was unsatisfied demand coming from that sector of the economy. But small loans are costly to evaluate and administer in relation to returns, and the following chapter will show how cost was related to the structure of the banks. To lend more to small firms the banks would have had to change structure, to be able to reduce costs and change their method of risk evaluation, but their existing high profits did not induce them to change structure to enlarge their customer base. As the next chapter will show, it took the Midland Bank about ten years to change its organisational structure and decentralise, once it had realised, in 1958, that Barclays had overtaken it, in terms of deposits and advances, becoming the biggest domestic bank. Slow reaction times and a relatively short working day<sup>28</sup> compared to bankers in the 1990s or in the nineteenth century, were, after all, the best<sup>of</sup> monopoly profits<sup>29</sup>.

The above pages have described briefly the events that shaped the post-war British banking system. The banks and successive governments colluded in creating a system that allowed a few large banks to serve the needs of a growing economy. The merger movement of the nineteenth century and of the first half of the twentieth meant that the banks grew in size alongside their most important customers. The increase in

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<sup>27</sup> Hannah, Barclays, chapter 3.

<sup>28</sup> Senior bankers were expected to work only from 9.30am to 4.00pm. See D.R. Pelly, Loose change, (London 1992), p. 17.

<sup>29</sup> J.R. Hicks, 'Annual survey of economic theory: The theory of monopoly', Econometrica, 3 (1935), p. 8.

the size of manufacturing, commerce and service businesses together with the increase in the size of the banks through amalgamation, brought about the disappearance of the local, provincial banks whilst the creation of a cartel of few, large banks was strongly favoured by successive governments as it allowed easier control of the monetary system. In exchange for concentrating market power in the hands of a few banks these agreed to be used as monetary tools (for instance, the fact that LCBs always altered their interest rates in line with official rates simplified the authorities' control over short-term market rates). In return the clearers were able to suppress price competition and, even after 1948, were exempted from having to disclose their true profit position to the public as other public companies had to.

The section on the Italian banking system will show the extent of the control exercised over the banks by the government and by the central bank and the active role of these institutions in shaping the banks' market by imposing limitations on geographical expansion and by creating strong barriers to entry. Such high levels of intervention were consistent with a vision of economic development in which the banks played a very important role. Though government intervention took a different shape in Britain, based as it was more on the 'governor's eyebrows' than on legislation, in both countries banking was shaped also by a perception that economic development would be better served by a specific structure, concentrated in the case of the United Kingdom and segmented in the case of Italy.

In Britain over the course of time even government officials started suspecting that the stifling of price competition and the pursuing of customers through the duplication of branches might have created a fundamentally inefficient system. In 1968

the Monopolies Commission investigating the proposed merger between Barclays, Lloyds and Martins, remarked that the price fixing arrangements had: "such a soporific effect on the banks that, so long as they exist[ed], no foreseeable change in the structure of the clearing bank system could greatly increase the degree of competition in it"<sup>30</sup>. Greater competition was facilitated in 1971 by Edward Heath's Conservative government's policy of "Competition and Credit Control". The London and Scottish clearers lost the right to collude on interest rates and the banks were urged to compete more among themselves and with other financial institutions.

The impact on lending to small firms of a concentrated and London-centric banking structure will be analysed in the following chapters. In the section that follows the existence of other sources of finance available to small firms in the provinces will be assessed.

### 3. Other sources of finance

This section, dedicated to non-bank sources of finance at a local level, uses Report No. 4 on 'Financial facilities for small firms' of the Committee of Inquiry on Small Firms, also known as the Bolton Committee, published in 1971. This was the first government-sponsored committee set up to concentrate exclusively on the problems of small firms and much of the data produced by the report cover the period concerned with in this research, thus providing an authoritative stepping stone for this section.

The main reason for starting this section with Report no. 4 is that it confirms

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<sup>30</sup> Monopolies Commission, Report on proposed merger between Barclays Bank, Lloyds Bank and Martins Bank, 1968, p.46

that the main barrier to the supply of finance to small firms was transaction costs, as hypothesised in Chapter 1 of this thesis. Though the report identified the problem, it did not suggest how transaction costs could be reduced even though its analysis clearly pointed in the direction of a reduction of information asymmetries. As argued in Chapter 1, this thesis maintains that information asymmetries can be reduced at a local level and, therefore, the existence of local sources of finance available to small firms and alternative to banks, has to be explored; this is done by concentrating on the Midlands. In the following pages it will be established not only that local sources of finance were scarce, albeit non-existent, but also that small firms had really no alternative to the commercial banks.

In 1971 the findings of the Committee of Inquiry on Small Firms were published. The Committee had been appointed in 1969 by Anthony Crosland, the then President of the Board of Trade, to study the problems confronting small firms. The Committee was to examine, in particular, the profitability of small firms, the availability of finance and their role as innovators and suppliers of specialised products. The decision to set up the Committee was influenced probably by short term considerations, as 1969 had been a difficult year for business and for small firms in particular and this started pressures for investigating the environment in which small firms operated. Nevertheless the major purpose of the enquiry was a long-term one; the collection of information on the place of small firms in a modern economy which would form a basis for recommendations about further policy on them<sup>31</sup>.

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<sup>31</sup> PP 1971, Report of the Committee of Inquiry on Small Firms, Cmd 4811. From now on Bolton Committee.

A number of sectoral reports, both on manufacturing and services, were commissioned from independent bodies. One of these reports was commissioned from the Economist Advisory Group, EAG, and it dealt with the problem of financial facilities available to small firms, with the aim of discovering whether small firms were at a disadvantage relative to large ones, in terms of an institutional gap in the provision of finance<sup>32</sup>. The main source of information used by the Economist Advisory Group was a number of interviews, about 84<sup>33</sup>, with members of various financial institutions<sup>34</sup>.

The conclusion reached by EAG in the report was that the existing structure of the market for finance presented no major defect in the supply of financial facilities for small firms but there were some other general problems which affected small firms and their ability to access finance. The report revealed how small firms were hit harder by credit restrictions and taxation; how the transaction costs connected with the gathering of information about the creditworthiness of a small firms were proportionately higher than for large firms; small firms suffered also from an information gap as they were less well informed about alternative sources of finance, furthermore small firms were less able to satisfy the requirements of lending

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<sup>32</sup> Bolton Committee, 'Financial Facilities for Small Firms', Research Reports, Report No. 4.

<sup>33</sup> The number is reported as approximate because the report itself is vague in this respect.

<sup>34</sup> These were: Clearing banks; merchant banks; overseas banks operating in the United Kingdom; discount houses; finance houses; insurance companies; pension funds; stockbrokers; firms specialising in leasing, factoring and export finance; building societies; firms specialising in medium and long term finance, like the Industrial and Commercial Finance Corporation; firms specialising in finance for technical innovation, including the National and Research Development Council.

institutions as regards financial information and managerial competence. On the basis of these findings the report suggested that a central agency be set up to help with the financial education of managers and in the dissemination of information about sources of finance. This agency was to be run either directly by the government or by an agency heavily supported by tax subsidies. The Report concluded that if the British capital market was not perfect, it was only so as far as information and transaction costs were concerned. The EAG felt that information asymmetry could not be corrected through direct action by the banks as, if financial institutions were to target their publicity to small firms in order to increase the amount of information available to them, the cost of finance would increase. One way to improve the flow of information, without increasing costs, was through the establishment of this independent government body or agency as described above<sup>35</sup>.

Concerning the other source of market imperfection, transaction costs, these were higher for small firms as the cost of investigation and administration incurred by lenders varied inversely with the size of the loan. The Committee considered that the existence of higher transaction costs for small firms was a "fact of life" and, as such, could not be reduced. At the same time it realised that scarce knowledge about the affairs of small firms could lead to the possibility of an incorrect assessment of risk and of interest rates not reflecting real risk<sup>36</sup>.

The Bolton Committee confirmed quite clearly that transaction costs constituted one of the main problems encountered by small firms vis-a-vis their relationship with lenders, but it nevertheless accepted that nothing could be done to reduce them.

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<sup>35</sup> Bolton Committee, Report No. 4, p.73. The emphasis is not in the original.

<sup>36</sup> Bolton Committee, Report No. 4, p.69.

Furthermore the issue of finance was shelved when the report by the EAG stressed that it had not found any evidence that availability of funds to small firms was restricted nor that there were any barriers, such as the existence of legal restrictions, to the free flow of capital.

Nevertheless a careful reading of the appendix to Report No.4 reveals that the claim that the problems of small firms could not result from imperfections in the supply of finance since "the ability and readiness of the financial institutions to exploit every new legitimate demand for funds is one of the greatest strengths of our financial system"<sup>37</sup> was a rather empty claim. The next pages will describe how high administrative costs and plain lack of interest prevented most financial institutions from considering the financing of small firms as part of their business. The reason for this lack of enthusiasm was the "fact of life" small firms had to live with: high transaction costs.

The first group of institutions to be analysed was that of the clearing banks. Neither the questionnaires nor the interviews reveals the amount the banks allocated to small firms. The banks, though, did admit to two things when asked if they thought that there was a financial gap. The first one was that the credit restrictions were affecting small firms negatively, as large firms pre-empted all available resources<sup>38</sup>. Most importantly the banks also admitted that they believed that it was uneconomic to handle small amounts (less than 20,000 pounds) as the administrative and other transactions costs were too high. Furthermore the banks were not interested in lending money for capital investments, especially to new ventures, as they felt that there were

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<sup>37</sup> Bolton Committee, Report No. 4, p.192.

<sup>38</sup> Bolton Committee, Report No. 4, pp. 88-89.

other institutions better suited to engage in this type of business, like the Industrial and Commerce Finance Corporation, ICFC<sup>39</sup>.

Concerning the provision of information about sources of finance to small firms, the report reveals that the analysts were satisfied that bank managers were an adequate source of advice, though it was also pointed out that as financial institutions became more complex bank managers often lacked full information. The interviewers also learned that small firms tended to be mistrustful of non-bank financial institutions. Much was made in the report of the fact that local branch managers could use their knowledge of businesses to acquire information about customers and use their discretionary powers to make loans, which would be continuously rolled over, on the strength of this information. Nonetheless the analysis did not fail to point out that the quality of service and the availability of finance depended on the managers' own ability, expertise and ambition and on how rigidly they interpreted their bank's role as a provider of short term finance: within the organisational structure of the banks no provision was made to take advantage of the local knowledge held by bank managers. Thus the conclusion we can draw from the findings of the Report is that as far as banks were concerned the availability of finance was curtailed by the credit restrictions<sup>40</sup> and by transaction costs. These could be reduced locally but only thanks

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<sup>39</sup> Bolton Committee, Report No. 4, p. 92.

<sup>40</sup> Ten years earlier the Radcliffe Committee had reached very similar conclusions to those presented by Bolton except that it placed more emphasis on the fact that the credit restrictions had made small firms mistrustful of the banks as overdrafts were reduced or recalled. The Committee recommended that banks reassure small firms of their intentions and of their support to regain their trust. The Committee also recommended the creation of term loans, where a fixed sum would be lent for a fixed period of time and at a fixed rate of interest. How effective these recommendations were will be evaluated in Chapter 5. See, PP 1959, Committee on the working of the monetary system, Report, Cmn 827, pp. 325-326.

to enterprising local bank managers.

Apart from banks and overdrafts the other source of short term credit was the Discount Houses through bill finance and factoring. In practice, though, the total amount of finance provided by the discount market to small firms was very small, less than 10 million pounds in 1970. The limited use of bill financing by small firms was due to the application of a minimum size criteria. Some houses stated categorically that they dealt only with much larger firms and only four of the twelve discount houses provided, to a limited extent, and only on bills larger than £1,000, discount facilities to small firms. Factoring is, and was, an expensive facility and small firms were discriminated against by the discounting firms on the grounds of cost and security<sup>41</sup>.

Medium term finance was provided by the Finance Houses. In 1960 fifteen companies were members of the Finance Houses Association (twenty two in 1968) and many more were not. The size of the companies ranged from the very large, like the United Dominion Trust or the Charterhouse Credit Company Ltd, to the very small, usually located in provincial towns. Most of the hire purchase business was controlled by nine Finance Houses and of these United Dominion Trust, Lombard Banking and Lloyds and Scottish Finance accounted for sixty-four per cent of total lending outstanding by the end of 1969. The business of the Finance Houses was mainly instalment credit for consumer durables and the key area of business was the motor car. In 1959, financing for the purchase of motor vehicles accounted for three quarters

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<sup>41</sup> Bolton Committee, Report No. 4, pp.163-166.

of the hire purchase business of the Finance Houses<sup>42</sup>. Financing plant and machinery did not bring as high returns as the other activities and was also expensive in management time whilst in the case of default and repossession the machinery was often too specialised to be re-used. These considerations meant that by 1958 the plant and machinery new business of one of the finance houses, Mercantile Credit Co. Ltd, was only 3% of the total annual intake of business. In 1961 the company's new business financed amounted to a total of £76 million pounds, of which 74% was for motor vehicles and only 7% was for plant and machinery<sup>43</sup>. Table 2.1 confirms that though the Finance Houses did lend to businesses for plant and machinery this was only a small share of their total financing.

Table 2.1 Analysis of instalment debt by commodity groups: 1957-1959 (£ million)

	Dec. 1957	Dec. 1958	Dec. 1959
Private and commercial motor vehicles	198	257	395
Household goods	221	262	402
Farm and industrial equipment	21	26	37
Other goods	9	14	23
Total	448	559	857*

\* Of this total, the Board of Trade estimated that about £700 million was owed by consumers, the remainder being owed by businesses.

Source: R. Harris, M. Naylor, A. Seldon, Hire purchase in a free society, (London, 1961), Table 16, p. 105.

<sup>42</sup> Data from previously unused records of the Finance Houses was kindly provided by Sue Bowden in 'Collusion and competition in the finance sector in the post-war period', unpublished paper, December 1995.

<sup>43</sup> M. Wood, Have a nice weekend. The story of Mercantile Credit Co. Ltd, (London, 1986), p. 44 and p. 112.

In theory any small firm could purchase an asset through some form of instalment credit. In practice, as Finance Houses found it extremely costly to repossess assets, they either charged small firms high rates or did not lend at all if they were in doubt about the creditworthiness of the firm. Furthermore the procedure for granting instalment credit ruled out the possibility of a firm using it as venture capital, as the application form required three year accounts. Creditworthiness was measured in terms of the ability to keep up repayments, making earnings the only valid criteria for evaluating a firm and this ruled out new firms.

When asked if they had any bias against small firms, the Finance Houses interviewed replied in the same way as the other institutions. The cost per pound lent was lower for large loans because small firms took longer to analyse as their accounts were usually very bad<sup>44</sup>.

A study done by the Institute of Statistics of the University of Oxford in 1957 on the use of hire purchase by small firms between 1950 and 1955 confirmed that small manufacturing business accounted for only 2-3 per cent of total hire purchase business and in general plant and equipment accounted for only about 7 per cent of total finance houses business. The reason given for the small share of hire purchase by small firms was that these tended to have small requirements for extensions and purchase of new machinery and the high cost of hire purchase meant that small firms would, if they could, rather use their bank's overdraft facility<sup>45</sup>.

Nonetheless Finance Houses devoted a considerable amount of resources to

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<sup>44</sup> Bolton Committee, Report No. 4, p. 170.

<sup>45</sup> J.A. Bates, 'Hire Purchase in Small Manufacturing Business', The Bankers' Magazine, no. 1362, (1957), pp. 278-279.

marketing and had branches in many large towns. Their branch representatives were trained salesmen and it was their job to find potential customers. This meant that, as far as information and local presence go, small firms should not have been at a disadvantage. The study done of the financial facilities available in Manchester confirmed that, apart from the commercial banks, Finance Houses seemed to have played the largest part in financing small firms, though mainly for the purchase of motor vehicles<sup>46</sup>.

How would a small firm in the Midlands have gone about finding a finance house in the 1950s? The literature on Finance Houses in the post war period is scant and the Finance Houses Association did not have a publication until 1960. Therefore the real extent of advertising, of 'door-to-door' sales is hard to assess, especially at a regional level. Nor is it possible to establish which companies had branches in provincial towns, except in a rather tentative way. A local businessman would have probably asked his bank manager if he knew of any alternative source of finance. Failing that source of information he could have used the Chamber of Commerce Directory, the telephone directory or asked his friends.

The Birmingham Chamber of Commerce Directory for 1951 had only one entry remotely connected to finance and that was "Investment Companies" and this entry had only two listings, both for mortgage finance companies. The trade directory for 1959 also had only one entry connected to finance for industry and that was "Industrial Bankers" and it only listed Forward Trust Ltd, United Dominion Trust Ltd and ICFC.

The Classified Telephone Directory (Trade and Professions) for Birmingham and the West Midlands for 1955 had an entry for "Finance Companies" with a list of

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<sup>46</sup> Bolton Committee, Report No. 4, p. 223.

fifteen companies but of the large finance houses only Charterhouse was listed. The telephone directory for 1964 listed forty companies under the entry "Finance Companies" but again of the large finance houses only Charterhouse was advertised, though the list included companies with suggestive names such as Personal Loan Without Guarantors Ltd.

The absence of a body of literature relating to the role played locally by Finance Houses makes it difficult to establish how relevant they were to provincial small firms. However, the evidence presented in these pages allows the assumption that even the local, small Finance Houses concentrated mainly on domestic credit, making them unlikely providers of finance to small firms for the purchase of machinery. Finance Houses did provide capital to small firms but we cannot think of them as a viable alternative to banks. Lending to small firms for the purchase of machinery was not an important part of their business and not many small firms used hire purchase other than to buy motor vehicles.

The two most important sources of long term finance, insurance companies and pension funds, did not invest their money in small firms because the cost and administrative problems of negotiating small investments and of managing an investment portfolio comprised of a large number of small holdings would have been too high. Small firms were also felt to be riskier because the credit restrictions put a strain on their liquidity as the larger firms they supplied delayed their payments. Furthermore, neither institution believed that small firms were a good investment, as this type of firm was seen as failing in the long term because the general economic conditions were against them and because of bad management<sup>47</sup>. Neither the

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<sup>47</sup> Bolton Committee, Report No. 4, pp. 104-106 and pp. 124-126.

insurance companies nor the pension funds, were the right type of institution for investing in venture capital, as they clearly did not really believe in the prospects of small firms. Overall both institutions did not invest more than 1 percent of their total funds in small firms, including whatever equity capital they held, and mortgage loans, in the case of insurance companies<sup>48</sup>.

Other institutions like the Merchant Banks, the Stock Exchange and the Overseas Banks operating in Britain proved, on inspection, to be of marginal importance to small firms. Merchant banks, though a few were provided with branches in the main provincial cities by the end of the 1960s, were not interested in loans of less than £150,000 and were prevented from doing business with small customers by the smallness of returns. Merchant banks provided some 'nursery finance' to firms in the period prior to going public and usually put one of their own staff on the board to police the firm's management. However, nor small firm benefited from this service<sup>49</sup>. In fact, though merchant banks did a fair amount of advertising, they did not make any special appeal to small firms as they were not particularly interested in this type of business<sup>50</sup>. The Merchant Banks, when asked about the possible existence of a financial gap, excluded the possibility on the strength of the fact that they received so few applications from small firms<sup>51</sup>.

The Economist Advisory Group estimated that only about 1 percent of small firms had a quotation on the stock exchange. The Group's conclusion was that the

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<sup>48</sup> Bolton Committee, Report No. 4, p. 108 and p. 129.

<sup>49</sup> Bolton Committee, Report No. 4, p. 139.

<sup>50</sup> Bolton Committee, Report No. 4, p. 140.

<sup>51</sup> Bolton Committee, Report No. 4, p. 141.

stock exchange was not the right place for small firms since institutional investors, such as insurance companies, pension funds, etc, found it more convenient to deal in securities of a limited number of large firms. A large number of small firms with quotations would not bring much profitable business to brokers as deals would tend to be small and infrequent, bringing small returns and being costly to execute. There is also the fact of the big overhead element in administrative and marketing expenses of a new issue, about £20,000-25,000 for a small firm.

Overseas banks tended to by-pass the small firms as they were more interested in multinational and large scale businesses. Also, they did not have the widespread branch facilities, the Clearing Banks had, to allow them to become household names and gain the trust of provincial customers. Furthermore the overseas banks felt that as credit restrictions were limiting their availability of loanable funds, these should go to large firms, particularly at the time when business in general was becoming more internationalised<sup>52</sup>. Though the overseas banks did not establish branches in the Midlands until the second half of the 1960s and the beginning of the 1970s<sup>53</sup> it is interesting to note that the reason given for opening branches in the provinces was that local branches could provide knowledge and were instrumental in building up relationships that could bring the bank more clients. This was still thought to be a competitive advantage in 1972 when Birmingham was only a ninety minutes train ride away from London<sup>54</sup>.

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<sup>52</sup> Bolton Committee, Report No. 4, p. 174.

<sup>53</sup> The Bank of America opened a branch in Birmingham in 1967 and American Express in 1972. See: I.I. Thomas, Expansion of U.S.Banks from London to the regions, PhD Thesis, (University of Wales, 1976), p. 227.

<sup>54</sup> Thomas, Expansion, p. 231.

Summing up, except for the Clearing Banks and the Finance Houses, the other financial institutions, though part of the vast and complex British financial market which should have ensured the impossibility of a financial gap, cannot in fact be considered as relevant when discussing the problem of supplying finance to small firms, as their dealings with this sector of the market were very limited.

Apart from the institutions described in the preceding pages, the report of the Economist Advisory Group also covered the activity of those institutions whose purpose was to finance new ventures. In 1969 the largest of these institutions was ICFC, which in that year transacted loans totalling £29 million pounds and processed 250 applications. The other eight venture capital companies in total transacted £5 million pounds and processed 50 applications. Furthermore the only one of these institutions to deal with really small firms, granting loans for as little as £5,000, was ICFC.

From its inception in 1945, one of the long-term goals of ICFC had been that of opening regional offices and the first provincial branch to open was in Birmingham, in 1950. Birmingham was chosen because it had been noticed that the Corporation was receiving fewer applications from the Midlands, and it was suggested that the reason might be the reluctance of businessmen to go to London to find finance<sup>55</sup>. Eventually the Midlands was to be the second most successful region, preceded by London, accounting for 11 per cent of total investment in 1951 and 16 per cent in 1961<sup>56</sup>.

According to Coopey and Clarke, the success of the Birmingham branch was due to the fact that Ernest Ralph, the branch manager in charge, was able to establish

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<sup>55</sup> R. Coopey, D. Clarke, 3i: Fifty years investing in industry, (Oxford, 1995).

<sup>56</sup> Figures kindly provided by Richard Coopey.

a network of local contacts, thanks to his connections with accountants and local bank managers. Through these Ralph was able to access the social and business circles of the region. The contacts established brought business for the Corporation and proved essential in providing informal references. One of Ralph's reports to head office outlines the workings of the network:

"The business and professional communities are closely knit within themselves. A great many of the men here were at school together and were brought up within a few miles of each other. They know each other's strengths and weaknesses, and with due discrimination on our part are a source of useful and sometimes valuable information"<sup>57</sup>.

Table 2.2  
ICFC - Midland region: Number of investments  
(total outstanding)

Year	Number	Year	Number
1954	58	1962	128
1955	60	1963	121
1956	72	1964	114
1957	82	1965	128
1958	94	1966	148
1959	98	1967	182
1960	105	1968	186
1961	111	1969	205

Source: Data extrapolated<sup>58</sup> from data kindly provided by Richard Coopey

The table shows the number of investments outstanding for each year made by ICFC in the Midland region, between 1954 and 1969, ranging from mechanical engineering to services.

<sup>57</sup> Coopey, Clarke, 3i, p. 42.

<sup>58</sup> Richard Coopey supplied data on amounts lent in the Midlands, in the whole country and data on the total number of loans granted nationally. The numbers I present in the table are an estimate based on the assumption that the % of loans granted in the Midlands in terms of numbers was the same % as for the money lent.

It's difficult to say if these numbers are high or not. They are low compared to the total number of small firms in the manufacturing sector in the Midlands in these years, but might reflect a low level of promising ventures in the area or the limits of Mr. Ralph's network, or extreme cautiousness on part of ICFC. The activity of ICFC at a local level can be compared with that of the Mediocreto Piemontese, presented in Chapter 8. Possibly because of its institutional role as a regional investor the Mediocreto granted loans to a larger proportion of small firms within the area it covered.

### Conclusion

In its analysis of the possible existence of a financial gap the Bolton report did not question the structure of the financial market, as it was taken for granted that the large number, and variety, of institutions guaranteed availability. By reasoning in purely abstract economic terms, the Committee considered that if there had been demand from small firms, this would have been satisfied, albeit at a higher cost for the firms. This reasoning did not allow for the possibility that in a seller's market, as it was at the time, made up of extremely risk-adverse actors, faulty information and high transaction costs would prove to be a disincentive to invest in small firms and not simply increase the cost of finance.

Transaction costs were disregarded as a "fact of life", whereas they were the one crucial element that prevented most institutions from considering small firms. No suggestion was made to identify a possible institution that might have been able to enter transactions with a small firm at a lower cost. The following chapters will establish that demand for bank loans from small firms existed but it was not being

satisfied because the structure of the commercial banks did not allow a reduction of transaction costs.

## Chapter Three

### The structure of the banks

As presented in Chapter 1, the other prong of the hypothesis this research wants to test is whether the centralised internal structure of the banks had a negative effect on bank lending to small firms. This chapter, based on archival material, shows how Midland, Lloyds and Barclays organised their internal structure and how these structures influenced the way information about customers was collected and processed. More specifically it will be shown how the banks organised their relationship with the provinces, in this case the Midlands.

This chapter will first define the different boundaries of the 'Midlands' in terms of the administrative unit considered by the banks. Then the internal structure of the banks will be presented, considering how the communication from the periphery (the branches) to the centre (Head Office) was organised both in specific terms (eg. the administration of advances), and, in more general ones (the information about the economy of the region).

#### 1. The Midlands

The map included in the text (Figure 3.1) shows the boundaries of the Midlands as conceived by the three banks at the beginning of the 1950s. The banks defined this region differently, both in extent and name. It was called 'Midlands Division' at the Midland Bank, and 'Birmingham District' both by Barclays and Lloyds. In 1950



Figure 3.1 Boundaries of the Midlands as defined by Barclays, Lloyds and the Midland, c. 1950.

Midland Bank had 163 branches in this division<sup>1</sup>, Lloyds 114 (figure for 1948)<sup>2</sup>, and Barclays 91<sup>3</sup>. In 1968 the boundaries had not changed greatly but the number of branches had increased. Midland's had grown to 209, Lloyds' to 174<sup>4</sup> and Barclays' to 151<sup>5</sup>. The difference between the three banks' 'Midlands' does not rest only in the number of branches held in this district/division but also in its geographical boundaries.

Figure 3.1 shows how Barclays and Lloyds adhered most closely to the normally defined boundaries of the region, while the Midland Bank had a more amorphous region, including areas not belonging to the traditional Midland industrial district, like Oxford and Windsor. This meant that the Midland Bank did not conceive its districts on the basis of a more or less conscious perception of the existence of a local identity that had to be preserved and reflected by the structure (as Barclays and Lloyds seem to have done), but instead merely as an administrative collection of branches. Lloyds and Barclays also segmented the country more intensively, since, by 1950, Lloyds had formed 10 districts (which had become 16 in 1968) and by 1947

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<sup>1</sup> Midland Bank Archive (hereafter MBA), Booklet for internal use with list of branches divided by division. Courtesy of the Group Archivist.

<sup>2</sup> Lloyds Bank Archive (hereafter LBA), Regional Offices, Birmingham, Record sheets submitted by the branches to Birmingham District Office, 1946-1949. Acc. no. RO/B 4235.

<sup>3</sup> Barclays Bank Archive (hereafter BBA), Inspection of Birmingham District Advances, 1950. Acc. no. 80/1883.

<sup>4</sup> LBA, Regional Offices, Birmingham, Record Sheets submitted by the branches to Birmingham District Office, 1968. Acc. no. RO/B 4238.

<sup>5</sup> A.W. Tuke, R.J.H. Gillman, Barclays Bank Ltd 1926-1969, (Oxford, 1972), Appendix VI. Nationally the figure had increased from: 2044 to 2712 for Midland, from 1798 to 2260 for Lloyds and from 2009 to 2610 for Barclays.

Barclays had 32 (31 in 1968), whereas Midland maintained all through this period just five broad divisions.

This difference in the banks' concept of 'region' may have been due to a precise strategy or simply to the historical development of their structures. To resolve this point the following pages will show how the structure of the banks evolved through time.

## 2. The structure of the banks

By the beginning of the twentieth century all three banks were firmly established as London banks but were organised with different degrees of centralisation.

The more centralised the structure, the higher the number of applications for advances that had to be processed by the centre. To contain costs, information had to be formalised in standardised and manageable formats. It is argued here that centralisation had a negative effect on small firms, as the personal knowledge of local managers was nullified as the Head Office decision to grant an advance or not had to be based on standardised requirements, with no reference to the regional economic context. Denying small firms their context made it more difficult for the banks to assess the firms' ability and competitiveness, thus reducing their chances of being granted a loan. Therefore centralisation meant that small firms were considered by the bank solely within the limits of the standardisation imposed by cost containment. To reduce information asymmetries the knowledge of the local bank manager would have had to be taken into account, involving the processing of more information (therefore increasing cost) and creating the problem of control: in a situation where the local bank manager has more information than Head Office, Head Office must either believe

that the bank manager shares the same goal (to minimise the risk of default) or it must create a system of controls (rewards and punishment) to avoid the bank manager taking undue risks<sup>6</sup>.

In the following pages it will be shown how, by chance and/or strategy, the three banks dealt with the relationship between principal (Head Office) and agent (local bank manager) creating organizations that though similar in appearance were, in fact, quite different, due to the differences in how information flowed and in the location of decision-making points. These differences influenced the banks' cost functions when dealing with small firms and in the following chapters it will be shown how this shaped the banks' pattern of lending.

## 2.1 The Midland Bank

The Midland Bank was established in 1836 in Birmingham with the name Birmingham and Midland Bank, and like the other provincial banks of the time, its business was firmly rooted in the local economy<sup>7</sup>. After expanding in the Midlands and Yorkshire through the amalgamation with other banks and the opening of branches, the bank moved its headquarters to London in 1891, following its main local competitors, Lloyds and the Birmingham Banking Company. This move was dictated by various reasons, but the main one was probably the fear of saturation of the Birmingham

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<sup>6</sup> N. Strong, M. Waterson, 'Principles, Agents and Information', in R. Clarke, T. McGuiness (eds.), The economics of the firm, (Oxford, 1987), pp. 18-41.

<sup>7</sup> This localism was reflected in the composition of the board of directors. The first board was made of Birmingham-based businessmen and subsequently the qualifications for directorship demanded that the directors should live within six miles of Birmingham Town Hall. This custom was maintained until the bank's Head Office was moved to London. See A.R. Holmes, E. Green, Midland 150 years of banking business, (London, 1986), p. 16.

market (it had more banks per head of population than London), and the attractiveness of the London money market. In fact, by the end of 1889, Midland's lending at call and short notice to London discount houses and stockbrokers (lending which carried a higher rate of interest than any other type of investment), amounted to 6.1 per cent of its total assets<sup>8</sup>. By the end of the nineteenth century Midland was firmly established as a London bank with a strongly centralised structure, with the main board of directors based in London.

Through subsequent amalgamations with other banks, the expansion of the Midland Bank followed the same pattern as that of its competitors. But, whereas other banks, like Barclays, created local boards of directors following the amalgamations, Midland would select individual directors and recruit them to the main board while the general managers of the country banks which had been taken over would usually remain as local branch managers. A few "advisory boards" located at the old head offices of the constituent banks were created following the take-overs, but these had little relevance, all disappearing a few months after amalgamation. This structure was thought to be the one that would eliminate all differences between the various amalgamated banks and quickly create a homogeneous 'Midland Bank'. This structure did not change in its basic conception of strong centralisation until the end of the 1960s.

At the beginning of the century Midland was well established as a London bank and, apart from the board of directors, the directing core of the bank was constituted by one managing director and three Joint General Managers. The branches

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<sup>8</sup> Holmes, Green, Midlan., p.81.

were grouped in divisions each one allocated to a Joint General Manager<sup>9</sup>. The Joint General Managers were assisted by branch superintendents and inspectors.

Apart from the local branch managers, all other managerial functions were based in London. Information about the economic conditions of the regions flowed from the branch managers in the form of reports to the Intelligence Department in London and from this department to the Management Committee. These reports were then used to comment on the changes in deposits and advances occurring in each Division. Though information came from the provinces, the top management considered that all relevant knowledge was held by the centre and dispensed from the centre to the periphery as the:

"Joint General Managers and their Assistants [visited] their branches from time to time and [attended] meetings of branch managers, at which policy [could] be explained, while branch managers [went] to Head Office to discuss their individual problems and to obtain guidance from senior officials"<sup>10</sup>.

Thus, though the information concerning the economic conditions of the places from which the business of the bank was generated came from the periphery, all policy decisions emanated from the centre.

In 1929 an Executive Committee was formed (later known as the Management Committee). This committee was attended by the Chief General Managers and the Joint General Managers, it met daily, and dominated the routine domestic business of the bank with the branches linked to the committee in a structure that offered them little autonomy. This situation continued until 1960.

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<sup>9</sup> At the time the districts were: London, Lancashire, Midlands, Southern and Yorkshire.

<sup>10</sup> H. Rouse, 'Midland Bank Ltd', in G.E. Milward, Large scale organisations, (London, 1950), p. 194.

Decisions about the business of the bank were also centralised. Each application (regardless of size) for a loan or overdraft was examined by the manager of the branch and then sent to London to the branch superintendent for the area in which the branch was located. If the amount of the advance was above the superintendent's limit then the advance was passed on to the General Manager's Assistant or further up depending on the amount, to the Assistant General Managers or the Joint General Manager in charge of the section from which the application had come<sup>11</sup>.

By the end of the 1950s the Midland Bank started losing its position of preeminence among the London clearing banks as Barclays Bank overtook it in terms of advances<sup>12</sup>. Among the senior management it was recognised that one of the reasons behind the loss of preeminence lay in the subjugation of the branches to head office, while the success of Barclays Bank was attributed also to its strong semi-autonomous regional boards and their capacity for attracting local businesses. Therefore, in 1957, a number of area managers were appointed, and sent to the provinces, to act as personal representatives of the General Managers in their divisions. These representatives had no executive powers but merely formed a new link in the communication chain between the branches and London. Nevertheless, only ten years

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<sup>11</sup> In 1950 England and Wales were divided in five sections (also known as divisions), each under the control of a joint general manager. These divisions were: City of London and Overseas Branch; rest of London and suburbs; northern counties; Midlands and eastern counties, southern counties and Wales. See Rouse, 'Midland Bank', p.182.

H.L. Rouse became one of the two chief general managers of the bank in 1948.

<sup>12</sup> In 1959, Barclays Annual Report shows for the first time that the bank had higher advances than the Midland Bank. The dates for profits and deposits are slightly different.

later the bank decided to acquire a regional structure by giving the regional managers authority over the branches they controlled, in matters of lending, staff and marketing of services, and by creating regional offices. By 1970 there were 21 regional offices in operation<sup>13</sup>.

The change in the size and focus of the bank, from the Midlands (the place where the bank had started its activity) to a more national and even international perspective over a number of years, induced variations in the treatment of different types and sizes of business accounts. Large businesses with a broader national outlook won a "small but discernible advantage"<sup>14</sup> over the local industrial customers which had been so important in the early years of the bank's history. The main advantage for the new large company customers lay in the possibility of negotiating overdrafts and loans directly with the centre of the bank, bypassing any form of localism. The smaller firms suffered the disadvantage of having to deal with a more distant and complex bureaucracy. According to Holmes and Green, the bank's official historians, the disadvantage was not so much that of an increased 'bureaucratic' element in the lending decisions, which meant that applications needing local knowledge were sent to London bankers with no knowledge of regional economies, but instead it lay in the enormous number of accounts handled by the bank, implying that, as the bank grew, accounts were not judged only on the basis of their security and track record but lumped together for the purpose of controlling lending by sectors (and presumably by

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<sup>13</sup> Holmes, Green, Midland, p. 223 and pp. 246-247.

<sup>14</sup> Holmes, Green, Midland, p. 113.

type of customer)<sup>15</sup>.

Until the decentralisation of the structure at the end of the 1960s, the movement of information from the branches to Head Office followed the informal channels of the Managers Club meetings and the more formal ones of the reports sent by the branch managers to the Intelligence Department. Because of the very limited power<sup>16</sup> held by the local managers the bigger businesses negotiated directly with the top management, whereas the smaller businesses were filtered up to London through more formalised channels, as described above. Knowledge of these individual customers, or even of the sector and environment they operated in, rested with whatever local experience the General Managers and their Assistants had accumulated during their careers. A study of these careers (see Appendix to this chapter) shows that in more than one case these managers' connection with the Midland division had been tenuous. During the various stops of their careers these men had collected experience in many areas of the bank's operations but in no way had this knowledge been specific to the economy of the Midlands.

The Midland Bank therefore had, until 1968, a very centralised structure which relied, for knowledge of what was happening in the provinces, on very formalised tools and on what knowledge of the various districts the managers in charge had acquired during their careers. The very limited degree of autonomy (the extent of this autonomy will be presented in a further section) enjoyed by the local managers meant that most advances were dealt with in London.

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<sup>15</sup> Holmes, Green, Midland, pp. 113-115.

<sup>16</sup> To judge how limited this power was consider Figure 3.2.

## 2.2 Lloyds Bank

Lloyds' beginnings are older than Midland's but the two banks started their activity in the same place: Lloyds' original business was set up as a partnership in 1765 in Birmingham. The connection with London began much earlier too, in 1770, when two of the younger partners of the Birmingham bank opened a bank in Lombard street so that the "Birmingham house" could have a trusted agent in London. The Birmingham partnership became Lloyds Banking Company, a joint-stock company in 1865 and in 1884 it amalgamated with the "London house", the firm of Messrs. Barnetts, Hoares, Hanbury and Lloyds<sup>17</sup>. The history of Lloyds' expansion through subsequent amalgamations has been told with a wealth of detail by R.S. Sayers and it will not be re-told here. The narrative will skip the nineteenth century and concentrate on Lloyds structure after the First World War.

Whereas the Midland Bank applied a policy of centralisation, Lloyds Bank pursued, through the merger period, the formation of Local Committees made up of the directors or partners of the amalgamated banks. This policy seems to have had more the intent of smoothing over the period of transition, "preserving interest and goodwill and placating local opinion"<sup>18</sup>, than of creating an integral and necessary part of the administration and direction of the bank. The Local Committees were chaired by a full Director of the bank based in London, who would know the particular trades of his district and could advise on them. The other members of the committee, apart from the District Manager, would be three or four directors of local

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<sup>17</sup> R.S. Sayers, Lloyds Bank in the history of English Banking, (Oxford, 1957), pp. 5-11.

<sup>18</sup> LBA, R.A. Wilson, S. Parkes, Chief General Managers, paper on Decentralisation submitted to the Board of Directors, 22/7/1943, Winton File.

businesses, "men of local position, influence and knowledge, who would each contribute something towards fostering interest in the bank and bring new business to it"<sup>19</sup>.

In 1918, when the merger wave subsided, there were, together with the London board, three other Local Committees of Directors. One in Liverpool, the product of the merger with the Liverpool Union Bank in 1900, and one in Salisbury, which followed the amalgamation with Wilts and Dorset Bank in 1914. The third Local Committee was in London, the result of the merger with the Capital and Counties Bank in 1918. In 1922 a new Local Committee was formed in Halifax, after the merger with the West Yorkshire bank; in 1931 a Local Committee was established also in Birmingham and in 1934 at Newcastle.

Apart from the Local Committees, Local District Offices were also set up. These, in contrast with the Local District Committees, had a more precise role in the organization of functions inside the structure of the bank. District managers were responsible for the District office and acted as a link between Head Office and the local branch managers and, by residing in the area, used their knowledge of the local environment to procure new business and to report to London any important changes and developments taking place in the district.

The first Local District Office was the Birmingham one, established in 1910 when Lloyds moved its Head Office to London. By 1920 there were Local District Offices managed by District Managers in Birmingham, Salisbury, Newcastle and Halifax. The District Managers worked together with Advances Controllers (based

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<sup>19</sup> LBA, Report by the Chief General Managers to the Board of Directors, 1943. Winton File on Regions.

locally) with the authority to authorise advances up to £15,000. By 1931, though, this decentralisation of functions had been abolished. Of the Local District Offices only one remained, Birmingham, and the Advances Controllers had been moved up to London to join the Advances Department, formed in 1930<sup>20</sup>. Before the beginning of the war, two of the existing District Committees, the Capital and Counties and Salisbury ones, had also ceased to operate.

In 1943, a report written for the Board by the Chief General Managers analysed the merits of the change in policy in favour of centralisation. This, they wrote, had the merit of "knitting together into a consistent whole all the various

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<sup>20</sup> The Advances and General Purpose Committee was created in 1930 for the purpose of discussing certain important advances and some general matters in order to reduce the load of work of the Board of Directors. The Committee initially was formed by the Chairman and Deputy Chairman of the Board and the Chief General Managers plus seven or eight other members of the Board. The committee would meet once a week and its recommendations would then be brought before the Board members who would give their final decision. At this initial stage, the Advances committee discussed only advances of specially large amounts, importance or complexity, submitted to them by the Chief General managers and the General Managers, for amounts above £15,000. Advances below this limit were considered and approved by the advances controllers at the district offices [LBA, "Paper submitted and approved by the Board, January 1930" in HO/D/Adv. File 151. Winton File on Head Office]. In 1931 the Advances department was re-organised by putting a Chief Controller in charge of it together with three Assistant Chief controllers. These people constituted a daily committee who approved and recommended to the general management all advances of £15,000 and upwards. Advances below this limit were sanctioned by the Controllers who, in the mean time had been moved from the district offices to Head Office. Local branch managers had the authority to authorise advances within their limits but these still had to be sanctioned by their controller. The old division of branches into geographical areas had been superseded by a new system, under which branches were grouped in order of size and the importance of their advances, and were placed under Controllers according to such Controllers ability and experience. [LBA, "Paper for the Advances and General Purpose Committee, 1931" in HO/D/Adv. File 151, Winton File on Head Office]. In 1946 the system was changed one more time. Advances up to £15,000 were sanctioned by the Advances Committee, between £15,000 and 25,000 by the Joint General managers and above £25,000 by the Chief General managers. The advances above the £25,000 limit were also reported to the Board of directors for final approval. LBA, Board Minutes, 22/3/1946, Winton file on Head Office.

constituents brought in by amalgamation". Nevertheless the Local Districts and Local Committees had proved to be valuable additions to the structure of the bank and it was thought that they should be fully re-established and expanded. The District Managers acted as a link between Head Office and the Local Managers and, by residing in the area, used their knowledge of the local environment to procure new business and to report to London any important changes and developments taking place in the district. The Local Committees were chaired by a full Director of the bank, who knew the particular trades of his district and could advise on them. The other members of the committee, apart from the District Manager, were three or four directors of local businesses, "men of local position, influence and knowledge, who would each contribute something towards fostering interest in the bank and bring new business to it"<sup>21</sup>. The committee met regularly and was attended also by the General Manager responsible for the area, in order for him to keep in touch with the District Manager and the branch managers, therefore connecting Head Office with the district. At the same time the District Manager had the duty to pay frequent visits to Head Office so as to keep in close contact with the General Management.

However, neither the District Committees, nor the District Offices, had any executive powers, even though the advances generated from the district were discussed in meetings. In fact the role of the committees was essentially social. The objects of these committees were: "To provide a wider channel of communication both ways between Head Office and the branches. To create a stronger feeling amongst the managers and staff that they [were] not being overlooked and that every endeavour [was] being made to search out and reward merit. To acquire a larger share of new business for the bank. To make greater use of local knowledge by focusing it together, discussing it and applying it for the bank's benefit. To provide a few more posts

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<sup>21</sup> LBA, Report by the Chief General Managers to the Board of Directors, 1943. Winton File on Regions.

which [would] serve as training grounds and stepping stones to higher executive officers"<sup>22</sup>. The aim of these committees was to co-opt businessmen of standing into the structure of the bank through lunches and dinners<sup>23</sup>.

In 1946 there were six local districts: Birmingham, Halifax, Liverpool, Newcastle and Salisbury plus the Capital and Counties one. In 1947 a committee was established for South Wales, in 1948 for Devon and Cornwall, in 1949 for the Pall Mall branch (this has strong connections with the military forces) and in 1951 for the eastern counties. The Capital and Counties committee was closed in 1958, following the death of Lord Blediscoe, its sole surviving member since 1949 while in the same year a committee was formed at Bristol. The expansion of Local Committees continued, increasing through the Sixties. District Committees (as they were called from 1961) were established at Aylesbury, Guildford and Nottingham. Committees were established also for Greater London and the South-East (based in Tunbridge Wells). The name was changed again in 1968 and the District Committees became Regional Boards. The number of District Offices (called Regional Offices from 1968)

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<sup>22</sup> LBA, R.A. Wilson, S. Parkes, Chief General Managers, paper on Decentralisation submitted to the Board Of Directors, 22/7/1943, Winton File.

<sup>23</sup> For example: in 1968 the South Wales District Committee was made up of three men: the Hon. Hanning Phillips, M.B.E. aged 64, educated at Eton whose other directorships included Dun & Bradstreet Ltd, Northern Securities Trust Ltd and was chairman of Schwepps Ltd and Schwepps (Overseas) Ltd; Sir Hugo Boothby, aged 60, educated Lancing and Hertford and lieut. Col. H.M.Llennellyn, C.B.E., aged 57, educated at Oundle and Trinity, whose other directorships comprised: Cardiff Malting Co.Ltd, Davenco (Engineering) Ltd, Dulland & Newcomber Ltd, Rhymney Breweries Ltd (Chairman) and Whitbread International Ltd . In 1960 the rate of remuneration for the members of the Committees was £750 p.a. both for the Chairman and the other members. If the Chairman was also a Vice or Deputy Chairman of the bank then the remuneration was nil. If a member of the Committee was also a member of the London Board then his remuneration was £350 p.a.. LBA, General file on history, development and formation of Local and District Committees 1958-1972, Winton File on Regions.

followed the development of the committees. In 1969 there were fifteen Regional Boards and sixteen Regional Offices (Birmingham was divided in two: one regional office for Birmingham and one for the West Midlands)<sup>24</sup>.

Another important element of Lloyds' communication structure was represented by the Managers' Meetings. These meetings started, rather informally, in the 1920s, and brought together managers from branches in the same area. In 1930 these meetings were formalised and their structure defined. Managers met, two or three times a year, at centres within a fifteen mile radius of their branch and minutes of the meetings were kept and copies sent to Head Office. The purpose of these meetings was to discuss local business, to exchange ideas about existing clients and possible new ones, to exchange introductions about new local businesses and so on. Staff and premises were also discussed<sup>25</sup>. These meetings achieved a double result: they allowed the managers to expand their knowledge of the environment surrounding them and to feel part of a group, while at the same time providing Head Office with further insight into the economies of the various areas, thanks to the copies of the meetings' minutes. In 1945 the Birmingham district had six Managers' Groups and by 1951 there were 81 Managers' Groups in the whole country<sup>26</sup>.

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<sup>24</sup> J.R. Winton, Lloyds Bank 1918-1969, (Oxford, 1982), p.142 and p.170.

<sup>25</sup> LBA, Circular from Chief General Managers to Branch Managers, 10/2/1930, Managers' Meetings Minutes. Acc. no. 1561.

<sup>26</sup> These were: Birmingham West (24 branches), Birmingham East (28 branches), Coventry (13 branches), Stafford (17 branches), Wolverhampton (19 branches) and Worcester (19 branches). In 1951 Birmingham was divided into Birmingham North East, North West, South East, and South West due to the increase in the number of branches. LBA, Allocation of Branches for Managers' meetings, Birmingham District, 1945, and List of Managers' Groups 1951, Managers' Meetings Minutes. Acc. no. 1561.

Notwithstanding the number of managerial positions created to increase the flow of knowledge from the regions to Head Office, the communication of information about a customer was quite formalised, as described above as all the advances sanctioned by the branch managers had to be authorised also by Controllers in the Advances Department in London.

How managers in the periphery and controllers in London should communicate was often a source of disagreement. Branch managers often viewed the controllers as unfriendly and bureaucratic because of the exchange of correspondence that had to go on between them before the advance was granted. On the other hand the controllers thought managers did not send them enough hard information. The controllers required, in order to grant an advance, a careful listing of the client's securities and, in the case of an overdraft or loan for a company, a three year analysis of the company's balance sheet, with a breakdown of each individual liability and asset. The controllers also required a trading account together with the balance sheet. The branch manager often did not include all this information with the application because his recommendation of the client was based mainly on his personal knowledge and on local knowledge of the economy. On the other hand, the advances controller in London received 40-50 applications a day, often from branches in very different areas. Therefore, to save time (and control costs), communication had to be formalised before an advance could be considered<sup>27</sup>. The advances controller was also responsible for any bad debt, together with the branch manager. But whereas the branch manager might know that the debt would be honoured because he could

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<sup>27</sup> LBA, Managers Meetings Minutes, Nottingham Group, 25/5/1953. Acc. no. 1561.

evaluate the person and the circumstances, this was the type of information that could not be standardised in a form suitable for the advances controller.

Lloyds Bank had a more decentralised structure than the Midland Bank did, relying on District Offices, District Committees and Managers' Meetings for the flow of information from periphery to centre and the other way round. The granting of advances, though, was mainly centralised, because none of the above mentioned bodies had any discretionary powers, until 1957 when District Managers were given the authority to sanction advances between £15,000 and £25,000. Local branch managers had discretionary powers of up to £5,000. What use this sum might have had for a firm in the 1950s will be shown in one of the next chapters.

### 2.3 Barclays Bank

Barclays' policy towards the amalgamated banks was different both from Midland's and Lloyds'. After an acquisition, Barclays would appoint the former owners of the local bank as directors of a Local Board in order not to destroy the "essentially local character of the new acquisition"<sup>28</sup> and to capitalise on local knowledge and existing goodwill. In 1929 Barclays had 1,270 branches and these were divided into 37 districts, with 37 corresponding Local Head Offices. In 1968, just before the acquisition of Martins Bank, the Local Head Offices had been reduced to 31 but the number of branches had increased to 1,906 (without including the subbranches and the DCO branches).

Archival evidence from Barclays Bank provides some information on the work of the local boards. In particular there is relatively rich documentation on Birmingham

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<sup>28</sup> Tuke, Barclays, p.78.

Local Head Office. In 1950 the business of this district amounted to between 5% and 6% of the whole deposits of the bank (this made Birmingham the most important district, together with Manchester)<sup>29</sup>. The Birmingham Local Board consisted of three prominent local business men<sup>30</sup> in addition to the Chairman (a professional banker). In 1950 an inspection done by London of this district reveals that the business of the district was run with such competence and that its record was so good, that:

"the Local Board should be granted as much autonomy as possible and that they should be encouraged and given every opportunity of conducting their businesses as is reasonably possible with the minimum amount of reference to Head Office for all those matters concerning advances, premises and staff"<sup>31</sup>.

At the end of the 1960s, A.W.Tuke, in his recollections of the bank, wrote about the Local Boards in very much the same terms:

"Policy in such fields as lending, staff salary scales, and the opening and closing of branches is a matter for Head Office and very large lendings and senior managerial appointments require Head Office approval. Within that framework it is for local directors to manage their District in the light of their knowledge of local conditions"<sup>32</sup>.

This evidence shows high degree of decentralisation of Barclays bank structure and the importance and independence of the Local Boards.

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<sup>29</sup> BBA, Inspection of Birmingham Advances, 1950. Acc. no. 80/1883. These inspections supplemented the role of the Inspection Departments (found in Midland and Lloyds) and were a feature of the rather decentralised structure of the bank.

<sup>30</sup> The practice of having local businessmen managing the local boards was peculiar to the Birmingham district. Most other local boards would have been made up of professional bankers. The peculiarity of Birmingham local board was due to its origins as it was the result of the takeover, in 1916, of the United Counties Bank, not a private bank with professional bankers but a joint-stock bank, run by local businessmen.

<sup>31</sup> BBA, Inspection of Birmingham Advances, 1950.

<sup>32</sup> Tuke, Barclays, pp. 78-79.

The Local Boards had the power to authorise all advances up to £30,000 (£50,000 from 1953) but these had to be registered and confirmed by the Assistant General Manager and also be sanctioned by the General Manager. All advances above the Local Board's limit had to be submitted to the board at London Head Office<sup>33</sup>. Nonetheless the limits discussed during Local Board meetings generally far exceeded the limit allowed<sup>34</sup> and the minutes of the Birmingham Board meetings make it clear that Head Office considered the Board's opinion on the firms to be final and gave its assent as a matter of course. In fact there were cases when the Local Board over-ruled the instructions from Head Office when it felt that Head Office did not have a clear enough knowledge of the local situation. Furthermore the Local Boards discussed and took active part in the affairs of their customers.

Barclays Bank structure was the most decentralised of the three banks under study. Similarly to Lloyds, it had District Offices which enhanced the flow of information between Head Office and the regions. Differently from Lloyds though, these district offices were also given a considerable amount of independence and, thanks to high discretionary limits, in practice directly controlled the lending done in their district.

This description of the internal structure of the banks has shown how communication, and control, between the centre (Head Office) and the periphery (the

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<sup>33</sup> BBA, London Head Office, Minutes of Directors Meetings, 13/3/1947.

<sup>34</sup> In one case the limit of the overdraft granted was higher than 1 million pounds (BBA, Birmingham Local Board, Minutes of the Meetings, 6/10/1941, Acc. no. 1/226), and in the case of a very important tea merchant the limit was as high as £2,250,000 (BBA, Birmingham Local Board, Register of Advances, 1954, Acc. no. 1/102)

branches) was organised. On the basis of the structure of the three banks studied, the one to rely the most on local knowledge and to allow the periphery most freedom seems to have been Barclays, whereas the most formalised, and centralised, was Midland. Lloyds, whilst not allowing the periphery much autonomy, had more transmitters of information. If the hypothesis this research aims to test is true, then Barclays' structure, in theory, made it easier for a small, local firm to gain access to finance as such a firm would have less to show for itself in terms of documentation, suitable for transmission to Head Office. Under the Barclays system, it could instead rely on the local manager's knowledge to reduce information asymmetries and on the authority of the Local Board.

Figure 3.2 Discretionary limits for Barclays Bank, Midland Bank and Lloyds Bank (£)

Barclays Bank	Midland Bank	Lloyds Bank
Branch: < 3,000	Branch: (n.a.)	Branch: < 5,000
Local Board: <30,000 (50,000 in 1953-1975)	Branch Superintendent: 1-3,000	Advances Dept.: <15,000
Assistant G.M.: <25,000	G.M. Assistant: 3,000-7,000	Joint G.M.: 15,000-25,000 (50,000 in 1957)
General Manager: <30,000	Assistant G.M.: 7,001-15,000	Board of Directors: >50,000
Advances Committee: >30,000	Joint G.M.: 15,001-25,000	
Board of Directors: >50,000	Chief G.M.: 25,001-50,000	
	Management Committee: >50,000 <sup>35</sup>	

Sources: Barclays Bank: BBA, Inspection of Birmingham Advances, 1950; Head Office Instructions and Information, section on Advances, 1928 (used until 1952) and 1953 (used until 1975); London Head Office, Minutes of Directors Meetings, 13/3/1947.

Midland Bank: MBA, Applications and Renewals, 1947.

Lloyds Bank: LBA, Memo to the Board, 1950, Winton File on Discretionary Limits; Board Minutes, 15/2/1957, Winton File on Advances.

The shaded area of the figure shows those decision-making units that operated at a local level. All the others were based in London. Although in theory all of Barclays advances had to be sanctioned by various managers in London, the evidence presented in the preceding pages shows that the autonomy of the Local Boards often even exceeded its formal discretionary powers. In practice in 1953 Barclays Local Boards had as much authority as Lloyds Board of Directors and as much as Midland's Chief

<sup>35</sup> In 1964 the limits, starting from the lower level had changed to: £ 10,000 for the Branch Superintendent, £ 25,000 for the General Manager's Assistants, £ 50,000 for the Assistant General Managers, £ 100,000 for the Joint General Managers and £ 200,000 for the Chief General Manager. Advances above this limit had to be authorised by the Board. MBA, Board Minutes, 31/1/1964, courtesy of the Group Archivist.

General Managers.

By the mid 1960s, Barclays Local Boards still had as much power as Lloyds' Assistant Joint General Managers and Midland's Assistant General Managers. Therefore Barclays, by allowing its regional offices to have autonomous decision-making powers, was, of the three banks, the one to minimise the distance between the bank and its customers.

### Conclusion

The distance between the centre and the periphery can be "measured" by the number of stops the application for an advance had to undergo from the moment the application was filled in at the branch until it was granted. The stops are represented by the discretionary limits granted to each managerial level. The further an application for an advance had to travel, the more standardised the information had to be, forcing the quantification of the quality of a business, or the potential for development reducing the relevance of local knowledge held by local managers and increasing information asymmetry. The more centralised the structure, the larger the number of applications which had to be processed by one person making it expensive (because time consuming) to use information that was not standardised. The need to minimise risk and cost made the banks turn down those customers whose creditworthiness was not easily quantifiable.

The description of the structure of the banks and of the various levels of autonomy existing inside these structures, provides some insight into how the banks perceived their relation with the periphery, both the internal (the branches) and the external one (the regional economies). The impact of this relationship on the

availability of credit to smaller firms is not easily quantifiable. But by looking more closely at the lending patterns of the individual banks during the long period of credit restrictions, it might be possible to identify differences that could be explained by the banks' varying degrees of centralisation and involvement with the regional economies.

## Appendix to Chapter Three

### Bankers' careers

Through a study of the Midland Chronicle, the bank's internal magazine, the career of some men who were Joint General Managers and Assistant General Managers for the Midland division between 1950 and 1969 has been reconstructed. All these men had climbed the career ladder from the bottom and by the time they reached senior management had been with the bank for many years. Joining the Midland division represented the top point of their professional development. In fact the people in charge of this division considered themselves as being the "elite" of the bank, because not only was this division the most important in terms of business produced (together with London) but it was the bank's "home ground", whence it had come and where its oldest customers were. The best people were called to manage this division and often reached the position of Joint General Managers prior to retirement. Nevertheless even if the professional progress of these men had equipped them with the ability to be very competent bankers, it had not necessarily given them in-depth knowledge of the economy of the region they were called to administer. To substantiate this claim it is necessary to take a closer look at these men's careers.

R.Hampshire was Joint General manager of the Midland division between 1950 and 1954. He joined the bank at Bradford in 1910 and then moved to Leeds, and Newcastle on Tyne in 1928 as Chief Accountant. In 1930 he moved to Head Office as an Inspector and in 1933 became a Branch Superintendent. In 1939 he was promoted to Assistant General Manager.

B.F. Clarke was Joint General manager from 1955 to 1956. He started with the bank at Liverpool moving between a number of branches, including Liverpool Foreign branch. He then moved to Head Office where he joined the Overseas department with the Atlantic staff on the Cunard liners. Clarke returned to London as a superintendent of branches, after which he became a manager at a Liverpool branch, until he returned to London as an Assistant General manager.

J.Christopherson was Joint General Manager from 1957 to 1962 and started his career in 1926 with the Clydesdale Bank in Scotland. He then moved to Midland in Newcastle, later he moved to Hull, Huddersfield and finally Leeds in 1942. After the war he was posted to Head Office as branch superintendent.

H.N.Barber became Joint General manager in 1963 and held this position for one year. He started in the early 1930s at the Tottenham Court Road branch in London and after that moved to Belgravia. In 1935 he became Securities Clerk at Head Office, then in 1938 became Branch Superintendent Assistant. From there he was subsequently moved to manage the Brentwood branch in Essex. He returned to London as Branch Superintendent in 1947 and was promoted to the position of General Manager's Assistant in 1952, and Assistant General Manager in 1956.

J.A.Cave was Joint General manager in 1965 to 1969. He started his career at Eye branch, then Nottingham, Norwich and Leicester. In 1949 he was transferred to Head Office as a clerk. In 1951 he became manager at Wolverhampton and after three years returned to Head Office as Branch Superintendent. Subsequently he became manager at the Poultry and Princess Street branch in London, General Manager

Assistant at Head Office and manager at the Threadneedle Street branch.

Some information about two Assistant General Managers of this division is also available. H.H.Thackstone (who became Chief General Manager in 1962) was Assistant General Manager between 1950 and 1954. He was born in Yorkshire in 1905 and started working at the Barnsley branch in 1920. In 1929 he became Secretary to the Managing Director at Head Office. After this position he filled those of Assistant Secretary, Assistant Chief Accountant, manager of Threadneedle Street and in 1946 became manager of the Overseas Department and subsequently Chief Foreign Manager.

E.J.Hellmuth became Assistant General Manager in 1955 and held this position until 1956. Of German origin, he started with the bank in 1924 in the Overseas Department. After the war he became Controller General of the banking branch of the finance division in the British zone in Germany. He also was the UK member of the Joint Foreign Exchange Agency in Germany. In 1948 he returned to overseas management in London and later on became Assistant Manager of the Poultry and Princess Street branch. In 1953 he was promoted to the position of manager of the Overseas Department.

## Chapter Four

### The postwar credit restrictions and small firms

The object of this chapter is to show how the credit restrictions imposed on the banks by the British government in the post-war period affected demand from small firms and whether the lending patterns of the banks differed according to their different internal structures.

#### 1. Patterns of lending and credit controls

Starting in the 1930s, as the banks' size generally increased (in terms of deposits and branches), the aggregate number of advances granted declined as a percentage of total banks' assets. This decline (initially due to lack of demand) continued during the Second World War as the banks took on large amounts of government securities to help finance the war effort, and general war controls constrained private sector borrowing. Consequently the share of advances fell to 16%<sup>1</sup>.

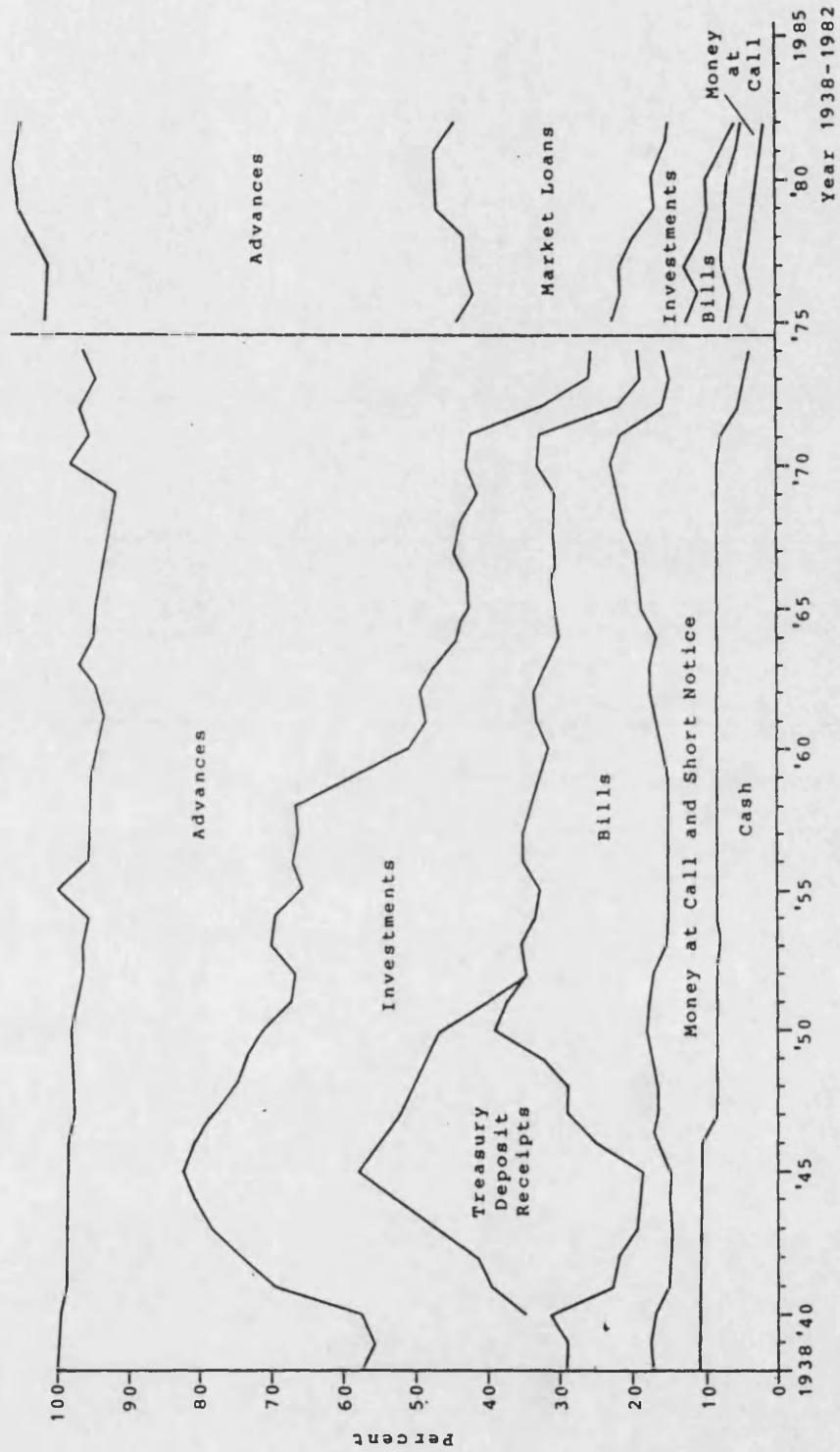
Figure 4.1 shows the distribution of London Clearing Banks' assets as a percentage of total deposits between 1938 and 1982. The figure shows the influence of government policy over the composition of banks' assets indicating the predominance of public sector liabilities in the LCBs' portfolio. These state liabilities took the form of cash, Treasury bills, Treasury Deposit Receipts and longer term government securities, which accounted for the bulk of the banks' investments. Even the item 'money at call and short notice' was indirectly lent to the state as most of the

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<sup>1</sup> During the 1920s advances as a percentage of total banks' assets had been close to 50%.

balances were deposited with the discount houses which in turn invested most of them in Treasury bills. If all these assets are lumped together it can be seen that, as a percentage of total deposits, they rose very sharply from 56 per cent at the outbreak of the war, peaked at 82 per cent in 1945 and remained at over 65 per cent until the late 1950s. In other words, these figures show that the government's financial needs dominated the clearers' asset portfolio, confirming that the banks were happy to hold government paper in exchange for being allowed to run a cartel.

Figure 4.1 Distribution of London Clearing Banks' Assets 1938-1982 (Assets as a percentage of total deposits [gross])



Source: Annual Abstract of Statistics and Bank of England Quarterly Bulletin. From: M. Collins, Money and Banking in the UK: A History, (London, 1988), p. 421.

After the war advances increased but retention of wartime controls and the continuing importance of public sector securities, plus the high liquidity of businesses<sup>2</sup> meant that by 1951 the recovery had been modest as the share of advances over other assets had increased to only 30%. The expansion of advances had been moderated by the growth of bills (mainly Treasury bills) and investments (mainly longer-term government securities). Between 1951 and 1958 government controls on lending, induced by macroeconomic policy, continued and this had a negative impact on advances. As soon as controls were lifted, however briefly, advances increased dramatically, as shown in Figure 4.1. In absolute terms the value of advances rose by 64% between 1958 and 1960, while the share of advances in total bank assets increased from 29% to 43%, as the banks offloaded government securities on a very large scale, to meet the growing demand for finance from the public<sup>3</sup>. After the controls were reinstated advances continued rising, though at a slower rate. When the "Competition and Credit Control" policy was started in 1971, removing all official quantitative ceilings, the share of advances rose from 53% to 69% of total assets. This relaxation of controls coincided with an expansionary budgetary policy from the government. The banks responded strongly to this policy by increasing loans sharply to the private sector and running down (in relative terms) all other assets. The increase in inflation meant that fixed term securities were losing their value in real terms and this might have made advances more attractive. Inflation might also have given people and businesses the incentive to get into debt, knowing that the real value of their debt was decreasing as inflation increased. Credit controls were reestablished in 1973 with

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<sup>2</sup> B. Tew, R. F. Henderson, Studies in company finance, (Cambridge, 1959).

<sup>3</sup> M. Collins, Money and Banking in the UK: A History, (London, 1988), p. 441.

the imposition of supplementary special deposits (the "corset")<sup>4</sup>.

As mentioned at the end of Chapter 1, one of the explanations used by banking historians for the clearers' relative preference for government paper over advances to the private sector has been the restrictions on bank lending imposed by the British government all through the 1950s and 1960s until 1971. By restricting the creation of credit the authorities sought to constrain domestic demand and inflation so as to avoid balance of payments deficits and protect the value of the pound, and to maintain a stable exchange rate within the parameters following Bretton Woods in 1944.

The legal basis of the post-war restrictions on capital-raising and borrowing was the Borrowing (Control and Guarantees) Act, 1946 and the Bank of England Act, 1946. The Borrowing Act prescribed those circumstances under which Treasury consent was necessary for borrowing, while the Bank of England Act limited the independence of the clearing banks by stating that, if authorised by the Treasury, the Bank of England could issue directions to the banks on how credit was to be restricted. Though these two Acts were the formal tools used by the British Government to control the supply of money and implement demand management, the banks' behaviour was regulated more by the "governor's eyebrows" than by legislation.

The banks were asked to favour projects concerning exports, agricultural development, transport and the production of raw materials and not to approve projects involving over-capitalization or speculation. Mergers requiring new money, hire-purchase finance and capital for the distributive trades were not to be encouraged. In

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<sup>4</sup> Ibidem.

December 1947, after the convertibility crisis, a fresh directive was issued to the banks which further restricted borrowing. In general, capital outlay was to be postponed unless it was directed to enlarging exports or to reducing imports, or was essential to basic industries. More lists of priorities were issued in the following years, especially after the outbreak of the Korean War. In November 1951, following the election of the Conservative Government, the bank rate was increased to 4% and banks were asked to intensify credit restrictions, giving priority to defence and exports and they were also requested not to make advances for capital expenditure. Qualitative restrictions were imposed until 1955, when quantitative limitations were introduced too. In July 1955 the Chancellor wrote to the Governor of the Bank of England asking for a "positive and significant reduction" in bank advances, leaving it to the banks to decide what steps to take. They decided that an adequate reduction in advances would be 10 per cent. Calls for reductions in advances continued in the following years, while the bank rate was increased from 4.5% in 1955 to 7% in September 1957.

It seems paradoxical that, since the aim of the government was to control demand, these controls were not extended to other financial institutions such as building societies, hire purchase houses and merchant banks. Nevertheless, considering the origins of the banking cartel and its strong links with the government, it is plausible to assume that pressure could be exercised more easily on this group of lenders than on the other financial institutions. On the other hand, the banking cartel was more likely to accept controls for two reasons: in exchange for a quiet life (the "best of all monopoly profits" according to Hicks<sup>5</sup>), and secondly controls made it

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<sup>5</sup> J.R. Hicks, 'Annual Survey of Economic Theory: The Theory of Monopoly', Econometrica, 3 (1935), p. 8.

easier to turn down customers by blaming the government.

Credit restrictions were lifted in July 1958, following the signs of a modest recession. the bank rate was also reduced to 4% (from 6% in March) and more public expenditure was announced. In February of the following year the control of capital issues was suspended, except for borrowing or share issues of over £50,000 from outside Britain. Bank advances rose sharply in the second half of the year and in November the Governor of the Bank of England indicated that the increase in advances "needed watching". In January 1960 bank rate was increased again to 5% and in April the Bank of England made the first call on the banks for Special Deposits at the rate of 1% for the London clearing banks and 0.5% for the Scottish banks. The bank rate was increased to 6% in June, but lowered again to 5% in December. Calls for Special Deposits continued until they reached a total of 3% for the London banks and of 1.5% for the Scottish ones in July 1961. Special Deposits were lowered in May 1962 and the Government resorted once again to asking the banks to give priority in their lending to exporting companies and to keep within modest limits any relaxation in lending connected with domestic consumption. Special Deposits were lowered again in September and fully paid back by the end of the year. Until April 1965 banks were allowed to lend without restrictions, except for the qualitative guidelines given by the Government. Following a sharp increase in advances during the first half of 1965, Special Deposits were requested once again. In May the Governor wrote to the clearing banks asking that their loans to the private sector should not increase by more than 5% in the year to March 1966. The bank rate was lowered by 1% to 6% in June but credit restrictions were not relaxed. In 1966 Special Deposits were called in again by a further 1% and expansion in advances was again to be limited to 5%. These

credit restrictions were relaxed the following year and the Chancellor announced in the Budget speech that Special Deposits were to be used in "a new and flexible manner, so that a call for special deposits should no longer be regarded as a crisis measure, but as a routine adjustment to conditions as they develop". This positive attitude towards bank credit did not last long: in 1968 the banks were again asked to restrict the growth of credit to 4%. In August the Bank of England issued a memorandum telling the banks that the "growing needs of borrowers in top priority categories will have to be met from further reductions in lending for other and less essential purposes". Special deposits were again introduced in 1970<sup>6</sup>.

Another tool used by the monetary authorities to control advances was the liquidity ratio. In 1951 the banks agreed with the Bank of England to keep it within the range of 28 to 30 per cent of total deposits. The ratio was reduced to 28 per cent in 1963. The ratio expresses the value of liquid assets as a proportion of the banks' total deposits. These "liquid" assets were cash, money at call and short notice and bills (mainly Treasury bills). As a tool for controlling advances the liquidity ratio was rather imprecise, as the bank could, instead of reducing advances, sell securities, other than Treasury bills, to maintain the liquidity ratio<sup>7</sup>. Nevertheless in 1959 the Radcliffe Committee denounced the liquidity ratio as being too high for a system dominated by few large banks and claimed that the ratio could have been much lower<sup>8</sup>. In 1971

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<sup>6</sup> For a detailed account of those years see: J. Fforde, The Bank of England and Public Policy 1941-1958, (Cambridge, 1992); and also, N.H. Dimsdale, 'British Monetary Policy since 1945', in N.F.R. Crafts, N. Woodward (eds.), The British economy since 1945, (Oxford, 1991).

<sup>7</sup> E. Nevin, E.W. Davis, The London Clearing Banks, (London, 1970), p. 155.

<sup>8</sup> PP 1959, Committee on the working of the monetary system, Report, Cmd 827, p. 119.

"Competition and Credit Control" abolished the clearers' existing liquidity ratio and replaced it with a reserve ratio which was applicable to all banks. This move freed bank resources for use in less liquid, but more profitable, assets such as advances<sup>9</sup>.

## 2. Bank lending with brakes on

The preceding section indicated that bank lending in the 1950s and 60s must be seen in the context of governments' policies and pressures. Nevertheless it is also useful to find out who the banks were lending to.

Quite predictably the sector of the economy to receive the largest share of the banks' lending was the manufacturing one. This sector's share of advances increased from 25% after the war to 41% in 1966, and to 43% in the following period up to 1970, (see Tables A4.1 and A4.2 in the Appendix to the chapter<sup>10</sup>). Among the purely industrial borrowers, the engineering sector retained, throughout the post-war period, a position of preeminence, in share of total advances, reflecting this sector's importance as a contributor to GDP. The strong bias towards the engineering sector

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<sup>9</sup> Collins, Money and banking, p.437.

<sup>10</sup> Tables A1 and A2 in the Appendix to the chapter show the Classification of Advances (percent of total) of the British Bankers' Association from 1946 to 1966 and from 1967 to 1972. These figures relate to all advances made by member banks through offices in Great Britain, irrespective of the borrowers' country of residence. Members of the Association comprised the London Clearing banks, the Scottish banks, most Northern Ireland banks, other deposit banks, and many dominion and overseas banks. The classification is based solely on the business of the borrower and does not take account of the object of the advance. The aggregate nature of this data makes it difficult to use it for anything else but the identification of very general trends in the pattern of lending of the banks. In the following sections and chapters more detailed data will be given, relating to the classification of advances of some individual banks, based on archival material.

was also consistent with the government's policy directives imposed on the banks. As much of the output of the engineering sector was also exported, this category of borrowers did not suffer the same type of restrictions as those imposed on firms which produced goods for the domestic market.

The category 'Personal and Professional' can be used, with great caution, as a proxy for loans to small firms. This category included advances to cover "house purchases, the provision of working capital for professional purposes, advances to executors to pay for death duties and general personal advances"<sup>11</sup>. If we use this category as a proxy for small firms, then Tables A4.1 and A4.2 in the Appendix to this chapter show a steady decrease in the importance of this type of borrower for the banks from 1946 to 1957 as its share of advances decreased from 29% to 16%. After the credit restrictions were temporarily lifted in 1958, this sector increased its share, though by 1966 this was back to the same level as in 1958. This declining trend continued in the following years, as shown by the figures for the 'Professional' category in Table A4.2. These figures are not surprising as they reflect the overall decreasing importance of the small firm sector in the British economy. Nevertheless the following pages will show that the credit restrictions shaped the banks' allocation decisions away from the demand coming from their smaller customers.

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<sup>11</sup> In 1949 40% of advances to the 'Personal and Professional' group of borrowers covered house purchases, 10% working capital for professional purposes, for example the furnishing of a doctor's surgery or the purchase of machinery for a small manufacturer, 10% covered death duties and the remaining 40% was taken up by general personal advances, usually to maintain previous rates of consumption. Bank of England Archive (hereafter BEA), Chief Cashier Private Files, 'Advances and the Control of Inflation Files', Working Party on Bank Deposits and Advances, 12th July 1949, C40/686.

Table 4.1 shows the percentage annual change in total national advances in real terms (in 1963 prices) for Barclays Bank, Midland Bank, Lloyds Bank, Martins Bank (this bank has been introduced to study the effect of the restrictions on a smaller, provincial bank) and for the London Clearing Banks as a whole. With different time lags and to a different extent, the credit restrictions affected the advances of all the banks. The degree of reduction, though, was different and seems to follow a pattern.

**Table 4.1**  
**Advances in constant terms (yearly % increase)**

	Barclays	Midland	Lloyds	Martins	LCB
1946	13.36	20.44	17.04	31.70	15.09
1947	15.09	15.80	27.36	18.85	16.13
1948	11.83	9.05	11.47	7.89	6.45
1949	0.48	3.32	15.86	1.96	7.38
1950	5.71	0.72	3.02	5.37	4.02
1951	2.20	4.12	7.73	7.83	7.14
1952	-14.88	-15.04	-16.80	-20.10	-16.87
1953	1.75	-8.13	-9.20	5.05	-5.01
1954	8.59	14.39	2.86	13.08	9.73
1955	-12.40	-7.98	-2.82	-11.53	-7.30
1956	-1.75	-1.56	4.26	-7.71	-1.51
1957	-1.40	-3.43	-6.21	2.73	-5.02
1958	17.66	15.38	16.40	14.09	17.12
1959	41.22	30.63	30.02	33.70	28.49
1960	17.00	20.76	12.30	14.95	8.93
1961	-1.46	-3.88	-2.88	-4.66	-3.89
1962	4.14	0.37	0.74	1.16	9.96
1963	17.91	14.13	10.96	9.11	5.66

Source: Annual Reports for the banks and Abstract of Statistics for LCB

In spite of the fact that calls for reductions in bank lending started in 1946, Table 4.1 shows that, in fact, advances did not decrease until 1952. The decrease which occurred in that year may perhaps be attributed more to the effect which rising interest rates had on the demand for credit than to the effectiveness of the Treasury's appeals. Nevertheless, in the following year the advances of Barclays and Martins were already increasing, whereas those of Midland and Lloyds were not.

Consistently with the hypothesis this thesis is trying to prove, the different lending patterns of Martins and Barclays can be explained by the fact that Martins Bank was a regional bank and Barclays had, as shown in Chapter 3, autonomous Local Head Offices which were, more often than not, little more than the original local bank. The autonomy of the Local Head Offices allowed Barclays' local directors to make decisions based on first hand knowledge of the regional economy and on personal relationships with their clients built through the years. This knowledge was of little use to the managers, say of Midland and Lloyds, as the local branches and regional divisions had little or no decisional autonomy as far as advances were concerned.

The existence of personal relationships between managers with strong powers of decision and local clients meant that these managers would have tried to reduce the effect of the increase in the Bank Rate in the period we are observing. Thus, after the first shock of bank rate rise had worn off, customers would go back to the bank confident that a suitable rate could be arranged. Furthermore both Martins and Barclays Local Boards were directly dependent for their profits on the economies of their district and thus prone to protect their rather small and not very segmented markets. This interpretation would also explain why, after three years of decreasing advances, only Martins managed to increase its advances in 1957, and the decrease for Barclays was much lower than that of Midland's and Lloyds', when interest rates had risen from 3% (1954) to 7% (1957) and after the Treasury had, in 1955, intensified credit restrictions.

To consider Barclays as a bank with a more intense involvement with local businesses is also consistent with the greater increase of its advances, compared to Midlands and Lloyds, after the credit restrictions were lifted in 1958 and interest rates

decreased from 6% to 4%. The lifting of restrictions meant that Barclays could go back to lending in full to all those customers who for years had been penalised by the restrictions, i.e. the smaller ones. This is also the year when Barclays became the largest lender in the country, overtaking Midland.

No evidence has been found to suggest that Barclays recognised its structure as being a competitive advantage. In fact, in 1955 Barclays Head Office started issuing circulars to the Local Boards asking them to restrict their advances by reducing overdraft limits and by a more careful scanning of new applicants. These appeals continued throughout the 1950s, with reminders to the Local Boards that the bank was incurring increasing difficulties in maintaining the 30% liquidity ratio imposed by the government and that this ratio was being kept only by continuous selling of investments, which was only possible at progressively lower prices, sometimes involving capital losses. Even after the credit restrictions were lifted, the bank encouraged the Local Offices to restrict advances to reach a 35% liquidity ratio. These appeals seem to have fallen on rather deaf ears, since in August 1960 Head Office wrote to the Local Head Offices:

"This analysis [of the Classified Return of Advances] is now before us, and compared with mid-May there has been an increase of £20.6 millions. But over 50% of our advances come under the headings of 'Personal and Professional', 'Other Financial', 'Hire Purchase', 'Builders and Contractors' and 'Retail Trade'. With the exception of 'Hire Purchase' which is almost unchanged, all these categories show increase, and frankly we find this disappointing because it was in these categories in particular that we were hoping for reductions"<sup>12</sup>.

These categories listed by Head Office were, except for 'Other Financial', those where small customers were predominant. Thus these instructions reveal how the

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<sup>12</sup> Barclays Bank Archive, Local Head Office Circulars, Acc. No. 29/740.

autonomy of the Local Boards allowed them to be more involved with local customers than with Head Office instructions and Treasury policies. These instructions also show the difference in focus between London Head office and the Local Head Offices, as one asked for the reduction of advances to small customers while the other maintained its role of local lender.

Thanks to the survival of some data from Barclays Birmingham Local Board it is possible to compare the lending activity within the District with that of the bank as a whole.

Table 4.2: Barclays bank and Birmingham Local Board  
Advances in constant term - Yearly % increase (from 1950)

	<b>Bank</b>	<b>District</b>		<b>Bank</b>	<b>District</b>
<b>1951</b>	2.2	6.7	<b>1957</b>	-1.4	-12.6
<b>1952</b>	-14.9	-13.9	<b>1958</b>	17.6	22.2
<b>1953</b>	1.7	13.8	<b>1959</b>	41.2	53.7
<b>1954</b>	8.5	23.5	<b>1960</b>	17	0.5
<b>1955</b>	-12.4	-10.5	<b>1961</b>	-1.4	15.7
<b>1956</b>	-1.7	4	<b>1962</b>	4.1	-7.2

Source: For the bank as a whole, Annual Reports, various years; for Birmingham Local Head Office, Barclays Bank Archive, Birmingham Local Board, Returns, Local Head Office Summary, Access 1/95.

Table 4.2 shows the behaviour of advances during the period under analysis both nationally and at a local level. Advances for the bank as a whole decreased more and increased less than the advances authorised by Birmingham Head Office, except in 1957, 1960 and 1962. This difference might be appreciated more by looking at the absolute level of advances. Between 1950 and 1958 advances decreased in real terms, for the bank as a whole from approximately £530 million to about £500 million, whereas the advances of Birmingham local board increased, during these years of

credit restrictions, from almost £25 million to more than £32 million.

In order to realise the importance of the above data, for the availability of finance to small firms, two things must be considered. First, Birmingham Local Board was one of the bank's most important provincial boards accounting, together with the Manchester board, for the largest regional segment of the bank's business. Secondly, London Head Office had the power to sanction all advances above the Local Board's discretionary limit, but not those below. In the light of these considerations I suggest that Table 4.2 shows that Birmingham Local board reduced its advances less and increased them more than the bank as a whole because, as its profits depended on its local advances, it was interested in 'protecting' those advances over which it had direct control, those below £50,000. In other words, these data indicate that at a local level the effect of the credit restrictions on advances for less than £50,000 was felt differently and to a lesser extent. The combination of these factors must have meant that, for those local firms that were clients of Barclays, the credit restrictions had a lesser impact than for those firms which were customers of the other centralised banks.

The following section will illustrate the changes in the composition of the Classification of Advances for the British Banking Association (BBA) together with archival material from the Bank of England on credit restrictions and their effect on small firms, between 1946 and 1963<sup>13</sup>. This section will show how the credit restrictions suppressed demand and were mostly felt by the smaller customers. Thanks

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<sup>13</sup> The analysis had to stop at 1963 because of the restrictions placed on the disclosure of archival material.

to reports on individual banks, these banks' different attitude towards their various categories of customers can be analyzed.

Between 1946 and 1951 credit restrictions were still rather loose and the banks followed rather vague guidelines, concerning mostly the control of capital issues and the mandate to support export companies. One of the Government's concerns was keeping inflation low and restoring the balance of payments. The need to curtail the rise of inflation meant that bank advances were monitored with the intent to question the banks if advances increased. The main problem with controlling the banks was that the Bank of England did not have direct access to the individual banks' figures for advances classified by type of customer. The banks would send their data to the BBA and they would compile aggregate figures for the Bank of England. If questioned the banks would provide reports commenting on their analysis of the reasons for decreases or increases in the amounts of money lent to the various categories.

In 1950 the category 'Retail Trade', in particular the sections dealing with the sales of furniture, boots and shoes, was beginning to cause some anxiety amongst the banks. The total figures had expanded in real terms (based on 1963 prices) from £134 million in 1946 to £295 million in 1950 (see Table A4.3 in the Appendix to the chapter). These figures were "somewhat disturbing"<sup>14</sup>. The Bank was perturbed because this increase indicated the pressure of consumer demand, leading businesses to increase their stock.

Between 1950 and 1951 advances kept increasing due to the rise in the price of raw materials and the pressure to buy stocks of materials in view of the Korean War rearmament. The only way the banks could find to restrain the overall increase

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<sup>14</sup> BEA, Chief Cashier Private Files, Banks' Reports, C40/686, 20/7/1950.

in advances was to squeeze those sectors which had less leverage with them, such as 'Personal and Professional' where advances decreased by 5% (Table A4.3 in the Appendix to the Chapter). For example, in the quarter ending September 1950, Barclays managed to reduce the advances to the 'Personal and Professional' sector by one million pounds<sup>15</sup>. This was deemed an 'easy' task as the average size of the advances to this category was only £400, whereas the banks could not contain the requests for bigger loans from the other categories<sup>16</sup>.

The quarter ending March 1951 saw the highest increase in advances since 1946. The Bank was forced to admit that it was no longer a matter of seasonal increases<sup>17</sup>. The Borrowing (Control and Guarantee) Act of 1946 allowed banks to grant advances only for the "ordinary course of business" of the customers. This was meant to reduce the possibility of advances being made for capital investments and to limit their use to working capital. For capital investments the Treasury supposed that firms would raise funds through a capital issue and this possibility was controlled by the Capital Issues Committee which had power to veto both advances and capital issues above £50,000. By 1951 the Bank and the Treasury started to realise that a section of the economy was escaping regulations and using borrowed funds to make capital investments, stimulated by demand connected to the Korean War. The Bank suspected that the banks were rolling over overdrafts, but especially lending money to Hire Purchase companies (for the normal course of their business and at the highest

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<sup>15</sup> BEA, Chief Cashier Private Files, Meeting between the Big Five and the Governor of the Bank, 28/9/1950, C40/687.

<sup>16</sup> BEA, Chief Cashier Private Files, Meeting between the Chief General Managers of the Big Five and the Governor of the Bank, 19/10/1951, C40/687.

<sup>17</sup> BEA, Chief Cashier Private Files, Memo, 20/3/1951, C40/687.

rate). These in turn would invest in goods, like machinery, that firms would buy and pay for in high interest instalments<sup>18</sup>, or instead finance the sale of consumer goods, like three piece living room suites, or cars.

When consulted the banks answered that they thought advances would keep increasing due to inflationary pressures and re-armament. Nevertheless this state of buoyancy of the firms was not thought to be sustainable, as competition from Japan, Germany and Belgium was being felt and the banks feared that "the continued rise in costs of production [would] price British firms out of many export markets". Interestingly enough the banks' recipe both for the problem of increasing advances and increasing cost due to borrowing was to increase interest rates: "However cautious borrowers may be they are not as careful as they would be if rates were higher"<sup>19</sup>.

In November 1951 the banks, after a number of meetings with the Governor of the Bank agreed to be firmer about advances to "less essential industries" in return for an increase in the Bank Rate<sup>20</sup>. In November of the following year a Bank memo stated that: "During the twelve months since the new monetary policy was introduced the total of advances has fallen by £201 million compared with an increase of £333 million in the preceding year". This fall was defined as "encouraging"<sup>21</sup>.

The Bank's enthusiasm and faith in the Treasury's policy was not shared by the banks. The reports of their Chief General Managers tell a different story from that

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<sup>18</sup> BEA, Chief Cashier Private Files, Memo, 24/4/1951, C40/687.

<sup>19</sup> BEA, Chief Cashier Private Files, Meeting between the Chief General Managers of the Big Five and the Governors of the Bank of England, 19/10/1951, C40/867.

<sup>20</sup> BEA, Chief Cashier Private Files, Memo, 7/11/1951, C40/687.

<sup>21</sup> BEA, Chief Cashier Private Files, Memo, 2/11/1952, C40/687.

told in the internal memos of the Bank. The Midland Bank believed that advances were falling because of reductions in stocks and in prices. Those firms that could were switching to public issues to finance their activities but the brunt of the monetary policies was felt by the 'Personal and Professional' sector. The main reason for the fall in advances was foreign competition and, in Edington's words: "things will be worse before they become better". This view was shared by Westminster and Lloyds. The only bank to be optimistic was Barclays, since advances in the Engineering sector were increasing and firms looked healthy. According to Barclays the credit squeeze was being felt only by the 'Personal and Professional' group of borrowers<sup>22</sup>. Between 1951 and 1952 advances to this sector decreased by 15% (Table A4.3 in the Appendix).

Through 1953, advances increased due to seasonal trends and prevailing lower levels of industrial profits. Lower profits meant that firms used bank finance both for working capital and for investments. This was particularly true in the case of large engineering firms<sup>23</sup>. The Bank was conscious of the fact that the smaller firms in the motor car, light engineering and rayon sectors were having difficulties and, according to Barclays, the only bank to refer to the troubles of small firms, these firms were "running into very deep water", whereas Midland mentioned only the heavy borrowing of the large-scale, capital goods engineering companies<sup>24</sup>.

Concerning large firms, it is interesting to note that, in some cases, the 'non-

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<sup>22</sup> BEA, Chief Cashier Private Files, Reports from Midland, Westminster, Lloyds and Barclays, 22/7/1952, C40/687.

<sup>23</sup> BEA, Report on Advances, 6/4/1963, C40/688.

<sup>24</sup> Ibidem, reports by Barclays and Midland.

'pinching' agreement between the banks seems not to have worked. At the end of 1953, Bernard Docker decided to transfer his personal account and those of BSA Ltd. from Midland to Barclays, because he wanted a better rate, thus decreasing Midlands total advances by £3 million and correspondingly increasing those of Barclays<sup>25</sup>. The "non-pinching" agreement within the cartel must have worked in the case of the smaller accounts, as Midland was able to charge the highest loan rates to the 'Personal and Professional' category, as high as 6%, without losing any customers<sup>26</sup>.

The fluctuation of advances continued in the following year due mainly to the working capital needs of large concerns (like Vauxhall and Tate & Lyle, in the case of Lloyds<sup>27</sup>) and of hire purchase companies, to satisfy consumer demand<sup>28</sup>. The fluctuations in advances were making the Treasury frantic, and the situation was not helped by the fact that communication with the banks had to go first to the President of the British Bankers Association who in turn would contact the banks. These would agree to be interviewed by the Governor of the Bank who would then have a report sent to the Treasury. For example, at the end of 1954, the Treasury wanted to inquire whether the banks were lending for capital purposes, as Lord Piercy of ICFC had complained that firms were going to the banks when they needed finance for investments. Following this conversation, the Treasury and the Bank exchanged a number of letters and memos, in which the Bank endeavoured to reassure the Treasury

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<sup>25</sup> BEA, Report on advances from Midland bank, 5/11/1953, C40/688.

<sup>26</sup> BEA, Report on advances by Midland, 6/3/1953, C40/688.

<sup>27</sup> BEA, Report on Lloyds, 28/2/1954, C40/688.

<sup>28</sup> BEA, Report on Midland, 15/2/1954, C40/688.

that the banks were not indulging in what was "not their business"<sup>29</sup>. If anything, advances were increasing because the banks were supporting firms with long term capital for exports<sup>30</sup>. The banks were certainly being very cautious about who they were lending money to, as Barclays, Midland and Westminster reported to the Bank very low, or non-existent, bad debt, while National Provincial was perfectly free from bad debts: "not being able to lose money even in the film industry"<sup>31</sup>. Nonetheless the Bank knew that banks were, in some cases, lending for capital purposes, as each bank manager had his own notion of what the normal business of his bank was. Otto Niemeyer, a director of the Bank, in a note dated 18 January 1955, mused on the possibility of changing this state of affairs, as "this state of anarchy was not desirable"<sup>32</sup>.

By mid-1955 the "extra exports to pay for imports were not coming" and too much production was being absorbed by internal demand. The Chancellor of the Exchequer was adamant that "investments should be made only in those sectors leading to exports". To curtail demand the banks were to endeavour to achieve a "positive and significant reduction in bank advances"<sup>33</sup>. How the banks were to achieve this significant reduction was up to them. In a meeting of the Committee of

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<sup>29</sup> BEA, Memo to Compton, 14/1/1955, C40/688.

<sup>30</sup> BEA, Report on Barclays, 29/9/1954, and Report on National Provincial, 14/10/1954, C40/688.

<sup>31</sup> BEA, Report on National Provincial, 11/3/1954, and Barclays, 16/3/1954, Midland, 25/2/1954 and Westminster, 26/2/1954, C40/688.

<sup>32</sup> BEA, Memo, 18/2/1955, C40/688.

<sup>33</sup> BEA, Statement by the Chancellor of the Exchequer, sent to the Bank, 25/7/1955, C40/689.

London Clearing Banks it was decided that the banks would reduce advances by limiting the number of new applications accepted, by reducing existing limits, by not taking customers from other banks and by restricting the availability of finance to hire purchase companies and for customers in the 'Personal and Professional' and 'Retail' categories. The aim was to reduce advances by a total of 10% by December<sup>34</sup>. By August the result of these manoeuvres was starting to be felt as advances declined in the 'Food', 'Retail', 'Other Financial', 'Personal and Professional', 'Other Textiles' and the 'Nationalised Industries' categories<sup>35</sup>. Customers were staying away from the banks as they felt that "it [was] no use asking"<sup>36</sup>. Nonetheless the banks were finding it difficult to reduce the advances of large, important existing customers who needed money for seasonal expenditure, as in the case of Imperial Tobacco, a customer of National Provincial<sup>37</sup>.

By the end of the year the squeeze was starting to be felt by the agricultural sector and by small industry. Thornton, senior manager of Barclays, wrote that:

"the small trader is certainly more liable to be hit than the larger or medium concern. This is not due so much to direct action as to the indirect effects of the squeeze, such as a general tightening and shortening of credit which has placed the more slender resources of the little man under greater strain...The banks are conscious that there is

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<sup>34</sup> BEA, Minutes of meeting of CLCB, 26/7/1955, and Report on advances, 31/10/1955, C40/689.

<sup>35</sup> BEA, Report on advances, quarterly figures, 16/8/1955, C40/689.

<sup>36</sup> BEA, Governor's note on interviews with bankers, 3/10/1955, C40/689.

<sup>37</sup> BEA, Governor's note about interviews with Mr. Robarts of the National Provincial bank and Sir Oliver Franks of Lloyds, 15/9/1955, and notes on interviews with Midland, Couts and Barclays, 3/10/1955, C40/689.

a very heavy suppressed demand for accommodation"<sup>38</sup>.

This report to the Bank followed a letter sent to the Governor of the Bank, by the Federation of Grocers, lamenting the effect of the credit restrictions on the "small man"<sup>39</sup>.

To avoid inflation it was not just a question of reducing advances, but most importantly of reducing the confidence of the public that finance was readily available<sup>40</sup>. Pressure was brought upon the banks to lower their liquidity ratio to 30 percent, though it was clear to Bank officials that there was little correlation between low liquidity ratios and low advances ratios<sup>41</sup>. As a result of this pressure the banks reduced their limits and the number of new advances accepted<sup>42</sup>.

The continuation of the credit squeeze was to bring back the problem of the impact on small firms over and over again. The banks, in their interviews with the Bank, reported the occurrence of a number of failures amongst the smaller concerns in agriculture and engineering, though this did not trouble them unduly, as the level of bad debt was still very low except in the case of Barclays and Williams Deacons<sup>43</sup>

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<sup>38</sup> BEA, Memo on how the credit restrictions are doing from Thornton, 13/12/1955, C40/689.

<sup>39</sup> BEA, Letter from the Federation of Grocers, 12/12/1955, C40/689.

<sup>40</sup> BEA, Draft paper on monetary organisation, undated but probably written in May 1956, C40/691.

<sup>41</sup> BEA, Internal memo with comparison between liquidity ratios and advances to deposits ratios, from 1952 to 1956, 5/6/1956, C40/691. When the liquidity ratio of the banks was at its highest, in September 1952, the advances ratio was at its lowest and the lowest liquidity ratio experienced, in May 1956 corresponded to the highest advances ratio.

<sup>42</sup> In 1956 the National Provincial reduced the number of new applications accepted by 60 per cent. BEA, Reports on advances, 10/10/1956, C40/693.

<sup>43</sup> BEA, Confidential reports from banks, 16/3/1956, C40/691.

and the latter did not think that the bad debt situation would improve as these were mainly from small builders<sup>44</sup>. The banks were conscious of the fact that the effect of credit restrictions on the small firms was, in many cases, indirect.

"The general pruning of limits affects the supply of advances for working capital...the extent to which advances for working capital have been curtailed has not been so great as to cause insolvencies, except indirectly where difficulties of obtaining commercial credit, as distinct from bank credit, have put some smaller concerns into liquidation"<sup>45</sup>.

A number of memos was circulated internally, showing figures for bankruptcies, and by the end of 1956 the Bank was aware of the fact that the credit squeeze was having an adverse effect on small firms and that the problem was compounded by the fact that, as large firms were short of working capital, the smaller concerns were not getting paid<sup>46</sup>.

This knowledge was kept confidential as a series of drafts of a letter from the Governor to Sir Edward Bridges shows. The Governor wrote to Bridges in response to his enquiry on the rumoured adverse effects of the restrictions on the economy. In the first drafts of the Governor's letter, small firms were mentioned as suffering from the restrictions, but in the final copy this mention was carefully left out<sup>47</sup>. There is no mention in the Bank's file of possible measures that could be taken to avoid the credit restrictions forcing firms into liquidation. The levers of monetary policy that were being pulled seemed, mysteriously, to be achieving the desired effect of holding

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<sup>44</sup> BEA, Report from William Deacons, 17/10/1956, C40/693.

<sup>45</sup> BEA, Report on monetary organisation, 3/7/1956, C40/692.

<sup>46</sup> BEA, Memos on number of bankruptcies, 12/9/1956, C40/692.

<sup>47</sup> BEA, Notes for letter to Sir Edward Bridges, 2/7/1956, C40/692.

down inflation and, presumably, nobody was going to risk distorting this effect. Nonetheless alternatives did exist and were brought to the Bank's attention. In July 1956, just before leaving for Rome, the economist D.H. Robertson wrote from Trinity College to Edmund Compton at the Treasury, commenting on the report on monetary policies that Compton had sent him. Robertson's suggestion was that to keep inflation down (i.e. to reduce private expenditure) it would have been more sensible to attract the public to bank securities (sic) than to lower advances. A copy of this letter was then sent by Compton to Mynors at the Bank, accompanied by a rather disparaging remark at Robertson's expense<sup>48</sup>.

The increase of unemployment might have had something to do with the decision taken by the government to lift the credit restrictions by mid 1958. The Bank's archives do not contain any discussion about the reasons for relaxing the credit squeeze, but only the text of the cable informing all the banks that they could lend freely<sup>49</sup>. Between 1958 and 1959 advances increased, in real terms, by 32%, as shown by Table A4.3 in the Appendix.

The impact of the lifting of the restrictions on the customers of the various banks is difficult to ascertain. For banks like the National Provincial and Barclays the remarkable increase of advances was attributed to their large customer base made of small businesses<sup>50</sup>. Other banks, like the Midland, increased the average size of their

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<sup>48</sup> BEA, Copy of letter from Sir Dennis Robertson to Edmund Compton, 17/7/1956, C40/692.

<sup>49</sup> BEA, Cable to banks, 1/7/1958, C40/696.

<sup>50</sup> BEA, Reports by National Provincial and Barclays, 1/5/1959, C40/697.

loans, as, unlike the other banks, it lent predominantly to capital goods industries<sup>51</sup>.

The large increase of advances, and the fear of inflation, led, in 1960, to another "stop" and the institution of the Special Deposits scheme. Access to the Bank's files is limited to 1963, and the documents covering the remaining three years do not reveal anything of interest, concerning the question of the impact on demand of the credit restrictions.

### 3. The credit restrictions, small firms and more qualitative evidence

The previous section has shown that the banks seemed to have been well aware of the effect of credit restrictions on small firms but were not unduly concerned. The chairman of Lloyds, in a speech delivered in 1960 on the subject of advances, among other things commented on some findings by the Radcliffe Committee which revealed that 98% of the banks' customers borrowed less than £10,000 but accounted for only one-third of the money lent. The remaining two-thirds of the money lent went to the 2 per cent of larger borrowers. Three borrowers out of four were holders of personal accounts (classified under Personal and Professional in the classification of advances). Of the remaining quarter approximately one-third were farmers and one-third retailers. These three categories accounted for about 40 per cent of the total lent. In other words this means that a very small percentage of the banks' customers borrowed most of the money. Sir Oliver Franks argued that in the light of these facts if 2 per cent of larger customers accounted for two-thirds of the money lent, in theory then any restriction of credit could be concentrated upon them and the remaining 98 per cent could be left alone. This presented a dilemma for the authorities and the banks. The banks

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<sup>51</sup> BEA, Report on Midland advances, 13/10/1960, C40/699.

recognised that small concerns, and many personal borrowers too, stood in special need of bank credit but at the same time had to remember that the sectors of the economy given preference by the Treasury were those where larger firms dominated, such as chemicals, iron and steel and engineering and that the larger concerns made an exceptionally important contribution to exports. The chairman of Lloyds pointed out that as much as 30 per cent of exports were produced by the forty largest companies alone. At the other end of the scale, only one quarter of exports came from smaller firms, even though these employed more than half of the total labour force in manufacturing<sup>52</sup>.

A letter written by the General Manager for Research and Statistics at the Midland Bank in March 1956 reveals how the response of many business-men to the restriction of bank advances seemed to have been to seek finance elsewhere rather than curtail operations. Smaller firms, though, were finding it more difficult than larger firms to tap alternative sources of finance and were increasing their applications for advances. The report does not say if these applications were being accepted by the bank, but it reveals that the credit restrictions were starting to effect capital expenditure: "in Birmingham plans for factory building are stated to have been slowed down and in some case suspended" and "some companies in the Midlands were stated to be re-examining commitments for capital expenditure"<sup>53</sup>. Another report, this time from the Intelligence Department, written a few months later, reveals how branch managers were starting to describe the credit squeeze as having a "considerable

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<sup>52</sup> Lloyds Bank Archive, Sir Oliver Franks, 'Bank Advances as an Object of Policy', pp.5-6, 1960, Winton File.

<sup>53</sup> Midland Bank Archive, Research and Statistics Department, March 1956, Management Committee File.

impact" on business expectations and plans, especially for those firms which had no alternative sources of finance. Moreover the report highlighted another effect of the restricted lending as " the loss of flexibility in bank borrowing [...] strained the debtor-creditor position in industry". Many large firms were taking extended credit and as a result of this "small firms [were] being hard pressed to make ends meet"<sup>54</sup>.

Confidential reports from a branch of Lloyds bank in Birmingham provide a different angle from which to view the effect of credit restrictions on small firms. These reports were written on an annual basis by all the branch managers and sent to Head Office. Few have survived and the report from the Bristol Street branch is the only one left for the Midland district. This branch was situated in the inner city, in an area of small working class property and small factories and its the customers were mostly small businesses in light engineering, brasswork and metal smallwares, platers and polishers, leather goods and dial makers sectors (the businesses which made up the traditional Birmingham industrial district). In the 1920s London Head Office started lamenting a decline in the number of deposits. This was attributed by the local branch manager to the fact that the inner city was becoming progressively poorer and people were moving to the suburbs, leaving behind small factories and one man businesses. Competition was also intense, as in 1931 within one quarter of a mile there were one National Provincial, one Lloyds, two Municipal and two Barclays branches. The Lloyds branch was quite small, never employing more than 6 or 7 people and in 1933 (the first year for which data is available) it had 146 debit balances and 473 credit ones. The manager of the bank was a churchwarden at a nearby church and also

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<sup>54</sup> Midland Bank Archive, Intelligence Department, July 1956, Management Committee File.

a director of the Halesowen Golf Club. These social connections were failing to bring the bank as much business as they should have done as the district was degenerating and becoming "more and more populated by a very poor class of Lodging House Keepers. The Municipal bank appeals to this class of people". The success of the Municipal bank might have also been due to the fact that it offered better rates on deposit accounts.

Branch managers not only had a problem with the class of the people in the neighbourhood, but also with their race. By the mid 1930s the area was being populated by "foreign speaking Jews. The synagogue used by them is directly opposite the branch and [the branch manager] mentioned to inspectors and controllers that if there were someone on the staff who could speak Yiddish [the branch] might get more business. Many of these people speak with a distinctly Foreign Accent". The manager and staff could not report success in the public life of the area as "there [was] no public life in the immediate locality other than that of the Hebrew congregation"<sup>55</sup>.

A further problem encountered by the branch was that its business customers were all small as the lack of physical space meant that any growing business had to move away. Small metal working factories were very busy but as soon as they needed to increase the size of their operations they would move to the suburbs. Other customers comprised builders, shopkeepers, brassfounders, furniture makers, manufacturers of motor components and of fancy leather goods.

The reports from the war years tell a story of bombing, destruction and falling advances, especially as people evacuated the city. The metal working factories, though,

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<sup>55</sup> Lloyds Bank Archive, Confidential Reports to Head Office, Smallbrook Branch (formerly Bristol Street). File no. 7749.

were flourishing and for this reason advances did not decrease unduly, in the opinion of the branch manager. In 1941 the first female clerk was employed and by 1944 there were four of them. The use of female cashiers was thought to be better for attracting customers than "elderly grumpy male" cashiers.

In 1945 a new branch manager was appointed and he enthusiastically reported that "with the enormous number of vacant sites available for rebuilding and for businesses, there is every prospect of further improvement in the course of the next few years". In 1947 the small and medium size concerns of the area all appeared to be fully and profitably occupied and advances grew by 50 percent between 1945 and 1949. But in 1950 advances started decreasing and reached an all time low in 1957, as the total number of advances dropped to 70 for a grand total of £87,000. The reasons for this decrease were various. At the beginning of the period the small firms of the area suffered from the restriction of metal supplies, but after 1951 these were compounded by the restrictions of credit. This had both a direct effect on small firms as the bank was forced to allocate finance in a selective way and an indirect effect, as the smaller firms were squeezed out of business by the fact that the larger contracting firms were not paying their suppliers, as cash became tighter and tighter. In the view of the Bristol Street bank manager this last reason was the one to weigh most heavily on the small manufacturing firms of the area. When, in 1958, the credit restrictions were lifted, advances soared and reached a total of 306 by 1962, for a total of £884,850, confirming that the bank was underlent<sup>56</sup>.

Indirect (and probably biased) evidence of the impact of the banks' policy on

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<sup>56</sup> Lloyds Bank Archive, Confidential Reports to Head Office, Smallbrook Branch (formerly Bristol Street). File no. 7749.

the small firms, at least in the Midland area, can be found in the Parliamentary Debates papers. In July 1955 the MP for Wednesbury (a Black Country constituency) lamented the effect the credit restrictions was going to have on the small firms in his constituency. The Black Country was defined as the 'stronghold of family business'. Within ten miles of Wednesbury Town Hall there were no fewer than 10,000 small manufacturing concerns, each employing less than fifty people. Most of these firms worked as subcontractors for the car industry and the MP feared that since these firms were not directly involved in exports they would suffer badly from the restrictions. A reduction in credit would affect the small manufacturers very seriously since:

"the people running these small family concerns have always been taught to look to the banks for money with which to modernise and expand their businesses. They [knew] nothing of the money market".

The MP addressed Parliament to ask the Government to impose on the banks some sort of regulation which would prevent them from reducing advances at the expense of smaller customers. He was answered by the Economic Secretary to the Treasury, Sir Edward Boyle in terms that leave little doubt that the fate of small firms was not one of the major concerns of the Treasury in formulating policies to curtail demand and maintain low inflation. The Treasury's main concern was to "encourage firms to postpone their marginal investment plans and, whenever possible, to postpone replacing their fixed assets". Credit restrictions were to accomplish this and the Government "[were] right to attempt to reduce internal pressure by asking the banks themselves to take what steps they regard[ed] as necessary to reduce the volume of credit". The smaller businesses were not to be protected from the "full rigours" of the

Government's policy<sup>57</sup>.

The Bolton Committee, commenting on the effects of the credit squeeze since 1963, remarked how the ceiling placed on bank lending affected small firms more as they were relatively more dependent on bank finance than large firms were. Furthermore the Committee had also found evidence that large firms, when credit was rationed, preempted a larger share of the total, by virtue of their greater bargaining power<sup>58</sup>. The findings of the Bolton Committee were in line with those of the Radcliffe Committee, which had considered the problems of small firms in relation to earlier squeezes. Firstly the Radcliffe Committee found that the main effect of the credit shortage had been to reduce confidence in the future availability of credit and this had led to the abandonment of schemes for capital expenditure<sup>59</sup>. The National Union of Manufacturers reported to the Committee that they believed, based on evidence collected from small firms, that these had been affected by the restrictions more than big firms and that the squeeze had driven them to other, and generally more expensive, sources of credit. The Engineering Industries Association confirmed that many firms, "particularly small and medium-sized businesses", had postponed or cancelled plans for new plant or expansion of sales because they foresaw difficulty in

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<sup>57</sup> Hansard, vol.554, 1413-1425, 28/7/1955.

For a contemporary account of the difficulties faced by small firms see: R. Lewis, A. Maude, The English Middle Classes, (London, 1949), especially chapter 7, 'Business Men and Managers'.

<sup>58</sup> Bolton Committee, Final Report, p. 159.  
This point was confirmed by another contemporary study by B. Tew, R.F. Henderson, Studies in company finance, (Cambridge, 1959), p. 80.

<sup>59</sup> PP 1959, Committee on the working of the monetary system, Report, Cmd 827, p. 161.

borrowing from their lenders<sup>60</sup>.

## Conclusion

Through drawing from different sources, this chapter has shown that during the 1950s, and at least up to the first half of the 1960s, there was demand from small firms that was being affected by the credit restrictions. The banks found it easier to follow Bank of England and Treasury directives by both reducing lending to their smaller customers and by not granting new advances.

The evidence found suggests that Barclays, the bank with the most decentralised structure and Martins, the provincial bank, restricted credit to local customers to a lesser extent than the other two centralised, London headquartered banks, Midlands and Lloyds. Two explanations for this behaviour can be put forward. The first one is that provincial banks (like Martins) and autonomous Local Head Offices (such as those of Barclays) had a strong, direct interest in supporting, to a certain extent, the economy of the region in which they operated, since their profits depended on the local business activity; the smallness of their market would also not allow them to discriminate against too many customers. The second explanation is more general and concerns the advantage local decision centres had in terms of lower transaction costs, compared to the centralised London banks, when dealing with local businesses. Local managers could make decisions on the basis of information, derived from direct and protracted contact with local firms and local economies which would have been too time consuming, (i.e. expensive), to formalise and transmit to London Head Offices. This advantage implied a higher propensity to enter transactions with

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<sup>60</sup> Ibidem.

customers generating relatively low profit (in absolute terms), such as small firms. The reduced transaction costs meant that for local banks or Local Head Offices, small firms were low cost-low profit customers, whereas for the London banks these same customers were classifiable as high cost-low profit ones, not the type of customer that would be considered when resources were constrained. But though small loans do bring a smaller return, small firms paid a higher interest rate than large firms did. Therefore, if administrative costs could be reduced, small firms, as a group, would become low-cost high-profit, making it rational for the banks to invest their constrained resources in them.

The difference in the lending patterns of Barclays and Martins (compared to those of the other banks) confirms that small firms suffered under the credit restrictions because of the centralised structure of the British banks and also because of the absence of provincial banks. These provincial banks would still have had to reduce advances and they too would have found it easier to squeeze their smaller customers. Nevertheless the impact of the restrictions on the firms would have been reduced, since the majority of the bank's customers would have been local small and medium-sized concerns, based on the assumption that large firms would have gone to banks whose availability of funds was larger, i.e. the national banks. The counterfactual question that follows this conclusion of what would have happened if there had been local financial institutions will be answered in the chapters where the Italian case is presented.

## **Appendix to Chapter Four**

### Tables

Table A.4.1

Classification of Advances - BIBA																						
Percent of total																						
		1946	1947	1948	1949	1950	1951	1952	1953	1954	1955	1956	1957	1958	1959	1960	1961	1962	1963	1964	1965	1966
Shipping and Ship Building		1.19	1.36	1.26	1.09	0.93	0.83	0.61	0.88	0.87	1.06	1.43	1.72	2.52	2.70	2.50	2.81	2.89	2.28	1.97	1.68	1.62
Iron & Steel and Allied Trades		1.75	1.29	1.28	1.58	1.30	0.91	1.61	3.03	2.58	1.43	2.04	2.80	2.44	2.44	2.38	2.54	2.73	2.97	2.93	3.03	3.22
Non-Ferrous		0.25	0.27	0.23	0.24	0.36	0.32	0.28	0.25	0.33	0.39	0.44	0.46	0.44	0.35	0.37	0.42	0.43	0.57	0.70	0.87	1.00
Engineering		7.07	7.40	8.39	7.38	5.57	5.77	7.82	8.47	7.27	7.52	10.09	11.64	11.48	10.39	10.55	12.73	13.46	11.99	10.98	12.60	14.33
Textiles		2.82	2.75	3.28	3.23	3.94	5.24	4.95	4.48	4.68	4.73	4.65	5.73	5.39	4.27	4.07	4.21	4.28	4.00	4.35	4.21	4.12
Leather		0.57	0.60	0.69	0.67	0.87	1.13	1.00	0.83	0.91	1.07	0.87	0.87	0.93	0.76	0.83	0.80	0.92	0.82	0.70	0.85	0.89
Chemical		0.97	1.35	1.47	1.25	1.32	1.39	1.83	1.43	1.42	1.47	1.70	1.59	1.59	1.30	1.18	1.38	1.77	1.82	1.62	1.72	2.36
Food, Drink & Tobacco		6.72	6.75	6.10	6.82	7.24	7.52	8.25	7.31	7.05	7.70	7.97	7.53	7.27	6.78	5.54	5.68	5.40	5.09	4.94	5.26	5.32
Unclassifiable		3.80	4.46	5.10	5.31	5.57	6.39	6.53	5.95	5.96	6.33	6.65	6.58	6.79	6.33	6.27	6.48	6.87	7.06	7.15	7.57	7.94
Tot.Manuf.		25.14	26.23	27.79	27.56	27.10	29.48	32.87	32.64	31.07	31.70	35.83	38.92	38.87	35.32	33.70	37.06	38.76	36.60	35.36	37.79	40.80
Mining		1.37	1.06	0.83	0.69	0.58	0.48	0.38	0.36	0.37	0.33	0.26	0.28	0.50	0.40	0.27	0.27	0.32	0.30	0.28	0.34	0.39
Agric. and Fishing		8.34	8.00	8.61	9.24	9.78	10.03	10.38	11.05	11.28	11.07	11.52	11.35	11.11	10.70	10.35	10.13	10.02	9.72	9.78	9.60	9.42
Retail		7.74	9.20	10.37	10.72	10.77	10.91	9.88	9.35	9.34	9.13	8.85	8.30	8.85	9.70	10.45	9.76	10.02	10.30	10.23	10.05	9.81
Entertain.		2.85	2.21	2.33	2.26	1.87	1.50	1.32	1.20	1.11	1.02	1.02	0.99	1.03	0.96	0.78	0.76	0.73	0.68	0.55	0.53	0.65
Building (Contrc. & Materials)		5.53	5.90	5.45	5.02	4.68	4.67	4.52	4.30	4.17	4.48	4.61	4.25	4.28	4.41	4.95	5.27	5.37	5.56	5.72	6.38	6.61
Local Authorities		8.13	7.09	6.41	5.94	5.44	4.83	4.07	4.32	4.70	4.31	4.09	4.14	3.85	3.37	2.57	2.42	1.89	1.79	1.85	1.54	1.56
Public Utilities (inc. Trans)		2.07	2.28	2.87	2.83	4.87	4.30	6.07	6.30	7.31	8.73	5.87	3.90	4.22	3.92	3.50	3.13	2.96	3.10	2.80	2.34	2.55
Stockbrokers		0.53	0.43	0.30	0.30	0.31	0.34	0.28	0.35	0.70	0.60	0.55	0.71	0.48	0.62	0.54	0.40	0.22	0.19	0.15	0.13	0.12
Other Financial		8.72	8.74	7.72	8.48	9.54	10.55	9.26	9.88	9.39	8.38	8.95	9.39	8.67	8.63	9.17	8.86	9.05	10.12	10.79	10.44	9.58
Hire Purchase *		0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.80	1.83	1.47	1.57	1.55	3.26	4.06	3.66	2.67	2.35	2.66	2.80	2.19
Personal & Professional		29.57	28.88	27.31	26.94	25.08	22.88	20.98	20.23	19.75	18.43	16.97	16.18	16.55	18.72	19.68	18.27	18.00	19.30	19.84	18.06	16.32
TOTAL		100.00	100.02	99.98	99.97	100.02	99.97	100.02	99.98	99.99	100.00	99.98	99.98	99.98	100.01	100.01	99.99	100.00	100.01	100.01	99.99	100.01

The figures for Hire Purchase are included in the "Other Financial" ones until 1954

Source: Bank of England Statistical Abstract, n.1, 1970, pp.68-70.

Table A4.2

Classification of Advances - BBA (new series)							
Percent of Total		1967	1968	1969	1970	1971	1972
Food		4.39	4.13	4.82	4.65	3.95	3.08
Chemical		3.25	2.88	3.12	3.34	3.23	2.65
MetalMan		3.25	2.34	2.24	2.20	1.47	1.36
ElectEng		3.82	4.47	5.14	5.18	3.80	3.16
OtherEng		7.22	7.68	8.36	9.40	8.56	8.16
Shipbuild.		1.26	1.57	2.38	3.19	3.50	4.24
Vehicles		4.37	3.16	5.19	5.29	4.20	3.31
Text		3.34	3.41	3.69	3.52	2.94	2.12
OtherMan		4.79	4.83	5.32	5.86	4.66	3.18
TotMan		35.68	34.46	40.27	42.63	36.32	31.24
Agric.		7.65	7.59	6.94	6.23	5.84	4.33
Mining		1.27	1.32	1.25	1.29	1.48	1.36
Construction		5.38	5.27	4.89	5.35	5.35	6.09
HirePurch.		1.71	1.84	1.40	1.09	1.77	1.78
Property		5.14	4.74	4.25	3.96	4.94	7.24
OtherBanks		0.40	0.73	0.90	0.88	0.97	1.31
OtherFin.		4.76	6.13	5.78	5.91	7.69	10.73
Transport		2.59	2.44	2.96	2.49	2.65	2.57
PubUtil.		1.36	1.11	0.92	0.74	1.75	1.78
LocalAuth		1.63	0.87	0.87	0.69	0.68	0.77
Retail		5.18	5.29	4.61	4.13	4.03	3.13
OtherDis.		5.66	6.11	6.14	5.89	5.84	4.65
Profess.		7.19	7.99	7.23	6.99	6.78	6.56
HousePurch		5.32	5.33	4.99	4.78	4.79	5.04
OtherPers		9.09	8.78	6.60	6.95	9.11	11.43
TOTAL		100	100	100	100	100	100
Source: Bank of England Statistical Abstract, n.2, 1975, pp.74-75.							

Table A4.3

Classification of Advances - BBA		End of year figures - Constant terms (1963)																				
(millions)		1946	1947	1948	1949	1950	1951	1952	1953	1954	1955	1956	1957	1958	1959	1960	1961	1962	1963	1964	1965	1966
Shipping and Ship Building		21	28	30	27	25	24	16	21	22	28	33	40	58	82	94	113	116	102	95	84	80
Iron & Steel and Allied Trades		30	26	30	40	36	26	42	73	64	38	48	64	56	74	90	102	109	133	142	151	159
Non-Ferrous		4	6	5	6	10	9	7	6	8	10	10	11	10	11	14	17	17	26	34	43	50
Engineering		123	152	197	186	153	163	205	205	181	198	236	268	264	315	396	512	540	536	532	628	708
Textiles		49	57	77	81	108	148	130	108	117	125	108	132	124	130	153	169	172	179	211	210	204
Leather		10	12	16	17	24	32	26	20	23	28	20	20	21	23	31	32	37	37	34	42	44
Chemical		17	28	35	31	36	39	48	35	36	39	40	37	37	39	44	56	71	81	78	86	117
Food, Drink & Tobacco		116	139	143	172	198	213	217	177	176	203	186	174	167	206	208	229	216	228	239	262	263
Unclassifiable		66	92	120	134	153	181	172	144	149	167	155	152	156	192	236	261	276	316	346	377	393
Tot. Manuf.		436	540	653	694	743	835	863	789	775	836	836	897	894	1072	1266	1490	1554	1636	1711	1882	2018
Mining		24	22	19	17	16	14	10	9	9	9	6	6	12	12	10	11	13	14	14	17	19
Agric. and Fishing		145	165	202	233	268	284	272	267	281	292	269	262	255	325	389	407	402	435	473	478	466
Retail		134	189	244	270	295	309	259	226	233	241	207	191	204	295	392	392	402	461	495	500	485
Entertain.		49	46	55	57	51	42	35	29	28	27	24	23	24	29	29	31	29	30	27	26	32
Building (Contrc. & Materials)		96	121	128	126	128	132	119	104	104	118	108	98	98	134	186	212	215	249	277	318	327
Local Authorities		141	146	151	149	149	137	107	104	117	114	95	96	89	102	97	97	76	80	90	77	77
Public Utilities (inc. Trans)		36	47	67	71	134	122	159	152	182	230	137	90	97	119	131	126	119	139	135	116	126
Stockbrokers		9	9	7	8	8	10	7	9	18	16	13	16	11	19	20	16	9	8	7	6	6
Other Financial		151	180	182	213	261	299	243	239	234	221	209	216	199	262	345	356	363	452	522	520	474
Hire Purchase *		0	0	0	0	0	0	0	0	20	48	34	36	36	99	152	147	107	105	129	139	108
Personal & Professional		513	595	642	678	688	648	551	489	493	486	396	373	381	568	739	735	722	863	960	900	807
TOTAL		1733	2060	2350	2516	2742	2832	2626	2417	2493	2639	2334	2304	2299	3036	3756	4021	4009	4471	4841	4980	4945

Source: Bank of England Statistical Abstract, n.1, 1970, pp.68-70.

## Chapter Five

### Midland Bank and discrimination against small firms

In the previous chapters some claims have been made about the British banks: that these were profit-satisficers as their lending was far too conservative, that they had a bias against small firms and that these suffered under credit restrictions also because of the absence of local lenders. Evidence has been presented to show that during the credit restrictions the two banks to ration their lending less were Barclays, the bank with a decentralised structure, and Martins, a provincial bank.

Ideally, to prove that British banks' lending was biased against small firms data on the number of advances granted by size of customer is needed. Unfortunately not all the archives used for this research have yielded these figures. The only bank for which it has been possible to collect data on the Classification of Advances and the number of customers has been the Midland Bank. The following pages describe the structure of Midland's customer base and show how this did not increase in size in the manufacturing sector, while the bank increased the average size of its advances, showing a tendency to move away from smaller customers and concern itself predominantly with few, large ones. Furthermore, two of its schemes, the Personal Loans and the Term Loans, designed to increase the bank's market share in the 'small sector' which had been eroded by Barclays, were in the first case seriously biased towards personal consumption and in the second case failed to make any real impact. Both schemes failed to increase the bank's market share in the small firm sector because the bank was overtly cautious and would not increase the number of its customers for fear of running the risk of bad debt, though this was negligible in this

period.

At the end of the chapter Midland's lending will be compared with Barclays, as this bank had a larger customer base and it granted, on average, smaller-sized advances.

### 1. Lending by a British bank

In 1951 total manufacturing accounted, [redacted], for 22 percent of Midland's total advances. Nevertheless, in terms of numbers of accounts, manufacturing represented only 5 percent of Midland's total customer base, and ten years later this share had decreased to less than 3 percent (as shown by the Classification of Advances for Midland Bank in Table A5.1 in the Appendix to the chapter).

The great expansion of the bank's business in terms of customer numbers, between 1951 and 1961, was not in manufacturing but, quite rationally, in sectors that carried less risk, as they were not subject to negative conjunctures or loss of competitiveness. Though, between 1951 and 1961, the amount of money lent to the manufacturing sector increased by more than 150 percent, the number of advances to this sector increased by only 23 percent, compared to 114 percent of the 'Other Personal' sector. These figures mean that Midland, though increasing the amount of money lent to manufacturing did not increase its customer base in this sector. Furthermore some industries decreased their importance in terms of number of customers, for example motorcar manufacturing, shipbuilding, chemical, paper and furniture makers. On the one hand, it is plausible to assume that Midland's lending to manufacturing simply reflected the trend towards concentration in British manufacturing, but the following pages will present more archival material to show

Midland's bias against small firms.

The assumption that the bank was shifting towards larger loans and larger customers finds confirmation in the fact that for those categories clearly made up of small customers, (like the 'Small Retailers' and 'Professional' ones), the average size of advances remained practically unchanged, in real terms, between 1951 and 1961. If we use the 'Professional' category as a proxy for small firms, between 1951 and 1961 this sector lost importance for the bank not only in terms of money (advances decreased by 12%), but also in terms of customers (the number of advances granted to this category fell by 22%). Overall the customer base of the bank, if the personal sector ('Other Personal' and 'Personal Loans') is taken out, hardly expanded at all between 1951 and 1961, as the number of advances increased from 96,830 in 1951 to only 119,155 ten years later<sup>1</sup>.

A clearer indication of the bias against small firms can be gathered from the lending activity of the bank during the 1950s, before credit restrictions were lifted. Between 1951 and 1957 the total lending of the bank decreased both in terms of money and number of customers, conforming to Treasury and Bank of England directives. Nonetheless, manufacturing as a whole did not register a decrease in the amount of money lent but a rather considerable one in the number of customers (-24%), in all sectors except for aeroplane manufacturing and 'Other Textiles'. Manufacturing sectors to show a decrease also in the amount of money lent were those where small firms were more prominent: 'Clothing' (-30%), 'Leather' (-38%), 'Food' (-24%), 'Paper' (-24%) and 'Furniture' (-28%), as shown by Table A5.4.

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<sup>1</sup> These calculations for the whole of the Classification of Advances are presented, in table form in the Appendix to the chapter, see Tables A5.2 and A5.3.

The general decrease in the number of accounts, not matched by a decrease in the amounts lent, is consistent with the evidence presented in the previous chapter, that the banks found it easier to reduce advances by rationing loans to small firms. Between 1951 and 1957 those categories where small customers were predominant like 'Small Retailers' and 'Professional' for example, suffered a considerable decrease, both in terms of money lent

(-38% and -49%) and number of accounts (-30% and -49% respectively)<sup>2</sup>.

The fact that the advances to the 'Personal' category did decrease in amounts but only very little in numbers (only 2%) is not inconsistent with the picture presented so far. Advances to finance private consumption, like the purchase of a motor car, or a new living room suite, though in theory strictly disapproved by the Treasury, were those that brought the highest returns (as small loans were charged the highest rates) with the lowest risk, the ideal customer from any bank's point of view.

The Classification of Advances for Midland Bank shown in the Appendix to this chapter suggests also that not only was the number of advances to manufacturing a very small share of the total number of advances but it was also a very low number in absolute terms (9924 in 1951, decreasing to 7500 in 1957 and rising up to 12176 in 1961). Considering that the Midland Bank had, together with Barclays, the most extensive network of branches and the largest share of advances and deposits, that firms tended to have more accounts with the same bank and that in 1960 there were more than 88,000 manufacturing firms in Britain, it would suggest that a significant

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<sup>2</sup> It is interesting to note that the figures, money and number of loans, referring to 'House Purchase', decreased between 1951 and 1957 whereas those referring to 'House Purchase for Staff' did not. Clearly the bank had to fulfil its contractual obligations despite the possible inflationary effects of its staff's spending.

number of firms did not have an overdraft. A study done in 1956 by the Institute of Statistics in Oxford suggested that two firms out of five did not hold a bank overdraft and that, on average, the larger the firm, the more often it resorted to banks as a source of temporary finance<sup>3</sup>. It is therefore plausible to assume that Midland's loans to the manufacturing sector were mainly to large firms. The following pages will present more evidence to reinforce this impression.

Table 5.1. Midland Bank. Number of advances renewed and new applications accepted by size of loan (£). 1954-1958

Size of loan	1954		1955		1956		1958	
	Renewal	New	Renewal	New	Renewal	New	Renewal	New
1-5,000	67,498	48,442	70,616	35,561	73,439	17,679	40,867	35,137
5,001-10,000	3,936	3,347	4,134	2,559	4,486	1,464	3,373	2,637
10,001-25,000	2,732	2,046	2,937	1,589	3,200	1,002	2,326	1,577
25,001-40,000	944	491	1056	498	1089	344	1084	507
40,001-75,000	984	465	987	403	1014	270	893	283
75,000+	1445	567	1474	499	1542	343	1500	407
Total	77,539	55,358	81,204	41,109	84,761	21,102	50,043	40,548

Source: Midland Bank Archive, courtesy of the Group Archivist.

Table 5.1 shows that, between 1954 and 1958, most of Midland's advances were in fact renewals of existing business. Furthermore, after 1955, when the Chancellor called upon the banks to make "a positive and significant reduction in their advances", the number of new applications accepted decreased drastically, while renewals kept increasing. Even after

<sup>3</sup> H.F. Lydall, 'The impact of the credit squeeze on small and medium-sized manufacturing firms', The Economic Journal, 67 (1957). These findings were confirmed by B. Tew, R. Henderson, Studies in Company Finance, (Cambridge, 1959), chapter 6.

the restrictions were lifted, the number of new advances increased only to the level it had been before the squeeze. These numbers confirm what the Classification of Advances suggested, i.e. that Midland's strategy in these years was not that of increasing its market share but was mostly concerned with reinforcing its existing one. This strategy was certainly the best one in terms of cost- and risk-minimising, but not in terms of profit maximisation, thus confirming the suggestion in Chapter 2, that British banks were behaving as satisficers. Further confirmation can be found by looking more closely at the numbers in Table 5.1.

Table 5.1 shows that the vast majority of advances made were between £1 and £5,000. I would like to argue that these loans were not made to small manufacturing firms. From the Classification of Advances in the Appendix to the chapter, we know the number of advances in the 'Other Personal' category. Advances to this category were usually for home repairs, the purchase of furniture, of motorcars, and motor bikes and generally for consumer spending. Considering that the average cost of a motor car in 1955 was around £600, that a university lecturer's salary would have been around £500 a year and that not many people in the country were likely to earn double that sum, it seems plausible to assume that the great number of advances to the 'Other Personal' sector would have been for sums less than £5,000. Furthermore, the advances to the 'Small Retailers' category were likely to be for less than £5,000 too, as they were usually needed to pay for stock.

Table 5.2 Midland Bank - Structure of lending in the £1-£5,000 category. 1954-1958

	1954	1955	1956	1958
Tot. number advances £1-£5,000 (from Tab.5.1)	115,940	106,177	91,118	76,004
'Other Personal'+ 'Small Retailers' (from Tab.A5.1)	104,650	98,764	85,709	130,083

The numbers Table 5.2 shows that it is unlikely that a significant number of advances in the £1-£5,000 category could have been made to small firms.

If the above argument is not convincing, the prices of machinery (machine tools for example) suggest that advances for sums below £5,000, even in the case when an advance in this category was made to a small firms, would have been used mostly for working capital, to pay for stock and wages. In 1953 a power press would have cost between £4,000 to £7,000, depending on the size and whether or not it was imported; an optical precision grinder would have cost around £8,000. On the basis of the price of machinery and assuming that overdrafts must have been used, to some extent, for the purchase of machinery<sup>4</sup>, advances to small firms would have fallen in the category £5,001-£10,000 and Table 5.1 shows how small the number of loans in this category was, compared to the £1-£5,000 one. The data in the Classification of Advances (Table A5.1 in the Appendix) together with the figures in Tables 5.1 and 5.2 suggest that Midland Bank made few advances to small manufacturers.

How much of Midland's reluctance to lend to small firms was determined by

<sup>4</sup> Bolton Committee, Report, p. 161.

the absence of creditworthy customers<sup>5</sup> or was due to the fact that the bank did not think that lending to small firms was not worth the return? To answer this question it is useful to look closely at two schemes launched by Midland at the end of the 1950s.

In 1958, Midland Bank introduced the Personal Loans scheme as a strategic move to increase its market share, threatened by Barclays. Personal Loans were not meant exclusively for private use but also for business or professional use. Their peculiarity was that these loans were to be for small amounts and for rather specific purposes such as the purchase of furniture, fittings or equipment, motor cars, motor cycles and bicycles, house repairs, decorations and improvements and commitments and expenditure of an annual or recurrent nature, i.e. working capital for business.

Data on the Classification of Personal Loans to private and business customers is available for 1958 and 1960, both for the bank as a whole and for the Midland Division, and is presented in tabular form in the Appendix to the chapter as Table A5.5. In both years the highest number of loans and largest amount lent was for the purchase of motorcars and motorbikes for private use. In 1958 the number of loans to this category was more than 34 percent of the total and the amount lent was higher than 45 percent of the total. In 1960 these percentages had increased to 43 and 62 respectively. On the other hand, loans to businesses or professionals held a small share of the total both in terms of numbers and amount lent, being about 8 percent and 12 percent respectively in 1958. Furthermore this share decreased in 1960 to 6 percent and 8 percent. The rather small share of business loans is not a reflection of the fact

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<sup>5</sup> as the banks suggested to the Radcliffe Committee: PP 1969, Committee on the Working of the Monetary System, Report, Cmn 827, p. 48.

that the data are aggregated for the whole country. In fact data for the Midland division, the division including the most industrialised areas of the country, show exactly the same percentages.

Personal Loans were quite successful, not so much in terms of amount lent (as this accounted, in 1958, to little more than 1 percent of the total lending of the bank) but in terms of numbers of customers (as the number of Personal Loans was almost 16 percent of total advances). Nevertheless the data show that the number of small business loans was very low, once again posing the question if this was due to scarce demand or scarce willingness on the part of the bank to lend to this category of customers. Possibly the Personal Loans scheme was not designed for small businesses as, in fact, it targeted mainly the purchasers of consumer durables. These borrowers could negotiate face-to-face with a bank manager, rather than having to be assessed by hire purchase companies, the main alternative source of this type of finance. The rate of interest was high enough to cover the additional risk of bad debt but low enough to compete with the Finance Houses<sup>6</sup>.

Paragraph 942 of the report of the Radcliffe Committee concluded with the recommendation that banks should be ready to offer term loan facilities, to increase the availability of finance to smaller businesses, as an alternative to a running overdraft. Prompted by the Committee's report, the Midland Bank decided, in 1959, to offer term loans for small businesses. These were heralded as the "new way to

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<sup>6</sup> A.R. Holmes, E. Green, Midland. 150 years of banking business, (london, 1986), pp. 224-225.

In 1958 to further increase its share of the growing 'consumer spending' market Midland acquired one of the hire purchase companies, Forward Trust. See, Holmes, Green, Midland, p. 227.

finance business expansion for small firms"<sup>7</sup>. Term Loans were meant to finance plant improvements and machinery purchase and had a duration of 3 to 5 years (sometimes even up to 10). Also, as long as the customer kept up repayments, the loan could not be recalled before the expiry of the agreed period.

Though the scheme received quite a lot of coverage by the press it would appear to have been little more than a public relations exercise, despite the laudatory terms used by the bank's official historians<sup>8</sup>. Internal memos show that the bank was adamant that the introduction of Term Loans did not alter the fact that its primary function in the field of lending continued to be the provision of short term credit, repayable on demand and that the bulk of the bank's business would continue to be in this field. Thus Term Loans had to be limited to a modest proportion of total advances. Head Office's instructions to their branch managers contained the outline of how Term Loans could be effectively discouraged. Though Term Loans were for quite small amounts of money, between £500 to £10,000, the procedure for processing these loans was to be no different from that for all other advances. All information about a customer had to be put on a form, sent to London and the decision was then taken by the Advances Department. If anything, to avoid "abnormal risk...the security requirements for Term Loans may well need to be rather more strict than they would be for "on demand" facilities"<sup>9</sup> (i.e. for overdrafts). Thus new businesses or those firms whose worth could not be easily summed up in an application form, would not

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<sup>7</sup> Quote from a Midland brochure for that year, emphasis in the original. Courtesy of the Group Archivist.

<sup>8</sup> Holmes, Green, Midland, p. 227.

<sup>9</sup> Midland Bank archives, letter from the Chief General Manager to Managers of Branches, 5th November 1959. Courtesy of the Group Archivist.

have been able to access this new facility. The interest rate for Term Loans did not vary depending on the amount or the security offered, and was quite high, compared to the rates for overdrafts, being 2% over bank rate, minimum 6%. In the bank's view this rate would have discouraged demand advances from being switched over to a term basis. Furthermore, branch managers were supplied with a very small number of brochures explaining the scheme in general terms and were to give them only to those customers who asked for this service; in other words branch managers were discouraged from advertising this new facility. Figures for 1962 and 1964 (when the scheme was terminated) suggests that Term Loans had not been very successful as the highest number of loans active was 274 in March 1964<sup>10</sup>.

Another reason for the limited success of Term Loans, compared to that of Personal Loans, was that branch managers had always offered personal advances and the public knew that this facility existed. Term Loans, or loans for small businesses were a new product and managers had not had any experience in marketing it. They would have had to actively search for customers, as the number of small firms that had an overdraft, i.e. that used bank facilities and might have known of the services offered, was very small, as the Oxford study suggested. Those firms who were already customers of the bank were more likely to prefer the old system of overdrafts, as these were in fact cheaper and more flexible.

The example of the Term Loans scheme confirms what the evidence presented in the previous pages could only suggest: that the Midland Bank had little real interest in lending to small firms and expanding their market share in this sector.

This thesis argues that though the actual number of small firms holding an

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<sup>10</sup> Figures courtesy of the Group Archivist.

overdraft might have been small, demand was also determined by the expectation of it being fulfilled<sup>11</sup>. Chapter 4 has shown how demand was being reduced by credit restrictions, and by virtue of the fact that small firms expected loans not to be granted and overdraft facilities to be withdrawn. Nonetheless demand for credit was there and banks, or at least the Midland Bank, were acting as satisficers by choosing not to tap into this potentially very remunerative market.

Thanks to the data presented in Table A5.6 in the Appendix<sup>12</sup> to the chapter it is possible to compare the lending of Barclays and Midland. The most striking difference between the two banks is that, in 1948, though Midland had a more extensive network of branches and a higher amount of advances than Barclays (more than 300 million pounds the former and about £280 million the latter), Barclays had about 20,000 more active advances than Midland<sup>13</sup>. The average size of loans to the

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<sup>11</sup> J.H. Wood, Commercial bank loans and investment behaviour, (London, 1975).

<sup>12</sup> Table A5.6 describes the distribution of advances and clients by category for Barclays Birmingham Local Board. Once again it is useful to remember that these advances were granted to customers of the bank residing in the Birmingham District (as described in chapter 3). Because of the industrial specialisation of the Midlands and of the bias towards the engineering sector, it comes as no surprise that the sector to be granted the highest amount of advances was the manufacturing one, and most specifically the engineering one. Unfortunately the classification of advances is available only for 1948, 1968 and 1972, and only for this District. The archives of Barclays bank have not yielded the classification for the bank as a whole and search in other archives such as the one at the Bank of England have also been unsuccessful. Nor has the British Bankers Association been forthcoming with any information.

<sup>13</sup> The total number of advances granted by Barclays Bank as a whole has been extrapolated in the following way, as these data are not available from the archives.

In 1948 the advances (in pounds) of Birmingham Local Board accounted for 5.38 percent of total advances. Assuming that the number of advances generated in the District was the same percent of the total, this total can be calculated as the number of advances generated by Birmingham district. The same calculation has been repeated for 1968.

manufacturing sector was also quite different as Barclays granted, on average, smaller loans than Midland did. Twenty years later, when Midland had changed its structure to a more decentralised one, its advances were still higher than those of Barclays (£1,456 million and £1,223 million respectively), but Midland also granted more overdrafts and loans that Barclays did, approximately 80,000 more. Nonetheless it must be remembered that Midland's great increase came from the Personal sector, as described in the section above, thanks to the launching of schemes like the Personal Loans in the late 1950s and early 1960s, while Barclays did not enter this market until later. Furthermore, the average size of advances to the manufacturing sector granted by Midland, was still higher than that of Barclays, by about 7,000 pounds<sup>14</sup>.

Though these data are estimates they suggest that Barclays Bank, the one bank with a decentralised structure, had a larger customer base and granted on average smaller loans, than a centralised bank like the Midland.

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To test the validity of this calculation the same procedure has been applied to the number of advances generated by the Midland Division of the Midland Bank and the result compared to the real total available from the archive. The estimated total and the real total are not very different, as the estimated total is a slight overestimate of the real number. The fact that the number of advances generated by the Midlands area accounted for a lower percent of the total than the amount of advances is consistent with the fact that densely populated areas like the South-East and the London area would have generated more small personal advances, whereas an industrialised area like the Midlands would have generated a higher level, measured in pounds, of advances but less advances in terms of numbers.

<sup>14</sup> The remarkable increase in the number of advances granted by Barclays Birmingham District in 1972 was due to the merger, in 1969, with the provincial bank Martins. Martins was a much smaller bank than Barclays (in 1968 its advances were only 22 percent of Barclays), but, as a provincial bank, it had a large base of very small accounts, especially in the personal sector. This would explain the increase, equal to almost 100 percent in the number of Barclays advances between 1968 and 1972.

## Conclusion

The data presented in this chapter shows that, until the mid 1960s, Midland Bank was not acting as a profit-maximiser as its customer base hardly increased in a period when there was unsatisfied demand from businesses and its bad debt was negligible, while Barclays, who also had very low bad debt, had a larger customer base.

Though the absence of data makes it impossible to compare the lending activity of Midland with that of the other clearing banks, no evidence has been found that any of the Big Five was particularly concerned with the difficulties of small firms, nor that they made an effort to tap into this market. After the Midland Bank realised that Barclays had overtaken it as the largest bank in the country, its senior management took about a decade to change the internal structure of the bank, as described in Chapter 3.

## **Appendix to Chapter Five**

### **Tables**

Table A5.1

Midland Bank -		Classification of Advances for the bank as a whole 1951-1968									
		Thousands of pounds in constant terms (1963) and number of loans									
		1951		1954		1955		1956		1957	
		Pounds	N.Accounts	Pounds	N.Accounts	Pounds	N.Accounts	Pounds	N.Accounts	Pounds	N.Accounts
Iron&St		4240	353	8907	352	6616	339	8296	329		
Non-ferMe		585	80	951	73	1154	91	837	74		
Engineer		27800	2286	24859	2071	37191	2087	43668	1952		
MotorMan		955	69	3422	54	5445	47	14447	45		
AirMan		1382	8	17	7	1165	8	4677	8		
Shipbuild		1191	55	1226	42	1323	45	3292	43		
Chemical		5725	252	3871	183	8504	204	11095	183		
WoolManf		7754	166	3226	131	3583	129	3401	120		
CottManf		954	54	976	50	1604	55	1457	55		
OtherTex		3346	301	4266	322	4050	311	3499	298		
Clothing		5694	758	7396	726	4130	668	3802	583		
Leather		2000	180	1338	150	1483	141	1718	161		
Food		27234	1643	26684	1521	29866	1411	17974	1200		
Paper		667	107	386	55	556	56	555	68		
Furniture		2257	639	1646	513	2035	466	2486	443		
UnclasInd		15103	2973	17374	2538	15814	2471	13197	2150		
Tot.Mannf.		106888	9924	106546	8788	124518	8529	134401	7712		
Coal		691	27	76	24	50	27	111	23		
Quarr		1045	124	662	98	640	97	411	77		
Transport		575	180	433	162	438	178	376	178		
RoadTrans		3213	1317	2537	1066	3241	1068	2751	1006		
Shipping		1421	68	988	51	2830	45	2788	54		
CottMerch		276	37	674	79	634	60	498	67		
WoolMerch		2616	99	2375	119	2265	113	7271	125		
Hide Merch		3190	231	2683	203	2296	201	2172	189		
Farmers		35666	16813	33437	17216	34000	17986	29613	16270		
AgriMerch		4354	701	3617	640	3915	601	3951	698		
Fish		1770	242	1734	229	1470	188	1221	184		
Stores		8836	272	7493	191	7066	202	7093	204		
Co-ops		325	8	113	6	269	14	308	3		
SmallRet		35887	21087	27730	19010	25531	17828	21931	15992		
Hotels		13094	4383	7503	3321	6606	2942	5279	2504		
Enter		3642	857	2022	693	2040	721	1760	662		
Builders		20736	5055	18014	4075	17953	3869	14693	3357		
BuildMater		4842	520	3704	420	4433	447	3672	429		
Print		3428	650	2366	645	2823	620	2220	553		
Laundries		764	214	496	186	523	163	358	144		
WholeMerch		12763	1682	15368	1657	14140	1604	12128	1477		
LocAuth		58803	990	60512	723	51348	615	48340	387		
PubUtil		22772	141	32942	74	29728	63	34107	53		
Churces		4233	2138	3978	1997	4179	1833	3569	1700		
Stock		440	48	278	31	384	23	399	30		
OtherFin		35667	749	41596	691	30863	776	28385	684		
BuildSoc		3458	194	1264	90	1304	115	1036	94		
HirePurch		2972	81	3012	98	5463	161	3274	133		
Prof		11700	8849	8475	6868	7421	5807	5933	4943		
HousePurc		19825	12064	11449	9211	9738	8183	6848	6458		
HouseStaff		3566	5222	10679	6316	10939	6510	11467	6634		
Execut		7175	1863	4276	1153	4589	1122	3554	1043		
OtherPer		37057	88139	26961	85640	24699	30936	20067	79717		
PersLoan		0		0		0		0			
TOTAL		478688	184969	445993	171771	438333	163647	421983	153784		

Source: Midland Bank Archives. Courtesy of the Group Archivist.

Table A5.1 (cont.)

1957		1958		1960		1961	
Pounds	N.Accounts	Pounds	N.Accounts	Pounds	N.Accounts	Pounds	N.Accounts
9564	303	9194	345	14770	419	17317	416
730	72	1478	71	1681	86	2383	96
43058	1931	42951	2193	109847	3021	133966	3210
6132	57	10305	63	16528	86	3041	64
3801	14	6728	17	10050	19	12303	13
1166	38	404	42	722	50	5243	53
6655	156	7079	167	13060	219	13997	203
3525	138	3275	141	4092	171	6035	172
1326	48	1516	52	1466	59	1419	61
3618	314	3227	308	5422	332	4650	325
3992	565	5136	595	8758	721	9898	692
1232	141	1906	158	2378	173	2404	177
20648	1148	21524	1363	27569	1914	29434	1847
495	42	723	48	768	65	998	74
1625	386	1848	439	2020	619	2197	601
13727	2147	13951	2518	24458	4013	24640	4172
121292	7500	131247	8520	243588	11967	269923	12176
78	30	151	31	74	26	61	24
495	68	566	76	1260	83	1606	102
491	171	446	191	2300	339	2039	337
2264	877	2621	1077	3987	1521	4740	1495
3295	48	4790	61	4464	66	4380	75
693	73	615	65	937	67	618	61
9452	131	8190	154	8899	164	8921	152
2365	183	2282	182	3174	231	3221	218
29394	16942	34204	18556	62858	25625	64943	25869
3722	598	4339	671	6056	793	5867	760
2252	180	2628	224	4416	265	4484	242
7472	204	7239	189	10396	216	9927	222
209	4	479	5	54	4	242	20
22337	14815	26661	18019	52398	28586	48955	28287
4849	2227	5084	2499	9644	3707	9143	3675
1579	582	1888	577	2682	745	2691	721
13213	3219	15321	3875	31022	5719	27709	5807
3903	424	3432	449	5426	569	5511	506
2130	536	1951	588	4614	893	5265	937
338	131	379	154	816	218	818	219
13243	1485	12736	1629	19226	2006	18163	1981
42066	361	37449	324	38499	291	21388	290
18901	62	25389	64	25062	58	17128	43
3478	1535	3640	1479	5278	1656	5192	1597
212	29	269	31	896	40	575	36
25412	678	29632	745	47588	1536	53735	1605
1130	88	914	78	910	99	758	84
4074	134	5593	198	16632	372	14571	371
5926	45281	6609	4903	10564	6519	102661	6899
6163	5641	7522	6229	19859	14075	18493	14470
12320	7159	13379	7697	15884	7946	17266	8507
3583	1150	3606	1372	5377	1375	4896	1367
19193	86492	24779	112064	51921	184508	47024	188207
0		6456	36046	20036	190583	12083	144318
387524	158285	432486	229022	736795	492868	722602	451680

Table A5.1 (cont.)

		1968
	Pounds	N.Accounts
Food	369131	780
Chem	214261	404
MetManf	278261	490
ElectEng	594711	914
OtherEng	848171	4203
Ship	96351	183
Vehic	447631	375
Text	317621	1915
OtherMan	381191	3772
<b>Tot.Manuf</b>	<b>354731</b>	<b>13036</b>
Agric	930561	27495
Fish	7991	119
Min	34961	202
Constr	424461	9040
HirePur	87191	436
PropCo	199831	3272
OtherBank	13811	9
OtherFin	147181	685
Insur	10861	199
Trans	185401	3340
PuUtil	98371	62
LocGov	51541	276
Retail	292931	2418
SmallRet	342701	24198
OtherDis	465551	4561
Proff	541421	20256
Exec	49611	1229
Catering	127101	5435
HousePur	216721	17135
HouPurStaf	339031	11496
OtherPer	725381	441500
OverseaRes	12241	236
OverseaBanks	91751	228
<b>TotLent</b>	<b>894389</b>	
NumAcc		586963

Table A5.2

Midland Bank			
1951-1961 Percentage change in advances (pounds & numbers)			
	Pounds	Numbers	
Iron&St.	308	18	
Non-ferMe	307	20	
Engineer	382	40	
MotorMan	218	-7	
AirMan	790	63	
Shipbuild	340	-4	
Chemical	144	-19	
WollManf	-22	4	
CottManf	49	13	
OthrTex	39	8	
Clothing	74	-9	
Leather	20	-2	
Food	8	12	
Paper	50	-31	
Furniture	-3	-6	
UnclasInd	63	40	
Tot.Manuf.	153	23	
Coal	-91	-11	
Quarr	54	-18	
Transport	255	87	
RoadTrans	47	14	
Shipping	208	10	
CottMerch	124	65	
WoolMerch	241	54	
Hide Merch	1	-6	
Farmers	82	54	
AgriMerch	35	8	
Fish	153	0	
Stores	12	-18	
Co-ops	-26	150	
SmallRet	36	34	
Hotels	-30	-16	
Enter	-26	-16	
Builders	34	15	
BuildMater	14	-3	
Print	54	44	
Laundries	7	2	
WholeMerch	42	18	
LocAuth	-64	-71	
PubUtil	-25	-70	
Churces	23	-25	
Stock	31	-25	
OtherFin	51	114	
BuildSoc	-78	-57	
HirePurch	390	358	
Proff	-12	-22	
HousePurc	-7	20	
HouseStaff	102	63	
Execut	-32	-27	
OtherPer	27	114	
PersLoan	n.a.	n.a.	
<b>TOTAL</b>	<b>51</b>	<b>144</b>	

Table A5.3

Midland Bank			
<b>Average size of loans 1951 and 1961 (constant terms)</b>			
		1951	1961
Iron&St.		12	42
Non-ferMe		7	25
Engineer		12	42
MotorMan		14	48
AirMan		173	946
Shipbuild		22	99
Chemical		23	69
WollManf		47	35
CottManf		18	23
OthrTex		11	14
Clothing		8	14
Leather		11	14
Food		17	16
Paper		6	13
Furniture		4	4
UnclasInd		5	6
Tot.Manuf.		11	22
Coal		26	3
Quarr		8	16
Transport		3	6
RoadTrans		2	3
Shipping		21	58
CottMerch		7	10
WoolMerch		26	59
Hide Merch		14	15
Farmers		2	3
AgriMerch		6	8
Fish		7	19
Stores		32	45
Co-ops		41	12
SmallRet		2	2
Hotels		3	2
Enter		4	4
Builders		4	5
BuildMater	*	9	11
Print		5	6
Laundries		4	4
WholeMerch		8	9
LocAuth		59	74
PubUtil		162	398
Churces		2	3
Stock		9	16
OtherFin		48	33
BuildSoc		18	9
HirePurch		37	39
Proff		1.3	1.5
HousePurc		1.6	1.3
HouseStaff		1.6	2.0
Execut		3.9	3.6
OtherPer		0.4	0.2
PersLoan	n.a.		0.1
<b>TOTAL</b>		<b>2.5</b>	<b>1.6</b>

Table A5.4

Midland Bank			
1951-57 Percentage change in advances (pounds and number)			
	Pounds	Numbers	
Iron&St.	126	-14	
Non-ferMe	25	-10	
Engineer	55	-16	
MotorMan	542	-17	
AirMan	175	75	
Shipbuild	-2	-31	
Chemical	16	-38	
WollManf	-55	-17	
CottManf	39	-11	
OthrTex	8	4	
Clothing	-30	-25	
Leather	-38	-22	
Food	-24	-30	
Paper	-26	-61	
Furniture	-28	-40	
UnclasInd	-9	-28	
Tot.Manuf.	13	-24	
Coal	-89	11	
Quarr	-53	-45	
Transport	-14	-5	
RoadTrans	-30	-33	
Shipping	132	-29	
CottMerch	151	97	
WoolMerch	261	32	
Hide Merch	-26	-21	
Farmers	-18	1	
AgriMerch	-15	-15	
Fish	27	-26	
Stores	-15	-25	
Co-ops	-36	-50	
SmallRet	-38	-30	
Hotels	-63	-49	
Enter	-57	-32	
Builders	-36	-36	
BuildMater	-19	-18	
Print	-38	-18	
Laundries	-56	-39	
WholeMerch	4	-12	
LocAuth	-28	-64	
PubUtil	-17	-56	
Churces	-18	-28	
Stock	-52	-40	
OtherFin	-29	-9	
BuildSoc	-67	-55	
HirePurch	37	65	
Proff	-49	-49	
HousePurc	-69	-53	
HouseStaff	44	37	
Execut	-50	-38	
OtherPer	-48	-2	
PersLoan	n.a.	n.a.	
TOTAL	-19	-14	

Table A5.5

Midland Bank								
Classification of Personal Loans 1958 and 1960								
Midland Division and Whole Bank								
		1958				1960		
		Midland Division		Whole Bank		Midland Division		Whole Bank
		N. Loans	Amount	N. Loans	Amount	N. Loans	Amount	N. Loans
Customers	Furniture (P)	2122	230017		9452		9203	631087
	Furniture (B)	154	27281		561		569	65744
	Motocar (P)	3164	674171		11992		21490	2850019
	Motocar (B)	510	130153		2076		1512	215927
	HouseRepairs (P)	1750	203792		7809		5822	410634
	House Repairs (B)	63	13144		297		225	23341
	Other	776	103447		2736		4378	380936
	Recurrent Expenditure					43	2917	520
Staff	Furniture	77	6165		485		290	15813
	Motorcar	69	11052		312		380	42694
	House Repairs	39	3341		246		95	5664
	Other	18	1208		80		67	4703
	Reccurent Ex.							5
	TotCust.	8539	1382005		34923		43242	4580605
GrandTot	TotStaf	203			1123		832	68874
	GrandTot	8742			36046		44074	4649479
N.B. (P) indicates Personal Loans to private individuals while (B) indicates Personal Loans to businesses								
Source: Midland Bank Archive, courtesy of the Group Archivist.								

Table A5.6

Barclays Bank Birmingham Local Board							
Classification of Advances							
(constant terms - 1963)							
	1948			1968		1972	
	(000)	N.of Custs		(000)	N.of.Custs	(000)	N.ofCusts
Iron&St.	1460	143	MetalMan	3294	98	3793	96
Non-FerMe	63	23	Engineer.	29307	1073	25302	1539
Engineer.	5089	488	Shipbuild	15	5	34	9
Shipbuild	26	6	Chemic.	125	26	393	45
Chemical	377	23	Text.Leath	411	80	669	122
Wool	18	1	Food	1168	40	671	57
Cotton	0	0	OtherMan	3858	416	8190	552
OtherTex	333	51	Tot.Man.	38179	1738	39052	2420
Leather	370	34	Min.Quarry	267	14	100	17
Food	632	150	Transport	993	417	1594	637
UnclasInd.	1107	298	Farmers	4108	1289	4609	1442
Tot.Man.	9475	1217	Retail	6318	4323	7681	4807
Coal	30	8	OtherDist.	3408	450	7967	596
Quarry.	89	16	Construct.	6192	1011	11124	1479
Transport	461	156	LocAuth	46	5	108	6
Farmers	2484	820	PubUtil	0	0	0	0
Retail	2795	1445	HirePurch	233	40	832	76
Enter.	846	89	Prop.Comps.	1746	373	5361	553
Builders	946	310	OtherFin	431	129	1539	316
BuildMater	411	54	Proff	12390	2627	14609	3983
LocAuth	977	12	Pers	4999	24726	13273	58214
PubUtil	495	7	HousePurch	3488	2614	6018	3746
Churches	449	102					
Stock.	119	7					
OtherFin	535	95					
Pers.Prof.	6784	6295					
	0						
Total	36372	11850	Total	120976	41494	152918	80712

Source: Barclays Bank Archive, for 1948. Inspection of Birmingham Advances, Acc. No. 80/1881;

for 1968-1972, Birmingham Head Office. Classification of Advances made to the Treasurer's Department, Acc. No. 1/30.

## Chapter Six

### The Italian Banking System

This chapter opens the Italian section of this thesis and describes the structure of the "counterfactual" banking system, one made of many types of banks, from small and regional to large and national. For reasons that will become clearer in the following pages, this narrative will start from the interwar period and unfold up to the first half of the 1960s.

#### 1. The Italian Banking System

Banking in Italy goes back as far as the fourteenth century. One of Italy's most important banks, the Monte dei Paschi di Siena, was established in 1472, and many others large banks date back to the sixteenth century. Between the end of the nineteenth century and the beginning of the twentieth, as the country industrialised and foreign capital came into the country, Italy's most important banks, the Credito Italiano, the Banco di Roma, the Banca Commerciale Italiana and the Banca Nazionale del Lavoro, were created<sup>1</sup>.

Speculation, and a misguided use by the Italian government of the banks as venture capitalists, brought about the collapse in 1893 of the country's two largest banks, the Credito Mobiliare and the Banca Centrale, <sup>followed</sup> and in 1920 by the Banca di Sconto. The crisis of 1930, which followed <sup>the</sup> the world economic slump, showed the flaws of the country's banking structures as these had become the major shareholders of the state-promoted iron and steel industries. In 1934 the three major

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<sup>1</sup> A. Polisi, Alle origini del capitalismo italiano, (Torino, 1993).

banks, the Banca Commerciale Italiana, the Banco di Roma and the Credito Italiano, which held the shares of most of the failing Italian firms, were taken over by the government, and their shares transferred to the newly created Istituto per la Ricostruzione Industriale (IRI). State control was meant to be a temporary solution, waiting for an upturn in the economic cycle that would allow private investors to come forward. In the following years few buyers appeared to purchase the companies held by IRI and, in 1937, state ownership was made permanent. IRI, by taking over the control of the three banks and of the shares they owned in the bankrupt firms, became the largest state controlled holding company of the Western economies<sup>2</sup>.

### 1.1. The Bank Law of 1936

The salvaging of the banks and the creation of IRI led, in 1936, to the basic banking legislation that was to regulate the system until the mid-1970s. The new law made the collection of savings, and the granting of credit, functions of 'public interest', therefore justifying and requiring control by the government. This definition of banking allowed the state to take the lead in promoting the accumulation and distribution of capital. Besides exercising supervision, the central supervisory authorities were given the power to control credit both for the development of the national economy and for the creation of savings. Most importantly, a clear line was drawn separating medium-term credit to industry from short-term credit. The intention was to separate short-term finance (for working capital) from medium- and long-term finance and especially from industrial credit

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<sup>2</sup> P. Ciocca, G. Toniolo, 'Industry and Finance in Italy 1918-1940', Journal of European Economic History, 13 (Special Issue, 1984). For the earlier period see: A. Confalonieri, Banca e industria in Italia (1894-1906), (Milano, 1974), vol. I.

(which had traditionally involved the banks in investments in industrial shares).

Nevertheless the separation of the two functions was never quite absolute as the provision of medium- to long-term credit to industry was to be performed by sections within the banks and by special institutions controlled by the government and owned by the banks, as will be described further on.

The Italian banking institutions were divided in six groups. Public Law Banks (Istituti di Diritto Pubblico), Banks of National Interest (Banche di Interesse Nazionale), Ordinary Credit Banks (Banche di Credito Ordinario), Co-operative People's Banks (Banche Popolari), Savings Banks (Casse di Risparmio) and Rural and Artisan Banks (Casse Rurali e Artigiane).

Table 6.1. Number of Italian banks by juridical type.

	1938	1948	1956	1966	1974
Public Law Banks	5	5	6	6	6
Banks of National Interest	3	3	3	3	3
Ordinary Credit Banks	170	151	145	152	131
Peoples Cooperative Banks	294	227	210	206	177
Savings Banks	97	84	89	90	89
Rural and Artisan Banks*	1151	756	730	787	663
Total	<b>1720</b>	<b>1226</b>	<b>1183</b>	<b>1244</b>	<b>1069</b>

\*the Banca d'Italia includes foreign banks in this figure.

Source: Banca d'Italia, Bollettino Statistico, various years.

Table 6.1. shows how that the number of banks decreased from the inter-war period to the mid-1970s, <sup>but</sup> the variety and total number is quite staggering in comparison with <sup>continuing</sup> the United Kingdom.

The crisis of 1930 and the salvaging of the banks gave the chance <sup>for</sup> economists like Alberto Beneduce, to promote, through IRI, the concept of the state

that Francesco Saverio Nitti had advocated in the second decade of the century. Nitti, the successor of Giolitti as Prime Minister, saw the state as a force that could stimulate economic development, by direct intervention in specific industrial sectors and long term planning. This intervention was to be conducted by autonomous bodies, which would behave like enterprises<sup>3</sup>.

The industrial activity of IRI was flanked by the financial activity of the Istituto per la Mobilizzazione Industriale (IMI). IMI provided large industrial concerns with medium and long term finance by placing bonds representing various industrial sectors on the market. These bonds were purchased by the public through the banks, by the banks themselves, by other institutional investors like the insurance companies and by foreign investors.

The rigid regulation of the banking system by the Bank Law of 1936 was the natural consequence of the economic thought behind the creation of IRI and IMI. The Bank Law was drawn up by the economists Menichella, Saraceno, De Gregorio and Beneduce in 1933 at IRI. In that year a report was sent by them to Mussolini, with a plan to redefine the structure of the banking system<sup>4</sup>. The report stated that ten large national banks were too many and that other large regional banks, like the Istituto San Paolo, or a Savings bank like the Cassa di Risparmio delle Province Lombarde were dealing on the same markets. Too many banks were competing in the same areas, offering the same kind of services. The fierce competition among these banks, for deposits and loans, meant that losses were incurred which had to be eventually borne

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<sup>3</sup> F. Bonelli, 'Alberto Beneduce, il credito industriale e l'origine dell'IRI', in IRI, Alberto Beneduce e i problemi dell'economia italiana del suo tempo, (Roma, 1983), p. 72.

<sup>4</sup> S. Cassese, Come e' nata la legge bancaria, (Roma, 1988).

by the state. The structure had to be made more rational, the sphere of activity of each bank, in terms of geographical territory and sector of the economy served, had to be defined and controlled<sup>5</sup>.

In 1946, when the Bank Law was updated, the view of the Banca d'Italia *main tained* reflecting that of the pre-war economists, that the role of the banks was to promote economic development (and full employment) through the granting of credit to concerns committed to increasing production<sup>6</sup>, as the Bank believed that growth could be attained only if firms, independently from their size, could access the credit market.

The banking structure inherited from the 1930s, with its vast number of *institutions of* various types and sizes, had to be defended as it guaranteed the diffusion of credit and a "fair distribution of the savings collected"<sup>7</sup>. Therefore it was not advisable to privatize again those banks which had been put under state control in 1936<sup>8</sup>.

The connection between Italy's rapid economic growth and the role played by the banks was assessed by a rather critical observer, Raffaele Mattioli, the chairman of the Banca Commerciale Italiana. According to Mattioli the banks contributed to Italy's "economic miracle" in the 1950s through the financial support given, not so

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<sup>5</sup> The text of the report is contained in D. Menichella, Scritti e discorsi. 1933-1966, (Roma, 1967).

<sup>6</sup> D. Menichella, Governor of the Banca d'Italia, Intervento all'Assemblea Annuale dell'Istituto Centrale per le Banche Popolari, 5 February, 1959. The extracts from Menichella's speeches can be found in G. Lunghini (ed.), Scelte politiche e teorie economiche in Italia 1945-1978, (Torino, 1981), pp. 13-70.

<sup>7</sup> D. Menichella, Discorso all'Assemblea dell'Associazione fra la Banche Ordinarie di Credito italiane, 8 November, 1957. In Italian in the original.

<sup>8</sup> D. Menichella, Discorso all'Assemblea dell'Associazione Bancaria Italiana, 23 June, 1955.

much to large firms but mainly to small ones<sup>9</sup>.

A consequence of this belief in the banks as agents of development was the shaping of regulations so as to restrain bank competition, to protect the medium-size and small banks from the large national banks. The existence of small banks was thought to be important because of the assistance they gave to small and medium-sized firms <sup>which</sup> who, it was felt, would otherwise be overlooked by the larger banks<sup>10</sup>. Therefore controls were needed to preserve a structure in which small banks, operating at regional or local levels, could coexist with the larger banks. Thus bank competition was restricted to prevent an increase in industrial concentration since it was felt that, if the small firms were deprived of necessary credit, they would be forced to merge with the larger firms<sup>11</sup>. The aim of the Banca d'Italia in granting permits to open new branches was to: "ensure a balanced distribution of various categories of banking institutions, such as to make room for the coexistence of decision centres at different removes from government power and thereby to avoid the drawbacks of excessive concentration"<sup>12</sup>. Furthermore, the monetary institutions believed that it was against <sup>that would</sup> <sup>causing</sup> the public interest to permit competition ~~to~~ eliminate banks by bankruptcy because of

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<sup>9</sup> R. Mattioli, Relazione sull'esercizio della Banca Commerciale, (Milano, 1961), p. 248.

<sup>10</sup> D. Menichella, 'Il sistema creditizio fattore di stabilità monetaria e di sviluppo economico', Dichiarazioni fatte all'Assemblea dell'Associazione Bancaria Italiana, Bancaria, 13 (1957).

<sup>11</sup> The government's concern about the impairment of competition in industry led to a parliamentary inquiry in 1959. See: 'Testo del disegno di legge per la tutela della libertà della concorrenza- Relazione ministeriale e parere del CNEL', Rivista internazionale di scienze sociali, 15 (1960).

<sup>12</sup> The Governor of the Bank, Guido Carli, Banca d'Italia, Annual Report for 1961, English edition, (Roma, 1962), p. 97.

the social cost implicit in the loss of confidence in the system and because of the state's obligation to protect depositors' money<sup>13</sup>.

Unlike the British system where regulation rested on the banks' willingness to watch the 'governor's eyebrows', in Italy controls on the banks could be easily imposed by the monetary authorities thanks to the structure of ownership of the banks and of the Central Bank.

## 1.2 Ownership and controls

Following the Bank Law of 1936, the Banca d'Italia<sup>14</sup> was nationalised and its shares given to the Savings Banks, the Public Law Banks, the Banks of National Interest and the state-owned insurance companies<sup>15</sup>.

The Bank was run by a Board of directors and by the Governor. The members of the Board were representatives of the main provincial branches of the Bank<sup>16</sup> and were elected by the local shareholders (i.e. by the local banks which owned the shares

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<sup>13</sup> Ibidem, pp.10-11.

<sup>14</sup> The Banca d'Italia was founded in 1893 as the result of a merger of three of the six banks of issue then in existence. It was given sole right of note issue in 1926.

<sup>15</sup> In 1959 the Bank had ninety-eight shareholders of which seventy-seven were Savings Banks. See: V. Lutz, 'The Central Bank and the System of Credit Control', in R.S. Sayers, Banking in Western Europe, (Oxford, 1962), p.154.

<sup>16</sup> Because of the regionally fragmented structure of the banking system and of the country, the Bank adopted from its inception a decentralised structure to monitor the activity of the banks. Therefore, in addition to a Head Office in Rome, the Bank instituted main branch offices situated in the main provincial capitals, sub-branches in other main towns and agencies to cover the rest of the territory. In 1970 the Bank also created Regional Economic Observatories attached to most of the main branches in order to "have a clearer view of the economies of the various regions, since Rome was too far away". (Interview with the Head of Regional Observatories, Dr. Orietta Vito-Colonna, Banca d'Italia, 12 April, 1993.).

of the Banca d'Italia), while the Governor was appointed by the Board following formal approval by the Prime Minister. The Bank was subject to the supervision of the Treasury to the extent that a representative of the Treasury had an office in the Bank and attended the meetings of the Board. In many matters concerning the control of the credit system, the Bank acted together with the Interministerial Committee for Credit and Savings. The members of this Committee were the Treasury Minister and the other Ministers from the main government departments dealing with economic affairs.

The Bank Law, apart from linking the Banca d'Italia to the banks (through ownership of its shares and the election by the banks of the members of the Board) and the government (through supervision by the Treasury and the Interministerial Committee), also regulated the structure of ownership of the banks in such a way as to create a system of interlocking controls. The banks were either owned directly by the state (i.e. the three Banks of National Interest owned by IRI) or indirectly controlled by it through the shares owned by the Banks of National Interest<sup>17</sup>. The Co-operative People's Banks also issued shares to their customers, though one individual could own only a very limited number of shares and in any case had the right to only one vote. The only banks that could be controlled by private industrial or financial groups were the Ordinary Credit Banks. Except for the Boards of Directors of the Ordinary Credit banks, the other banks' Boards were usually made of bankers from other banks and members of the municipal, or provincial, authorities, creating institutional links with the local community.

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<sup>17</sup> The Banks of National Interest owned the majority shares of the Public Law Banks and of the Savings Banks. The rest of the shares were held by other banks and by the municipalities of the towns in which the banks had their head office.

The main controls imposed on the banks were those limiting their credit activity to short-term lending, and restricting competition, both by limiting the creation of new banks and the opening of new branches, and by preventing the merger of pre-existing credit institutions. At least until the end of the 1950s, the Banca d'Italia, when granting the authorization to open new branches favoured credit institutions of a local or provincial-regional character, while at the same time pursuing the policy of limiting "the further expansion of the bigger institutions to a few large or medium-sized centres"<sup>18</sup>. In 1948 there was a total of 7,403 branches and by 1960 this number had increased to 9,157. Of these, 83% were concentrated among the type of bank most accustomed to operating in small centres and with small customers, whereas only about 8% of the authorizations were granted to the largest banks which, in the early fifties, accounted for about 35% of the deposits of the entire Italian banking system<sup>19</sup>.

The allocation of new branches among competing applicants was one of the biggest problems faced by the Associazione Bancaria Italiana (ABI - Italian Banking Association), which in the early 1950s was called in to give advice to the Banca d'Italia. One of the most important factors that had to be taken into account was the area's potential. If the area could support another bank or branch, the ABI was inclined to authorise the new entry, even when it prejudiced an existing bank. Another consideration was the branch status of the applicant. For example, if two banks wanted to open a branch in the same area, and one already had a branch in that area, the ABI was inclined to give the other bank a chance in order to avoid the presence

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<sup>18</sup> Banca d'Italia, Relazione 1956, (Roma, 1957), p. 440, and Relazione 1948, (Roma 1949), p. 216 for quote.

<sup>19</sup> L. Ceriani, 'The Commercial Banks and Financial Institutions', in Sayers, Banking in Western Europe, p.126.

of only one bank in a single place. The size of the applicant was also an important consideration. If one bank was large and the other small, the ABI considered whether the area had primarily large or small banks, and then made the allocation so as to redress the balance. The nature of the business demand in the community and the comparative ability of each of the applicant banks to satisfy this demand was also taken into account<sup>20</sup>. Though this system regulated competition by restricting the opening of new branches, it also promoted competition by ensuring the presence of more than one bank and of more than one type of bank in the same area.

Competition was controlled also through the limitation of the territorial area in which the banks could operate. The assumption on which the Banca d'Italia based its regulation of territorial expansion was that the granting of credit should be confined to a very specific area. This varied according to the size of the bank and on where its head office was. The banks of National Interest (those directly controlled by IRI) were the only ones to have a nation-wide organisation. The other large banks (defined as such by the extent of their deposits) could operate in a whole region only if their head office was established in the regional capital, otherwise they could operate only in the province in which their branches were concentrated. The other banks could collect deposits and make loans in the province only if their head office was based in the main provincial town, otherwise their territory was limited to the municipality in which their branches were located<sup>21</sup>. For bank customers the area from which they

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<sup>20</sup> ABI, 'L'intervento dell'Avv. Siglienti ai lavori della Commissione d'inchiesta sui limiti della concorrenza', Bancaria, 19 (1963).

<sup>21</sup> Banco di Roma, The Italian Banking System, (Roma, third edition, 1974), chapter 2, sec.2.2; L. Barca, G. Manghetti, L'Italia delle banche, (Roma, 1976), p. 215.

could borrow was determined by the place of residence (personal borrowers) and by the legal domicile (firms). Banks were allowed to lend to a customer outside their area of competence only if the customer ran at least part of ~~his~~<sup>his/her</sup> activity within that area or if the intervention of the bank did not harm the banks situated in the area in which the lending operation took place and thus contravene the conditions of "healthy competition"<sup>22</sup>.

Another important regulation of the activity of the banks was the imposition of a limit on the size of advances, this had the effect of segmenting the market, so that small banks would cater for smaller customers and large banks for large ones. The banks had to be authorised by the Banca d'Italia before they could grant a loan to a single customer which would bring that customer's total liability to the bank to over one-fifth of the paid-up capital and reserves of the bank. This regulation linked the size of the advances to the size of the banks, therefore segmenting the market.

In 1959 the number of banks which had been authorised by the Banca d'Italia to lend above their limit was 292. Of these 83 were in the class for which the minimum size of operations to which control was applied was 10 million lire or less; another 98 were in the class between 10 and 50 million; at the other end of the scale there were 9 banks whose limit was above 700 millions (two of these had a limit above 1000 millions)<sup>23</sup>. These figures show the differences in the Italian banking system between the capital position of the very large banks and that of the small ones

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<sup>22</sup> Banca d'Italia, Annual Report for 1952, english version, (Roma, 1953), p. 429. The amount of lending authorised outside the area of territorial competence was usually quite a small proportion of total bank lending, see: Lutz, 'The Central Bank', p. 158.

<sup>23</sup> Lutz, 'The Central Bank', p.160.

and also imply that, even though the highest number of applications came from the smaller banks, the largest amounts related to the large ones. In theory this rule also meant that the ability of the Central Bank to monitor advances depended on the size of the bank from which the loan was sought, since, as far as the big banks were concerned, only the very large loans would be scrutinised as their capital position continued to improve. In practice the lending business of the big banks tended to be concentrated among the large borrowers; hence the supervision over the high figures outstanding at these banks was sufficient to allow the authorities to keep watch over those sectors of the economy where large firms were predominant. Similarly, those sectors where firms and operations tended to be smaller were well covered by virtue of the fact that these firms dealt mainly with the smaller banks for which the limit was low<sup>24</sup>.

The regulation of competition included also the regulation of prices to avoid price wars that would have eliminated the smaller banks. To control prices the Bank Law made the creation of a banking cartel compulsory. In the post-war period the Interministerial Committee made numerous changes to the cartel rates, but nevertheless competition was fierce, reflected in the increasingly widespread tendency among the banks to pay interest rates on deposits higher than those allowed by the cartel, to attract customers from other banks. Therefore the authorities sought a new agreement that would be signed voluntarily by the banks under the auspices of the Italian Banking Association. This Interbank Agreement became effective in 1954 and was renewed annually. The Agreement was occasionally broken by some banks to attract more customers, especially during periods of economic downturn, but it generally proved

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<sup>24</sup> Ibidem.

effective in preventing price wars among the banks.

This oligopolistic practice was acceptable as it prevented the smaller banks having to offer rates on deposits that they could not afford, in order to keep customers. Unchecked competition would inevitably have lead to the disappearance of small banks and, as these were thought to be essential for the provision of finance to small and medium sized firms<sup>25</sup>, a reduction in their number would have reduced the assistance to small firms<sup>26</sup>.

Alongside the genuine belief in the importance of small firms and small banks for economic development, it is reasonable to suppose that the monetary and political authorities (the two are inexorably linked in the Italian practice of government) had a more disingenuous reason for supporting these two sectors of the economy. Local banks could be used as political tools as the elected municipal authorities participated in the selection of the local banks' boards. The support given by those banks to small firms had an important political significance as the survival of the small firm was seen as a way of preventing people from leaving peripheral areas and changing local balances of power. This process was particularly evident in areas like Veneto and Friuli, Piedmont, controlled by the Christian Democrats, or regions such as Tuscany and Emilia Romagna where the Communist party ruled<sup>27</sup>.

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<sup>25</sup> Banca d'Italia, Relazione 1956, (Roma, 1957), p. 440.

<sup>26</sup> D. Menichella, 'Il sistema creditizio fattore di stabilità monetaria e di sviluppo economico', Dichiarazioni fatte all'Assemblea dell'Associazione Bancaria Italiana, Bancaria, 13 (1957).

<sup>27</sup> An example of the connection between political power and banks can be found in the fact that in 1975, seventy of the eighty nine Savings Banks had presidents belonging to the Christian Democratic Party. For an informative, if slightly biased view, of the relationship between politics and banks see: L. Barca, G. Manghetti, L'Italia delle banche, (Roma, 1976), p.19 .

### 1.3. Banking specialisation

The Banca Commerciale Italiana, the Credito Italiano and the Banco di Roma, were given the title of Banks of National Interest following the Bank Law of 1936. These were, and are, joint-stock companies and had branch networks which covered most of the peninsula. Their capital was, until the privatisations of the 1990s, owned directly by the state through the holding company IRI. These three banks occupied a position of pre-eminence as bankers to the very large industrial concerns, and also thanks to their foreign banking business. Up to quite recently, these banks were reluctant to enter the field of small commercial loans and of personal loans, which meant that the average size of their lending operations was higher than that of the other banks. In 1959 the average size of their advances, more than 10 million lire, was about nineteen times the average figure for the Savings Banks<sup>28</sup>.

The Public Law Banks are foundations or public corporations which are between 50 and 400 years old. The largest of them, the Banca Nazionale del Lavoro was (until the 1980s) the only one to have a national network, whereas the other four, the Banco di Napoli, Banco di Sicilia, Monte dei Paschi di Siena, and Instituto Bancario San Paolo di Torino, were regional or at most interregional banks. Each of these banks had Special Sections, themselves organised as public corporations, which specialised in lending at medium- or long-term for special purposes (real estate, agriculture, public works and utilities and industrial concerns), as will be described further on in the chapter.

The Ordinary Credit Banks are joint-stock companies and were the only banks

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<sup>28</sup> L. Ceriani, 'The Commercial Banks and Financial Institutions', in Sayers, Banking in Western Europe, p.134.

in Italy to be controlled by private industrial and financial concerns. The Ordinary Credit Banks varied greatly in size, from small units with a few offices to concerns with a hundred branches spread over many regions. The consolidated figures for the group show that their loans consisted of a large number of relatively small operations: the average size of advances was about a fifth of the figure for the Banks of National Interest. Until the middle of the 1970s the four most important of these banks were the Banca Nazionale dell'Agricultura, the Banca d'America e d'Italia, the Banco Ambrosiano and the Banco di Santo Spirito.

Within the Co-operative People's Banks the size differences are still greater than in the preceding group, as this group includes one of the country's largest banks, the Banca Popolare di Novara. Nowadays no substantial difference exists between the activities of the Ordinary Credit Banks and the Co-operative People's Banks, save for the preference the latter have shown for smaller deposits and the extensive granting of personal advances, remaining faithful to their traditional function as collectors of small savings and lenders to small enterprises<sup>29</sup>.

Juridically the Savings Banks were public bodies governed by special regulations. They were chartered corporations whose object was to promote the formation of savings and find suitable uses for them. The local authorities presided over the selection of the members of their boards. These banks were originally created at the end of the nineteenth century for the promotion of saving among the working classes and farmers and, even now, the profits of these banks are divided between reserves and gifts to charities. These banks were grouped together by law in regional or interregional federations. The object of the federations, which were corporate bodies

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<sup>29</sup> Banco di Roma, The Italian Banking System, section 1.3.

with full legal status, was to coordinate the activity of the member banks, to fix their respective spheres of action and grant assistance to the Savings Banks that were most in need of help. The Savings Banks carried out a great many small lending operations: while at the end of 1959 they accounted for only 20 per cent. of total loans and <sup>and</sup> advances, they covered about 55 per cent. of the total number of credit relationships over the whole banking system<sup>30</sup>. The most important Savings Bank was the Cassa di Risparmio delle Provincie Lombarde (CARIPLO).

The Rural and Artisan Banks were co-operative banks in the form of either unlimited liability partnerships or joint-stock companies. They enjoyed particular popularity in small country towns and villages. In addition to clearly defined short-term lending operations, such as the discounting of bills, the opening of current accounts secured by government or equivalent securities or by bills of exchange, they were authorised to handle medium-term operations, not exceeding five years, in the form of unsecured and mortgage loans, and also to perform subsidiary transactions more in the nature of loans among farmers than of banks loans, such as purchasing farm machinery, tools and products on behalf of members and acting as farm syndicate agencies for supplies to members.

As mentioned above, the banks within each type were not very homogeneous. Nonetheless as the standard deviation around the mean of each group is not very large, they can be grouped by size of deposits and judicial nature. The group with the largest banks includes the banks of National Interest and the Public Law Institutes. This group is followed by that of the Ordinary Credit banks, the only privately owned banks; the last group comprises the smaller banks, the Co-operative People's banks, the Savings

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<sup>30</sup> Ceriani, 'The Commercial Banks', p.137.

banks and the Rural and Artisan banks. Table 6.2 shows the lending activity of the three groups.

Table 6.2 . Italy - Bank lending to manufacturing - 1960

	Tot. lending %	Number of accounts %	Aver.size of loan	Number of banks	Number of branches
Group 1	53%	26%	18 mil.	9	2097
Group 2	24%	25%	9 mil.	146	2078
Group 3	23%	49%	5 mil.	1112	4845

Group 1=Banks of National Interest + Public Law Banks.

Group 2=Ordinary Credit Banks.

Group 3=Co-operative People's Banks + Savings Banks + Rural and Artisan Banks.

Source: My calculations from data in: Banca d'Italia, Bollettino Statistico, 1960. The choice of 1960 for this table is for presentation purposes only since the picture does not change in other years.

The table shows how, in 1960, the larger banks granted the larger average loans and accounted for most of the lending to the manufacturing sector. The smaller banks had the highest percentage of customers and the smaller average loans. The first group of banks conducted its business on a national scale but with a branch system limited to the capital towns of the regions and the busiest centres. The second and third group comprises much smaller banks but with a network of branches extending to the smaller urban and rural centres.

Table 6.3. Italian banks. State Securities as a percent of total assets

	1950	1960	1970
Group 1	16%	17%	9%
Group 2	18%	15%	8%
Group 3	15%	11%	4%

Group 1=Banks of National Interest + Public Law Banks.

Group 2=Ordinary Credit Banks.

Group 3=Co-operative People's Banks + Savings Banks + Rural and Artisan Banks

Source: My calculations on data in: Banca d'Italia, Bollettino Statistico, 1950, 1960, 1970.

Table 6.3 shows the state securities held by the three groups of banks as a percent of total assets in 1950, 1960 and 1970. These three years might not be representative. Nonetheless the table shows that the group holding the highest concentration of small banks, group three, invested a lower proportion of its assets in state securities. This behaviour is consistent with the hypothesis that banks solely involved with local economies would be more prone to investing in the private sector. This propensity also indicates that local banks were risk-takers to a higher degree than the national banks. Another explanation could be that some types of banks, the larger ones, were more involved in the financing of public debt, probably because their connection with the state was closer. Nevertheless the segmentation of the banking structure ensured that the allocation of the banks' assets was not uniformly in favour of one sector of the economy, as in the case of the British banks.

## 2. A bank oriented system?

The Italian financial system has been defined, by many commentators, as a bank oriented one, with a poorly developed capital market characterised by an underdeveloped stock exchange<sup>31</sup>. In 1965, for example, the number of companies,

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<sup>31</sup> The Italian financial system has been classified as historically (since the end of the nineteenth century) more oriented towards banking intermediaries than towards the stock market compared to other European countries and the USA. For further reading see T.M. Rybczynski, 'Business finance in the EEC, USA and Japan', in Three Banks Review, 102 (1974). On the role played by the banks in the industrial development of the country and on the limited importance of the stock market see: R. Sylla, 'Financial Intermediaries in Economic History', in R.E. Gallman (ed.), Recent Developments in the study of Business and Economic History, (Greenwich, 1977); L. Cafagna, 'The Industrial Revolution in Italy 1830-1914', in The Fontana Economic History of Europe, (London, 1971), Vol. IV; P. Ciocca, A.M. Biscaini Cotula, 'Financial Structures: Long-term quantitative characteristics (1870-1970)', in G. Federico (ed.),

including those controlled by the state, quoted on the Milan stock exchange (the country's main exchange) was very small, 135, compared to 4100 in London, 1200 in Paris and New York, 1000 in Amsterdam and 670 in Brussels<sup>32</sup>.

The purpose of the following pages is to analyse more closely the structure of the Italian financial system and to verify the nature of this "bank oriented system". The focus of these pages will be on a set of institutions created in the late 1940s and early 1950s, the Istituti di Credito Speciale (hereafter ICS - or Special Institutes), created to provide various sectors of the economy with medium and long term loans. These Special Institutes represented a novelty for the Italian financial market and their presence greatly influenced its structure and development.

## 2.1 The Istituti di Credito Speciale - ICS

At the end of the 1940s the first two Special Institutes were funded, Mediobanca and Efibanca, followed by a number of other institutes, mostly of a regional nature. Between 1950 and 1960, 26 between institutes and special sections of banks were opened and by 1960 the total number of ICS (including the special sections) had increased to 67 from 41 in 1950. Of the Special Institutes created in that decade, three were concerned with loans to the agricultural sector, two with loans for building, eight with funding public works (for example the building of motorways), and thirteen with loans for industry<sup>33</sup>. The existence of more institutions concerned with industrial

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The economic development of Italy since 1870, (Aldershot, 1994).

<sup>32</sup> A. Confalonieri, 'Credito ordinario e medio termine: considerazioni sull'esperienze italiane', Annuario dell'Università Cattolica, (Milano, 1965).

<sup>33</sup> V. Pontolillo, Il sistema di credito speciale in Italia, (Bologna, 1980), p. 20.

finance, rather than with agriculture and construction, can be explained by the fact that the latter had already been developed in the pre-war period.

Especially in the case of industrial finance, the Special Institutes and the special sections of the banks were created and controlled by the commercial banks to supply firms with medium and long-term credit and to provide them with an intermediary that would assist them in placing shares on the market. For example, Mediobanca was created by the three banks of National Interest (Credito Italiano, Banco di Roma and Banca Commerciale Italiana), while Interbanca and Efibanca were the medium and long-term financial sections of the private banks (the Ordinary Credit banks) and of the Public Law banks. Centrobanca was connected to the People's Co-operative banks.

One of the most important ICS were the regional institutes, the Mediocrediti Regionali for the financing of small and medium sized firms created in various stages from 1950, by consortia of local banks. The aims of these institutes were to assist small and medium-sized firms whose development was likely to increase the number of jobs, to finance the modernisation and mechanisation of plants in order to improve the competitiveness of these firms in local markets and abroad and, finally, to encourage the building of plants in less developed areas of the region<sup>34</sup>. These institutes were created at a regional level for two reasons. The first was that their funds would be derived from the sale of bonds to the local banks. The second was that, as the loans made by these ICS would be small and to small businesses, to avoid excessive transaction costs, the institutes should operate close to the firms and to the

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<sup>34</sup> A.S. Camilleri, Industrial medium-term financial institutions in Italy, (London, 1966), p. 64.

banks these firms usually dealt with, so as to be able to operate on the basis of trust and reputation. A local institution would also have been better equipped to evaluate *both* the market in which the firms operated and their real prospect for development. This seemed particularly important in view of the fact that these institutes were to grant medium and long-term loans for capital investments<sup>35</sup>. Data of a more specific nature on the activity of the Mediocrediti will be presented in the chapter on banking in Piedmont.

We have noted that the shape of the current Italian banking system has its origins (in the preceding pages) in the Bank Law of 1936. Nonetheless the financial structure of the country emerged in the post-1945 period as the result of the intense debate that was sparked, in 1946, by the Ministerial Committee of Inquiry on Finance and Insurance<sup>36</sup>. This debate concerned, among other issues, the separation of short-term loans from medium and long-term ones and the distinction between equity and debt finance in the context of the pre-war 'pollution' of the two, that <sup>had</sup> led to the banking and industrial crises of the 1930s. The decision taken by the Assemblea Costitutente (the body whose mandate was to create the institutions of post-fascist Italy), on the strength of the recommendations of the Committee of Inquiry, dictated the structure of Italy's financial system.

One of the most important findings of the Committee, through interviews with

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<sup>35</sup> G. De Marchi, 'Osservazioni critiche sull'attuale legislazione italiana per il medio-credito alle minori imprese industriali', Moneta e Credito, 4 (1952), p.251.

<sup>36</sup> Ministero per la Costitutente, Rapporto della Commissione Economica presentato all'Assemblea Costitutente, Relazione su Credito e Assicurazione, (Roma, 1946).

the representatives of the country's various financial institutions, including the Banca d'Italia, the Istituto Mobiliare Italiano, IMI, the Associazione Bancaria Italiana, ABI, the Istituto per la Ricostruzione Industriale, IRI and the largest banks, was that, though the separation between banks and the provision of medium and long term finance to firms was to persist, the stock market was not seen as an important alternative source of capital for industry. Though lip service was paid to the importance of a well-functioning stock market, little was actually proposed to promote it, apart from a more favourable fiscal treatment<sup>37</sup>. Rather, it was felt that the funds held by investors should be passed on to firms through the mediation of the Special Institutes, ICS, as these would lend to firms and finance their activity through the sale, to the public, of industrial bonds, with the activity of the stock exchange being only marginal, reserved for the more adventurous investors<sup>38</sup>.

The dismissal of the stock market to a subsidiary role and the creation of institutions, connected to banks, to channel and control funds from investors to firms, has been seen as anomalous in the context of the pro-market attitude that animated post-war debate<sup>39</sup>. Nevertheless, this 'anomaly' made perfect sense from the point of view of the government, the monetary authorities and the banks. Though Luigi Einaudi, the Finance Minister, and Donato Menichella, the Governor of the Banca d'Italia, were firm in their belief that the market should function without hindrance,

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<sup>37</sup> For a more detailed analysis of the proposal made to promote the stock exchange see: C. Pace, G. Morelli (eds.), Origini e identità del credito speciale, (Milano, 1984), p. 374.

<sup>38</sup> Relazione sul Credito, pp. 446-453, Questionario, n. 18, answers in the Appendice.

<sup>39</sup> M. Bagella, Gli istituti di credito speciale e il mercato finanziario (1947-62), (Milano, 1986), p. 47.

they were also equally committed to the stability of the country's currency and to promoting Italy's industrial development. In this context a financial system in which funds were channelled through institutions was seen as more easily manoeuvrable than a system left to the vagaries of individual firms and investors<sup>40</sup>. Thus, while nothing was done to hinder the development of the stock market, little was done to promote it. Most importantly it was also believed that the smaller industrial and artisan concerns would be left out of the transfer of money, if the supply of credit was left solely to the workings of the market<sup>41</sup>.

As the 1950s progressed, a more Keynesian approach to the economy was adopted, following the Schema di sviluppo dell'occupazione e del reddito nel decennio 1955-64 (Plan for the growth of employment and incomes in the decade 1955-64), also known as the "piano Vanoni", from the name of the minister who drew it up. This plan was the first attempt formally to adopt Keynesian policies by declaring that state intervention and planning in the economy were essential to sustain economic growth and maintain employment, especially in the southern part of the country. This plan was born of the realisation that foreign loans were not going to finance the growth of the Italian economy over the long term and thus it was paramount to identify other instruments that would promote the accumulation and distribution of capital. Accordingly the banks and the ICS were to be the linchpin of the state's financial intervention<sup>42</sup>.

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<sup>40</sup> Bagella, Gli istituti di credito speciale, p. 88.

<sup>41</sup> Banca d'Italia, Relazione del Governatore, (Roma, 1958), pp. 371-72.

<sup>42</sup> For further reading on the "piano Vanoni" see: R. Balducci, M. Marconi, 'L'accumulazione del capitale nella visione del governo, della Banca d'Italia e della Confindustria', in A. Lunghini (ed.), Scelte politiche e teorie economiche in Italia

The point of view of the banks in the matter of the promotion of the stock market was more disingenuous. The banks had little to gain from the development of the stock market except an increase in competition, but, as the following pages will make clear, they could reap substantial profits through the sale of ICS bonds to the public and the direct purchase of these bonds as a way of investing deposits, as ICS bonds carried a higher return than state securities and were risk free.

Guido Carli, who replaced Menichella as the Governor of the Banca d'Italia in 1960, was conscious of the need to develop the stock market to avoid firms suffering from an imbalance between debt and equity. One proposal was to transform part of the credits held by the ICS into shares to be placed on the market, as these credits represented the majority of funds used by industrial firms to finance new investments<sup>43</sup>. If this proposal had become operative, it would have had the effect of enlarging the stock market and might have prevented the development of that connection between banks and firms that was to become pathological in the 1970s<sup>44</sup>.

The following section will be a quantitative analysis of the factors that influenced the growth of ICS bonds and of industrial shares. The starting point of this analysis will be the evolution of demand for ICS bonds, state securities and for bonds

(1945-78), (Milano, 1980), pp. 72-79.; for the implementation of the plan and its reception by the monetary authorities see: D. Menichella, 'Espansione economica in regime di stabilita' monetaria', Bancaria, 11 (1955); P. Saraceno, 'Riesame del Piano Vanoni al fine 1957', Moneta e Credito, 1 (1958). But also A. Shonfield, Modern Capitalism, (London, 1965), especially pp. 180-185.

<sup>43</sup> G. Carli, 'Trasformazioni reali e trasformazioni finanziarie', in F.A. Grassini (ed.), Le banche e il capitale di rischio: speranze o illusioni?, (Bologna, 1984), p. 23.

<sup>44</sup> Bagella, Gli istituti di credito speciale, pp. 60-61. For the 1970s and the increasing role of the banks in the financing of firms see: M. Onado, Il sistema finanziario italiano. I circuiti di distribuzione del credito: 1964-1978, (Bologna, 1980), pp. 13-20 and pp. 91-100.

and shares issued by companies. For reasons that will become clear further on, part of the quantitative analysis is restricted to the period 1947-1962.

The period between 1947 and 1962 was characterised by low rates of inflation and by the stability of the exchange fostered by the Bretton Woods system. Table A6.1 in the Appendix to the chapter shows that the retail price index between 1953 and 1961 increased but at a very slow rate, inflation averaging about 1.5 percent, one of the lowest rates of the industrialised countries, as shown by Table A6.2 in the Appendix to the chapter. At the same time, between 1952 and 1962, real incomes increased at an average annual rate of 5.4 percent. These two elements increased confidence in the system and induced savers to choose investments over liquidity.

The demand for fixed-interest securities showed a marked preference for the bonds issued by the ICS. The share of ICS bonds (as a percent of the total value of net issues of fixed interest securities) increased throughout the 1950s from 18 percent in 1950 to 34 percent in 1960. This increase was accompanied by a reduction in the demand both for state securities and for industrial bonds issued by private companies, as their share fell from 62 to 44 percent and from 14.7 to 9.8 percent respectively. Furthermore, the ICS bonds issued by the institutes particularly involved in medium and long term finance for industry had the largest share (52 percent of total ICS bonds in 1950 and 66 percent in 1960). Thus it can be said that, throughout the period, bonds issued by industrial ICS encountered increasing favour with the public<sup>45</sup>.

The preference for ICS bonds can be compared with the share of industrial securities (bonds + shares) issued by firms as a percent of the total issues (measured

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<sup>45</sup> Data from: Banca d'Italia, Relazione del governatore, Appendice, (Roma, 1951 and 1961).

in current liras) of fixed interest securities. From 1950 to 1960 the share of ICS bonds increased from 9.9 percent to 18.2 percent, while the share of securities issued by firms decreased, only slightly, from 56.8 percent to 52.4. By the end of the 1950s the share of ICS bonds equalled that of securities issued by firms (32 percent for ICS and 31.6 for firms). These figures are particularly interesting because they show that, contrary to expectations, in the 1950s the expansion of ICS bonds did not impinge so much on the share of industrial securities issued by firms but rather on the share of government bonds (this declined, between 1950 and 1960, from 31 percent to 24 percent of the total<sup>46</sup>). The share of industrial securities issued directly by firms (therefore non ICS bonds) started declining in 1962, when a 15 percent tax was placed on them while ICS bonds and government bonds remained tax-free. In 1973 a 10 percent tax was put on ICS bonds and as a consequence the share of government bonds increased<sup>47</sup>. Taxes introduced an element of distortion in the functioning of the capital market<sup>48</sup>, the reason why most of the analysis done in these pages focuses on the period before 1962.

The factor that influenced investors' choice before 1962 was the difference in the return (the yield) of industrial bonds and shares issued by firms, compared to that of industrial bonds issued by the ICS and other forms of investment, such as Treasury bonds, bonds issued by ICS in the building sector, as

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<sup>46</sup> These percentages do not add up to 100 as they do not include the share of bonds issued by the state owned hydrocarbons holding, ENI, by IRI and by ENEL, the nationalised electricity company.

<sup>47</sup> Banca D'Italia, Relazione, (Roma, 1962 and 1973).

<sup>48</sup> F. Cesarini, 'Sistema bancario e offerta di capitale di rischio in Italia', in A. Lamfalussy, I mercati finanziari europei, (Torino, 1972), p. 202.

shown in Tables A6.3 and A6.4 in the Appendix to the chapter. These two tables show how industrial shares could not compete with ICS bonds, as their yield was consistently lower. In fact, between 1950 and 1962, the bonds issued by industrial ICS were the form of investment with the highest yield. The purchase of shares suited those investors more interested in a quicker, though riskier gain, while ICS bonds matured only after 15-20 years.

Table A6.5 in the Appendix shows how demand was distributed between 3 categories of investors in the reconstruction period (1947-51), the 'take off' period (1952-57) and the rapid growth period (1958-62). Non-institutional investors directed their demand mostly towards ICS industrial bonds throughout the three periods. Banks steadily increased their participation in the demand for these bonds, while other institutional investors, like insurance companies, the Banca d'Italia and other ICS, decreased their share.

The banks played a very crucial role in the supply of ICS bonds to the market. The ICS increased their market share in the 1950s thanks to the intermediary role taken on by the banks, both in the primary market, through the sale to bank customers of ICS bonds, and in the secondary market, connected to the purchase and resale of securities already in circulation. By using the banks as a channel of distribution, the ICS had no difficulty in eroding the market share of the bonds, and eventually of the shares, of firms. Furthermore ICS bonds were guaranteed by the banks, and ultimately by the state, thus being almost risk-free, compared to the bonds offered directly by firms.

Throughout the 1950s, the market share of industrial bonds, placed directly on

the market by firms, decreased (except for those of state-owned companies, like the motorway group owned by IRI), until in 1963 it was just 4.6 percent. For firms it became more advantageous to finance their medium and long term activities through loans granted by the ICS instead of issuing bonds. The Institutes had lower costs in terms of issue and management of the bonds and could use their extensive national network (that of the banks' branches) to distribute the bonds. In 1951, for a firm the cost of finance through a bond was 9.1 percent, while the ICS would charge it an interest rate, for a medium-long term loan, of 8.4 percent, on average. The interest rate charged by ICS remained lower than the cost of other forms of finance throughout the 1950s (shares were even more expensive to issue than bonds). At the beginning of the 1960s the difference decreased, as the issue of bonds would have cost a firm about 7.1 percent, while the interest on ICS loans was 6.9 percent, but it increased again as the decade progressed<sup>49</sup>.

The banks gained from the distribution of ICS bonds by increasing the cost of purchase for investors (to absorb the sale cost) and by charging a commission justified by the fact that the banks purchased the bonds from the ICS and sold them to customers<sup>50</sup>.

The issue of bonds was the sole source of finance for the ICS involved with finance for building, while the ICS which dealt with industrial loans financed 40 to 60 percent of their activity through the sale of bonds. Other sources of finance for

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<sup>49</sup> P. Savona, 'Nota su una stima del costo del capitale in Italia. Rassegna storica dal 1951 al 1967', in Banca d'Italia, Gruppo di studio sulla politica monetaria e fiscale, (Roma, 1970), no. 10.

<sup>50</sup> F. Cesarini, 'Intermediazione nel mercato delle nuove emissioni e tecniche consortili', in AA.VV., Scritti in onore di Ugo Caprara, (Milano, 1975), vol. II, pp. 321-356.

these institutes were the collection of medium-term deposits and the issue of medium-term bonds, redeemable after five years on average. Furthermore the industrial ICS received part of their funds from the Treasury<sup>51</sup>.

Table A6.6 in the Appendix shows how the share of industrial investments covered by ICS loans increased through time, from 22 percent in 1959 to 59 percent in 1971<sup>52</sup>. The table also shows how the issues of shares of industrial firms increased until 1960, after which it became somewhat variable. The interesting data are those that show how state-owned companies and companies quoted on the stock exchange financed only a very small percentage of their investments with shares, while private, unquoted companies used share issues to finance 1/8 to 1/3 of their investments<sup>53</sup>.

This section dedicated to the ICS has explored the complex nature of Italy's 'bank oriented' system where the supply of medium and long term finance was controlled by the banks and, ultimately, by the government. Furthermore even the supply of investment capital was segmented to meet the needs of the various sectors of the economy with regional institutions, such as the Mediocrediti Regionali, catering especially to small firms.

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<sup>51</sup> Between 1947-51 the Treasury covered about 37 percent of the total supply of funds, this share increased to 40 percent in the period 1952-57, but decreased to 20 percent between 1958-62. See: Bagella, Gli istituti di credito speciale, pp. 156-157.

<sup>52</sup> The slowdown in 1963 and 1969-70 was due to the credit squeeze, showing the susceptibility of ICS bonds to supply conditions.

<sup>53</sup> R. Balducci, 'L'evoluzione degli intermediari e dei mercati finanziari: 1950-1972', in F. Vicarelli, Capitale industriale e capitale finanziario: il caso italiano, (Bologna, 1979), pp. 179-180.

The purpose of this chapter was to describe the structure of the Italian banking system, the 'counterfactual' example used in this thesis to test the hypothesis that a financial system including local financial institutions is better suited to supply the financial needs of small firms, rather than a nationally concentrated structure such as the British one. Nevertheless the 'Italian system' might be better for small firms but might also be generally inefficient, thus diminishing its value as a 'counterfactual example'. For this reason the following section will address the issue of inefficiency.

### 3. Italian Banking: An inefficient system?

The banking system that was shaped by the Bank Law of 1936 was tightly regulated, so that competition would not eliminate the smaller and more local banks. As described in the preceding pages, local banks were seen as very important sources of finance for small firms and their role was fundamental in the context of a Keynesian approach to economic development.

Nevertheless, as the country industrialised, the segmentation of the banking system and the virtual absence of other financial institutions led to the efficiency of the system being questioned, especially from the mid-1970s onwards. The debate that followed brought about the progressive lifting of many of the territorial restrictions and the abolition of controls over interest rates and, in the 1990s, to the merger of some banks.

Within this debate, the role of small banks was recognised as having been very important in the earlier stages of post-war economic development, but their permanence, in a modern, international, financial environment, was questioned. Small banks were considered inefficient because of their inability to achieve economies of

scale, provide modern services and use advanced technologies. Furthermore it was claimed that regulation stifled competition and that local banks exploited monopoly positions in their relationship with local customers<sup>54</sup>.

### 3.1 Competition

Did regulation and segmentation really limit competition between banks, as claimed by some critics? At a local level the market of the smaller banks in Italy was composed of personal borrowers, small retailers and small and medium-sized firms. These, because of higher risk and/or limited bargaining power, were subject to high interest rate differentials, more than 2.5% (interest rates will be discussed at length at the end of the chapter). Thus, by virtue of the fact that most of their customers were small, small banks had control of the sector of the market that brought the highest returns. Nevertheless, this did not exclude competition inside this market. In practice the Italian banking system was characterised by the type of oligopolistic competition among interconnected groups traditionally called 'chain' competition<sup>55</sup>. Inter-branch competition (between branches of different banks) was at its most intense between adjacent branches and weakened as the distance between branches increased; the larger banks competed for customers which the smaller banks were unable to attract, but the passage along the scale was gradual. Finally the various categories of banks specialised in fields that were neither entirely separate nor entirely coincident, and where each bank tended to compete in different ways and to a differing extent with the others.

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<sup>54</sup> C.A. Ciampi, La politica creditizia e l'innovazione finanziaria, (Milano, 1984).

<sup>55</sup> Banca d'Italia, Italian Credit Structures. Efficiency, Competition and Controls, (London, 1984), pp. 66-67.

Also there was imperfect competition between banks and other financial intermediaries: the Post Office for deposits, the ICS for some types of lending, insurance companies for investments in securities, and so on. As the chapter dedicated to the two case studies on the Cassa di Risparmio di Torino and the Istituto San Paolo will show, competition among local banks was often ferocious, seriously eroding profit margins, at least in some areas with a high banking density, like most of the industrial north of the peninsula. Competition was particularly strong among the smaller banks in urban centres and often brought about the breach of the interbank agreement, as deposit rates were increased and lending rates decreased to 'poach' customers. Therefore, though the existence of discrimination in terms of price differentials against small firms cannot be denied, a "fact of life" for Italian small firms as much as for British ones, it would seem that the criticism that the regulation that protected small banks killed off competition can be rejected.

### 3.2 Economies of scale and profitability

Critics have also suggested that small banks had higher costs, not being able to achieve economies of scale, thus making them less profitable. A study done by the Banca d'Italia on a sample of 375 banks in 1980 showed that average total operating costs decreased as the size (in terms of assets) of the banks increased<sup>56</sup>. This indicated that larger banks did enjoy economies of scale, probably due to higher degrees of automation. Other studies have not been able to establish with certainty the existence of economies of scale, other than the supply, on the part of larger banks, of more

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<sup>56</sup> Ibidem, pp.19-23.

services<sup>57</sup>. Nonetheless small banks were shown to be more profitable, as the ratio of interest received on advances to total assets decreased with the increase in the size of the banks. The reason for this was that small banks, as described above, tended to have customers that brought higher returns and also because the composition of assets changed as banks increased their size. In fact the ratio of loans to assets declined sharply with increasing bank size, as large banks tended to invest more in government securities than small banks did as shown by Table 6.3.

Furthermore, study done in 1990 on the profitability of banks in the 1980s, showed that small and medium-sized banks (defined as such on the basis of capital needs, deposits, loans, number of branches, etc) with a regional dimension were the ones with the lowest unit costs (measured as total costs over total business transacted), while larger banks had the highest unit costs<sup>58</sup>. These findings are in line with research done, albeit for a different period, on American banking. These studies showed how costs decreased with the increase in size up to 5 million dollars (worth of deposits held by the bank), while costs remained virtually the same for banks in the 5 million to 50 million bracket. For banks with more than 50 million dollars in deposits costs decreased only slightly as size increased<sup>59</sup>. Other studies have shown the existence of increasing economies of scale up to 50 million dollars, but only very

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<sup>57</sup> G. Marchesini, 'Gli effetti delle fusioni bancarie', Moneta e credito, 1 (1969), pp. 59-81.

<sup>58</sup> A. Landi, Dimensioni, costi e profitti delle banche italiane, (Bologna, 1990), pp. 61-66.

<sup>59</sup> D.A. Alhadeff, Monopoly and Competition in Banking, (Berkeley, 1954), p. 83.

small changes in larger banks<sup>60</sup>. Further studies showed how, if a bank were to increase by 100 percent the number of its deposits and loans, <sup>and</sup> if all other elements that might influence costs were kept constant, all other costs directly connected with the increase in size, rent of processing machinery, rent of larger premises, more personnel, and postal costs would increase by 92 percent<sup>61</sup>.

The advantages of large scale in terms of automation are undeniable but of no great importance for the period this research is concerned with<sup>62</sup>. Furthermore the chapter on the Piemontese banks will show how local banks had a competitive advantage over large, national, banks by being able to reduce transaction costs thanks to local networks.

### 3.3 Interest rates - Britain and Italy compared

The critics of the Italian banking system also claimed that the absence of price competition meant that interest rates were kept artificially high and that local banks exploited monopoly positions in their relationship with local customers<sup>63</sup>. This criticism can be put into perspective by comparing interest rates in Italy and Britain.

As described in the preceding pages, price competition was regulated in 1954

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<sup>60</sup> I. Schneiger, J. Moole, 'Chicago banking. The structure of banks and related financial institutions in Chicago and other areas', Journal of Business, 34 (1961), p. 325.

<sup>61</sup> F.W. Bell, N.R. Murphy, 'Economic scale in commercial banking: the measurement and impact', New England Business Review, (1967).

<sup>62</sup> For further reading on the "myth" of economies of scale in banking in the post-war period see: M. Ackrill, L. Hannah, Barclays Bank, forthcoming.

<sup>63</sup> C.A. Ciampi, La politica creditizia e l'innovazione finanziaria, (Milano, 1984). M. Monti, T. Padoa-Schioppa, 'Per un riesame del sistema creditizio italiano', in G. Carli, La struttura del sistema creditizio italiano, (Bologna, 1978).

by official cartel agreements that set maximum deposit rates, minimum loan rates and account charges. The Italian Banking Association (ABI) was responsible for working out the agreement to regulate bank competition and the minimum cartel rates were changed annually on the basis of the most important policy decisions facing the banks. The banks had to agree with the Association's decisions and were subject to fines, or expulsion in the worst cases, if the agreement was broken.

The cartel's minimum rate applied only to top-quality borrowers; all the others had to pay higher rates in accordance to the additional risk or cost to the banks. According to the Italian Banking Association the rates paid by those customers not granted the minimum rates, in the 1950s, were much higher than the cartel's minimum rates<sup>64</sup>.

Table 6.4 compares Italian bank rates with the interest rates on advances charged by Barclays Bank. The comparison is quite rough as the Italian data come from published sources while the British data are the result of archival research and are, therefore, more reliable. In both cases, the figure given as the maximum rate might not be, in fact, the real one, as in some cases, for certain types of customers, the rate might have been higher.

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<sup>64</sup> ABI, 'La structure du systeme bancaire italien au point de vue de la liquidite', in First International Credit Conference, (Roma, 1953), vol. II, p. 304.

Table 6.4. Interest rates (minimum and maximum) charged by Italian banks and by Barclays bank.

Italian Banks	Barclays Bank
1950	4.75/7.50
1951	4.75/7.50
1952	4.75/7.50
1953	4.75/7.50
1954	7.50
1955	7.50
1956	7.50
1957	7.50
1958	7.50
1959	7.50
1960	7
1961	7
1962	6.4

\* See notes on sources.

Sources: For Italy: 1950-1953, Banca d'Italia, Relazione all'Assemblea, 1951 (tab. 76) and 1953 (table 109); 1954-1961, Banca d'Italia, Relazione all'Assemblea, 1964 (table 12); for 1962, OECD, Interest Rates 1960-74, OEDC Financial Statistics, 1976, Table III.1.a.ii in Italian section.

For Barclays: Barclays Bank Archives, Local Head Office Circulars, Acc. no. 29/740 for 1950-1960; for 1961-62 the data refer to rates applied by London clearing banks, OECD, Interest Rates, cit., Table III.1.a in United Kingdom section.

Table 6.4 shows that the differential between the rates charged to 'blue chip' customers and less important customers such as small firms was higher in Italy than in Britain. Undoubtedly part of the differential was due to the fact that in Italy, as much as in Britain, small firms had fewer sources of capital than large firms did and banks exploited this advantage. Nevertheless the fact that the differential was higher in Italy than in the UK can be explained if we consider that Italian banks, especially local-regional ones, had to take higher risks than their British counterparts as their markets were smaller<sup>65</sup>. These banks took more risk and priced it accordingly, while British banks, with their very low bad debt, were taking no risks and the differential was simply the result of their monopoly power over small firms.

Though the differential in the rate charged to small firms compared to large

<sup>65</sup> Unfortunately no data on the interest rates charged by local banks are available.

ones was higher in Italy than in Britain, the fragmentation of the Italian banking structure (with the existence of the special institutes and more specifically, in the case of small firms, of the Mediocrediti Regionali), meant that firms could access medium to long-term credit, in some instances, at a lower rate than the market rate, thanks to a series of laws that, under certain circumstances, allowed for "credito agevolato" (literally, "eased credit"), at a rate subsidised by the Treasury<sup>66</sup>. Table 6.5 shows the rates charged by ICS in 1960-61 and 1962, the years when the data are available.

Table 6.5. Interest rates charged by Special Institutes, market rate and subsidised rate.

	Market	Subsid.
1960	7.1	5.4
1961	7	4.8
1962	7.1	4.9

Source: OECD, Interest Rates, cit., Tables III.1.b.i. and III.1.b.ii. in Italian section. The data are not available before 1960 as the OECD tables were compiled from data provided directly by the Banca d'Italia.

Not all firms could be charged this lower rate all the time. Rather stringent conditions applied, depending on the geographical area, type of investment proposed, return forecast and industrial sector occupied<sup>67</sup>.

<sup>66</sup> The first law to introduce subsidised rates for small and medium-sized firms became active in 1959 and was called "legge Colombo", from the name of the minister who sponsored it. This law allowed the Mediocrediti to finance, in some cases, the construction of new plants or the updating of old ones at a special rate of 5%, slightly higher than the banks' minimum rate. See T. Bianchi, Il credito a medio termine, (Milano, 1963), p. 87.

<sup>67</sup> In 1975, 43 percent of credit granted by ICS was "agevolato". Istituto per la Ricerca Sociale, Evoluzione della struttura finanziaria, ruolo degli istituti di credito a medio termine e tendenze del credito agevolato, (Roma, 1982), p. 138. tab. 20.

#### 4. Analysis of bank lending

In the years immediately following the end of the war and the creation of the Italian Republic, the needs of the banks and of industry coincided, helping the country's industrialisation. The newer industries, such as car manufacturing, metal working and chemicals, needed increasing quantities of external capital to renew their structures in order to compete in the European and international markets. At the same time the banks needed an outlet for their expanding liquidity. The fact that the leading firms in the new sectors were the country's few large firms (Fiat and Montecatini, for example), and that these were also historically connected with the government, meant that the banks' liquidity was not to be channelled only towards short term credit and the financing of the state's debt but was going to be used as an instrument of economic policy, as described in the preceding section.

Table A6.7 in the Appendix to the chapter shows advances granted by the banks by sector while Table A6.8 shows each sector's share of total bank lending. The interest shown by the banks in manufacturing is evident. The percentage of finance to manufacturing firms almost doubled in 1951 (57.5%) compared to 1938 (35.7%), growing mostly in the food, textiles, iron and steel, mechanical, and chemical sectors. Looking at the figures more closely it can be noticed that the support given to the food sector (manufacturing and retail) reached its highest level in 1949, the most intensive year of stockpiling in the post-war period<sup>68</sup>.

In 1951 financial resources from the banks were absorbed mainly by firms in

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<sup>68</sup> V. Foa, 'La ricostruzione capitalistica nel secondo dopo guerra', Rivista di Storia Contemporanea, 4 (1973).

the food, textiles, metal working, building, agriculture, and chemical sectors. Compared to the prewar period the main increases concerned food manufacturers (from 12% to 21%), textile firms (from 6% to 11%), and metalworking (from 9% to 11%), whereas the share going to agriculture decreased. The government policy of promoting the export industries was certainly instrumental in shaping the banks lending<sup>69</sup>.

Between 1951 and 1961 the pattern of bank lending changed rather drastically. As the country industrialised and the newer industries became more important, the loans to agriculture decreased as did those to food (from 21.4% to 15%) and textiles (from 11% to 6%)<sup>70</sup>. Metal working and mechanical engineering increased their share (from 11% to 15%). Between 1951 and 1961 those sectors which increased their share of advances were the same which grew in terms of investments and/or value added. This trend in the banks' pattern of lending continued in the following decade, with the mechanical engineering sector taking the lion's share of advances to the manufacturing sector.

Lending to manufacturing as a whole remained consistently above 40% of the banks total lending, changing from 60% in 1949 to 44% in 1972 as the country changed from being an industrialising economy to a fully industrialised one. To put these percentages into context compare them with those for Britain in Table A4.1 in the Appendix to Chapter 4. Though advances to manufacturing increased from 25% in 1946 to a peak of 40% in 1966, by 1972 this share had decreased to 31%. These

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<sup>69</sup> In 1951 food, textiles, and metalworking were the most important exporting sectors accounting for 73.3% of total manufacturing exports. Vicarelli, Capitale industriale e capitale finanziario, p. 307.

<sup>70</sup> Ten years later this trend was confirmed, as loans to agriculture decreased to 7.2 percent and to textiles to 4.6 percent.

figures might not necessarily imply that British banks had a bias against manufacturing<sup>71</sup> compared with Italian banks, but could simply reflect the different level of industrialisation<sup>72</sup>, and rate of economic growth, achieved by the two countries in the post-war period.

### Conclusion

This chapter has described the structure of the Italian banking system and analysed the lending activity of the banks. The data on lending has shown that Italian banks lent more to manufacturing, as a proportion of their total lending, than their British counterparts did. This difference in lending preferences is consistent with the picture of a country that was rapidly industrialising and where banks were the main, if not the only, source of finance.

This chapter provides other interesting comparative elements. In both countries banks were seen by the political authorities as important agents of development, but while British banks were allowed to merge and increase their size to better serve the needs of large firms, Italian banks were rigidly controlled and their activity regulated to maintain a highly segmented system where different types and sizes of banks supplied capital to an economy where large firms were more the exception than the rule. More interestingly, though, this chapter has shown how political and monetary authorities recognised that the needs of small firms were better served by local banks

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<sup>71</sup> In fact Duncan Ross has shown that as far as large firms were concerned the clearing banks were quite willing to have them as customers: D.M. Ross, 'The Clearing Banks and the Finance of British Industry, 1930-1959', PhD Thesis, (London School of Economics and Political Science), 1989.

<sup>72</sup> The industrial structure of the two countries was also very different, as Britain had many more large firms which relied on stock exchange finance than Italy did.

and other regional financial institutions such as the Mediocrediti. The sharing of the same economic environment was seen as an advantage and the nature of this advantage will be explored in the last chapter. The relevance of decentralisation and of localism was reflected even by the organisational structure of the Central Bank, with its regional offices.

This chapter has also shown how small banks were more profitable and had lower unit costs than large banks, thus confirming that the small firms' market was a profitable one, especially if risks were taken and priced accordingly, as the Italian banks seem to have done.

## **Appendix to Chapter Six**

### **Tables**

Table A6.1. Italy - Wholesale and retail price index. (1913=1)

	Wholesale	Retail
1947	249.7	198.9
1948	263.5	210.6
1949	250.2	213.7
1950	237.1	210.8
1951	270.2	231.3
1952	255.1	241.1
1953	254.1	245.8
1954	251.9	252.4
1955	254.1	259.5
1956	258.5	272.4
1957	261.0	277.8
1958	256.4	290.9
1959	248.8	289.7
1960	248.8	297.4
1961	251.6	306.1
1962	259.2	321.7

Source: ISTAT.

Table A6.2. Retail price index (1963=100)

	USA	FRG	France	Italy	UK	Nether.	Belgium
1953	87	82	69	75	75	-	87
1961	98	97	95	89	94	94	97
1962	99	97	95	93	98	96	98
1964	101	102	103	106	103	106	104
1965	103	106	106	111	108	111	108
1966	106	110	109	113	112	117	113
1967	109	111	112	117	115	121	116
1968	114	113	117	119	121	126	119
1969	120	116	124	122	127	135	124
1970	127	121	131	128	135	141	129

Source: UN, Statistical Year Book.

Table A6.3. Italy - Nominal and real yield of industrial bonds issued by firms (1) and bonds issued by industrial ICS (2)

	Nominal		Real	
	(1)	(2)	(1)	(2)
1948	6.89	6.37	1.01	0.49
1949	6.86	6.59	5.40	5.13
1950	6.95	6.77	8.29	8.11
1951	7.37	7.25	-2.34	2.46
1952	6.91	7.06	2.66	2.81
1953	6.78	7.09	4.83	5.14
1954	6.51	7.13	3.82	4.44
1955	6.34	7.05	3.53	4.24
1956	6.48	7.11	1.51	2.14
1957	6.65	7.24	4.72	5.31
1958	6.55	6.78	1.76	1.99
1959	4.74	5.72	5.16	6.14
1960	4.35	5.37	1.66	2.68
1961	4.77	5.36	1.85	2.74
1962	5.91	5.85	0.81	0.75

Source: Banca d'Italia, Bollettino Statistico, various years; ISTAT

Table A6.4. Italy - Nominal yield of government bonds (1), bonds issued by ICS involved in financing building work (2) and industrial shares (3).

	(1)	(2)	(3)
1948	6.22	7.11	2.31
1949	5.68	6.97	3.97
1950	5.83	6.80	5.44
1951	6.12	6.97	6.56
1952	5.97	6.84	6.19
1953	6.16	6.77	5.93
1954	6.21	6.72	5.98
1955	6.39	6.61	4.64
1956	6.90	6.56	5.07
1957	7.19	6.59	4.96
1958	6.17	6.49	5.24
1959	5.41	5.82	3.60
1960	5.24	5.42	2.63
1961	4.58	5.40	2.44
1962	5.06	5.54	3.28

Source: Banca d'Italia, Bollettino Statistico, 1964.

Table A6.5 . Italy - Distribution of ICS industrial bonds between: private investors (1), banks (2), institutional investors (3), others (4). Net issues (%)

	(1)	(2)	(3)	(4)
1947-51	50.5	23.7	20.5	5.1
1951-57	50.3	21.0	25.9	3.4
1958-62	55.0	29.1	11.9	2.2

Others: Banca d'Italia, ICS, Cassa Depositi e Prestiti.

Source: Calculations based on data from: Banca d'Italia, Relazione Annuale, Appendice Statistica, various years.

Table A6.6. Italy - Industrial investments and external sources of finance  
(flows, billions of liras, current values)

	Gross Fixed Investments			ICS	Shares (net issues)						
	Public (1)	Private (2)	Total (3)		Public (5)*	Private (6)	Total (7)				
								(4):(3) %	(5):(1) %	(6):(2) %	
1951			729				64			9	
1952			817				95			12	
1953			865				146			17	
1954			897				109			12	
1955			1016				124			12	
1956			1111				158			15	
1957	194	1065	1259				159			13	
1958	216	1041	1257				180			14	
1959	188	1106	1294	285	22		194.1			15	
1960	207	1311	1518	374	25		429.3			29	
1961	311	1558	1869	497	27		374.7			21	
1962	495	1684	2179	753	35	133.6	260.3	393.9	26.9	15.5	
1963	800	1761	2561	710	28	3.2	256.8	260.0	0.4	14.6	
1964	868	1290	2158	798	37	21.6	406.4	428.0	2.5	31.5	
1965	672	1083	1758	654	37	31.7	245.3	277.0	4.7	22.6	
1966	659	1314	1973	750	38	57.8	255.3	313.1	8.7	19.4	
1967	728	1547	2275	1118	49	56.7	198.5	255.2	7.8	12.8	
1968	832	1735	2267	1026	40	31.3	264.2	295.5	3.7	15.2	
1969	1003	1994	2997	1108	37	80.6	376.2	456.8	8.0	18.8	
1970	1455	2295	3750	1304	35	103.7	607.3	711.0	7.1	26.4	
1971	1864	2256	4120	2425	59	178.5	506.2	684.7	9.5	22.4	
1972	2030	2240	4270	2467	58	125.3	735.0	860.3	6.2	32.8	
										20	

\* State owned public companies and companies quoted on the stock exchange

Source: F. Vicarelli (ed.), Capitale industriale e capitale finanziario: il caso italiano, Mulino, Bologna, 1979, p.p. 206-207.

## Italy - Classification of Advances (1949-1972)

## Constant Terms (1955)

		1949	1950	1951	1952	1953	1954	1955	1956	1957	1958	1959
Pers+Prof		1156	1485	1532	1704	2115	2485	2924	3302	3709	3754	4572
Local Authorities		721	819	1149	1147	1364	1616	1735	2080	2701	2931	3397
Banks, Stock Market & Financial		806	1028	993	1084	1238	1477	1578	1573	2048	2035	2399
Transports & Communication		383	486	562	688	888	914	1071	1339	1435	1446	1703
Electricity, Gas & Water		85	144	351	530	524	560	580	609	699	686	693
Hotels & Entertainement		179	239	255	299	436	525	583	627	655	647	745
Building		1037	1438	1481	1798	2241	2563	3078	3459	3608	4042	4595
Agriculture		1350	1503	1819	1494	2057	2408	2481	2897	2827	2953	3445
Various		250	321	365	347	406	454	457	464	417	398	476
Retail		798	953	944	1143	1345	1587	2003	2062	2252	2218	2661
Food		3988	4537	4604	5681	6460	7042	7932	8612	8318	8297	9532
Wood		420	517	528	650	773	920	1035	1108	1141	1133	1332
Non-ferrous Metals		794	940	1176	1447	1741	2038	671	796	931	965	1073
Iron and Steel & Metal working*		1740	2168	2467	3258	3919	4557					
Metal Working**								1504	1799	2088	1957	2209
Mechanical**								3923	4457	5020	4952	5529
Chemicals		523	657	700	801	928	1050	1349	1382	1515	1787	1946
Paper		213	266	318	341	425	476	544	576	612	635	788
Leather		442	543	484	551	583	592	602	628	679	682	817
Textiles		1851	2522	2494	2916	3150	3365	3049	3111	3328	3054	3406
Mines								522	558	619	516	932
Hydrocarbons								1277	1592	1895	2037	2234
Ex National Electricity Comps.												
Total Man.		9971	12151	12771	15644	17979	20040	22408	24621	26146	26015	29798
Total		16737	20566	22220	25877	30592	34631	38898	43033	46498	47124	54485

\*Only in 1938, 1949 and 1953.

\*\* Only after 1953

Source: Data calculated from, Banca d'Italia, Relazione presentata ai partecipanti all'assemblea, various years.

Table A6.7

Table A6.7 (cont.)

1960	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970	1971	1972
6100	7269	8142	8901	8593	9061	10075	11329	12735	13259	14614	15236	18191
3996	4295	5213	6047	7003	8183	9205	11794	12141	14064	17317	19294	23507
3419	5624	6299	7025	7402	7915	9405	10259	13145	14507	15412	18871	24307
2020	2258	2681	2937	2864	2714	3141	3488	3644	3762	4384	4834	6818
661	685	1574	1814	986	734	490	1059	895	1130	1866	3496	4252
905	1162	1519	1598	1505	1557	1770	2032	2232	2540	2632	2681	2764
5660	7021	8952	10228	10408	10919	12435	14007	16180	18918	19784	20511	20754
4071	4519	4954	5055	5076	5147	5619	6094	9029	9476	9924	9816	10060
581	736	838	927	786	833	1007	1135	1329	1510	1459	1534	1783
3385	4025	4684	5252	5025	4842	4271	5063	6149	6430	6948	7425	7365
10022	11182	12164	13043	12068	12571	14889	15889	15082	15473	15316	15530	15460
1658	2020	2303	2514	2248	2286	2528	2892	3281	3456	3483	3399	3579
1314	1560	1931	2278	2243	2391	2548	2778	3094	3379	3583	4031	4030
2517	2893	3509	4389	5074	5647	6551	7845	7455	7648	8382	9230	10620
6902	8732	10800	12901	12143	12276	13693	15735	17015	19586	22686	23278	25099
2329	2672	3566	4445	4313	4360	4530	4690	5428	6204	8533	9908	11363
1013	1183	1421	1761	1799	2038	2309	2535	2741	2928	3172	3286	3305
966	1106	1194	1250	1089	1056	1264	1353	1534	1761	1632	1680	1948
4126	4715	5677	6505	6253	6040	6853	7340	7684	8195	8374	8686	9075
652	755	953	1078	974	941	1061	1134	1271	1352	1421	1489	1406
2358	2667	4034	3837	3458	3311	3744	4059	3994	4311	5033	6063	8370
						10	12					
33857	39485	47552	54001	51662	52916	59979	66263	68580	74292	81615	86580	94256
64654	77079	92410	103786	101312	104821	117397	132523	146059	159888	175955	190277	214057

Italy - Classification of Advances (1938-1972)												
(% of total)												
		1938	1949	1950	1951	1952	1953	1954	1955	1956	1957	1958
Pers.+Proff		11.6	6.9	7.2	6.9	6.6	6.9	7.2	7.5	7.7	8.0	8.0
Local Authorities		14.5	4.3	4.0	5.2	4.4	4.5	4.7	4.5	4.8	5.8	6.2
Banks, Stock Market & Financial		9.6	4.8	5.0	4.5	4.2	4.0	4.3	4.1	3.7	4.4	4.3
Transports & Communication		1.5	2.3	2.4	2.5	2.7	2.9	2.6	2.8	3.1	3.1	3.1
Electricity, Gas & Water		0.9	0.5	0.7	1.6	2.0	1.7	1.6	1.5	1.4	1.5	1.5
Hotels & Entertainement		0.8	1.1	1.2	1.1	1.2	1.4	1.5	1.5	1.5	1.4	1.4
Building		11.8	6.2	7.0	6.7	7.0	7.3	7.4	7.9	8.0	7.8	8.6
Agriculture		9.7	8.1	7.3	8.2	5.8	6.7	7.0	6.4	6.7	6.1	6.3
Various		0.5	1.5	1.6	1.6	1.3	1.3	1.3	1.2	1.1	0.9	0.8
Retail		3.3	4.8	4.6	4.2	4.4	4.4	4.6	5.1	4.8	4.8	4.7
Food		12.1	23.8	22.1	20.7	22.0	21.1	20.3	20.4	20.0	17.9	17.6
Wood		1.4	2.5	2.5	2.4	2.5	2.5	2.7	2.7	2.6	2.5	2.4
Non-ferrous Metals		2.6	4.7	4.6	5.3	5.6	5.7	5.9	1.7	1.9	2.0	2.0
Iron and Steel & Metal working*		9	10.4	10.5	11.1	12.6	12.8	13.2				
Metal Working**									3.9	4.2	4.5	4.2
Mechanical**									10.1	10.4	10.8	10.5
Chemicals		1.6	3.1	3.2	3.2	3.1	3.0	3.0	3.5	3.2	3.3	3.8
Paper		1.2	1.3	1.3	1.4	1.3	1.4	1.4	1.4	1.3	1.3	1.3
Leather		1.6	2.6	2.6	2.2	2.1	1.9	1.7	1.5	1.5	1.5	1.4
Textiles		6.3	11.1	12.3	11.2	11.3	10.3	9.7	7.8	7.2	7.2	6.5
Mines									1.3	1.3	1.3	1.1
Hydrocarbons									3.3	3.7	4.1	4.3
Ex National Electricity Comps.												
Total Man.		35.8	59.6	59.1	57.5	60.5	58.8	57.9	57.6	57.2	56.2	55.2
Total		100	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

\*Only in 1938, 1949 and 1953.

\*\* Only after 1953

Source: Data calculated from, Banca d'Italia, Relazione presentata ai partecipanti all'assemblea, various years.

Table A6.8

Table A6.8 (cont.)

## Chapter Seven

### Monetary controls in Italy between 1947 and 1972

This chapter describes the sequence of monetary controls adopted by the Italian government between 1945 and 1971 to maintain the stability of the currency. Particular attention is paid to the restrictions imposed on bank lending to verify how effective these were in curbing the activity of the banks and whether a segmented banking system like the Italian one ~~reduced~~ the impact of these restrictions on small firms.

#### 1. Rapid growth 1945-1960

In the years immediately following the end of the war one of the problems which most concerned the Italian government, together with those connected with (re)building the country's industrial structure, was the reduction of inflation. In view of a return to a fixed exchange rate system in accordance with the Bretton Woods agreement, the country's recovery could be achieved only through monetary stabilisation. The control of inflation and the fixing of the exchange rate were the preconditions for the resumption of exports, thus allowing foreign exchange reserves to increase and pay for imports.

Inflation had exploded after the liberation, especially in the South, and was fuelled by the expenditure of the occupying Allied troops<sup>1</sup>. Inflation was also caused by the policy of progressive liberalisation of trade and abolition of controls fostered

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<sup>1</sup> This expenditure was financed by the Allies through the issue of Allied Military Notes (AmLire), paper money used for the troops' pay and for the purchase of goods and services.

by the government of Alcide De Gasperi which had come to power in December 1945.

Further, to promote exports, banks were encouraged to lend to the private sector and also to the government, through the purchase of state guaranteed bonds. Due to the necessity of rebuilding the country's infrastructure (roads, railways, etc), public expenditure increased and this too might have contributed to inflation. The index of wholesale prices, based on 1938=100, increased to 858 in 1944, to 2060 in 1945, until it reached 5159 in 1947<sup>2</sup>.

Inflation was not due simply to the building boom but also to the fact that the elasticity of domestic supply in the primary products sector (foodstuffs and raw materials) and ~~of~~ basic industrial goods (fuel, electricity, steel and cement) was very low, leading to increasing imports and to rising inflation despite very high unemployment. High unemployment and unused capacity in some sectors of the economy made it pointless to try to contain inflation and increase production by controlling and restricting consumption and investment. Nor was the country's productive structure in a condition to generate enough exports to finance an adequate volume of imports.

Stabilisation was achieved between 1947 and 1949 thanks to the measures conceived and implemented by Luigi Einaudi, who in May 1947 had become the Finance Minister. Einaudi clearly believed that the main cause of inflation was monetary and sought therefore to reduce the quantity of money in circulation. The first measure was the reduction of the banks' liquidity by the introduction of a system of obligatory reserves. Compulsory reserve requirements (of either Treasury bills and/or

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<sup>2</sup> A. Graziani, L'economia italiana dal 1945 ad oggi, (Bologna, 1972), p.30.

deposits with the Central Bank) were fixed at 25 per cent of total deposits held<sup>3</sup>. In 1948 the bank rate was increased from 4% to 5.5%<sup>4</sup>. These measures had a positive impact on business expectations and on public confidence and the velocity of circulation of money fell rapidly<sup>5</sup>.

Following these measures inflation stopped (as shown by Table A6.1 in the Appendix to Chapter 6) and what followed were thirteen years of monetary stability<sup>6</sup> and rapid economic growth<sup>7</sup>. At the same time the balance of payments on current account improved and registered a surplus<sup>8</sup> in 1958 and 1959. Employment in the non-agricultural sector rose by 30% and under-employment was also reduced.

At the end of November 1947 the lira was devalued and the exchange rate was raised from 350 to 589.47 lire to the dollar and in December to 603 lire to the dollar. By 1948 the lira had been stabilised at 625 lire to the dollar and this rate was maintained until 1971 when the dollar came off gold. The new value of the lira made Italian exports more competitive and, as confidence and stability increased, capital returned to the country and foreign exchange holdings began

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<sup>3</sup> To prevent the Treasury from using banks' liquidity to finance public expenditure Treasury Bonds with a term exceeding one year could not be used as reserves.

<sup>4</sup> The bank rate (Tasso di Sconto) went back to 4% in 1951, where it remained until 1959, when it was lowered to 3.5%. The interest rate remained at that level until 1969, when it was increased to 4.3%.

<sup>5</sup> P. Baffi, 'Monetary Stability and Economic Development in Italy 1946-1960', Banca Nazionale del Lavoro Quarterly Review, 56 (1961), p. 4.

<sup>6</sup> In 1958 the lira was acknowledged by the IMF to be the most stable currency of the western economies. See: Graziano, L'economia italiana, p. 65.

<sup>7</sup> GDP almost doubled between 1947 and 1959, rising, at constant prices, from 100 in 1947 to 194 in 1959 at an annual rate of growth of 5.7%.

to increase. Though devaluation reduced the demand for imports, a return of inflation was avoided mainly thanks to the availability of free goods, at first under the Marshall Plan in 1948 and in 1949, thanks to grants-in-aid that allowed the Italian government to release foreign goods for sale on the market, thereby generating a strong deflationary effect. Further deflation allowed Italian exports to increase even more, aided also, if not especially, by the over-valuation of the pound sterling, until 1949.

The core of monetary policy was built in the two years between 1947 and 1949 and it was based on the reduction of bank liquidity through the obligatory reserve, on the control of government expenditure through the restriction placed on the Treasury's ability to use funds from commercial banks and the Central Bank and, finally, on the widening of the foreign exchange reserve through exports.

Some historians have attributed the effect of reducing the availability of credit to firms to the imposition on the banks of an obligatory reserve to reduce their liquidity, leading to a reduction in investments and to further unemployment, affecting demand generally between 1947 and 1948<sup>8</sup>. Nevertheless an analysis of bank lending shows that this interpretation is not entirely correct. Inflation had been provoked both by the needs of reconstruction and by pent-up consumer demand. Output continued to increase but at the expense of the balance of payments, as most raw materials and semi-finished products had to be imported<sup>9</sup> but by December 1947 domestic demand

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<sup>8</sup> For a critical appraisal of Einaudi's policies see: M. De Cecco, Saggi di politica monetaria, (Milano, 1968); and C. Daneo, La politica economica della ricostruzione 1945-49, (Torino, 1975). On the other hand, Vera Zamagni has shown that there is no conclusive evidence that the credit squeeze of 1947-49 induced a production slump. See: V. Zamagni, 'Betting on the Future. The Reconstruction of Italian Industry 1946-52', in V. Becker, F. Knipping (eds.), Power in Europe. Great Britain, France, Italy and Germany in a Post War World 1945-50, (Berlin, 1986), pp. 287-90.

<sup>9</sup> V. Zamagni, Dalla periferia al centro, (Bologna, 1990) p. 410.

had been reduced by a number of factors. The central bank identified the three months between October and December 1947 as the crucial moment when supply exceeded demand and prices began to fall. The effect of having reduced aggregate demand is imputed to the credit restrictions imposed on the banks in September 1947<sup>10</sup>. Table 7.1 would seem to contradict this interpretation at least partially.

**Table 7.1 Italy - Advances to manufacturing 1947-1950 by type of bank  
(constant prices - 1955 - million of lire)**

	1946	1947	1948	1949	1950
National	104	120	175	226	300
Public Law	68	78	107	149	193
Ordinary	70	83	111	161	199
Peoples'	42	42	59	86	101
Savings	17	34	41	59	74

Source: Banca d'Italia, Bollettino Statistico, various years.

Table 7.1 shows that, in fact, commercial banks did not restrict credit to businesses. After complying with their reserve obligations, the banks preferred to devote their available resources to meeting the strong demand for credit coming from businesses.

Though there are no monthly statistics for advances to match Table 7.1 it is nevertheless possible to calculate the banks' lending between March 1946 and December 1947.

<sup>10</sup> Gianni Toniolo writes: 'L'inevitabile caduta della domanda aggregata prodotto dalla stretta creditizia provocò nel 1948 una diminuzione delle importazioni', [Translation: The inevitable fall in aggregate demand due to the credit squeeze reduced imports in 1948] in 'La politica monetaria degli anni '50 (1947-1960)', in G. Franco (ed.), Sviluppo e crisi dell'economia italiana, (Milano, 1979), p. 55.

Table 7.2 Italy - Advances and Deposits - Commercial Banks (million of lire).

		Advances (a)	Deposits (b)	a/b
1946	December	418	698	59%
1947	March	496	780	63%
	June	616	873	70%
	September	706	946	74%
	December	723	1013	71%

Source: Banca d'Italia, Relazione dei partecipanti all'Assemblea 1947, (Roma, 1948), p. 160.

Table 7.2 confirms that in the first three months of the 'credit restrictions' the banks did not reduce their overall lending activity, while at the same time their liquidity improved, thanks to an increase in deposits, due in all likelihood to the change in the consumers' propensity to spend. These data indicate that the fall of inflation was probably due more to the conjunction of three factors: the completion of the first phase of reconstruction, the arrival of free goods under the European Recovery Programme and devaluation, as this made imports more expensive, thus reducing consumer demand<sup>11</sup>.

Between 1947 and 1960 monetary stability and growth were achieved together without inflation thanks mainly to the availability of real resources, the supply of labour and the productivity of additional amounts of capital and labour. The availability of real productive resources had improved mainly because defeat had reduced the State's expenditure regarding defence and released human and capital resources from the colonies. In the late 1940s mineral resources, mainly natural gas, had been found. Furthermore the state owned petroleum company, AGIP, was

<sup>11</sup> Between 1947 and 1948 imports decreased by 8% and exports increased by 58%. Banca d'Italia, Assemblea Ordinaria dei partecipanti, (Roma, 1949), p. 43. Another estimate relates a larger fall in imports, by 11% but the same level of exports. See P. Ercolani, 'Documentazione statistica di base', G. Fua' (ed.), Lo sviluppo economico in Italia, (Milano, 1969), vol. 3, p. 423.

able to enter into agreements with North African countries both as an exporter and as a contractor, thanks to the loosening of the ties between certain European countries (like France) and their colonies. Last but not least a large amount of raw materials and semi-manufactured materials was made available free by the United States<sup>12</sup>.

The supply of labour, calculated as both those employed and those jobless, increased by about 2.2 million units, of which 800,000 were absorbed by net emigration, mainly to Switzerland, France and Germany. Employment in the non-agricultural sector increased by 2.9 million drawn from the additional supply of labour (the 1.4 million that did not emigrate), from the large pool of agricultural workers (about 900,000) and from the unemployed (about 600,000). These numbers suggest that the productive capacity of the country could increase and reduce unemployment without putting pressure on wages thanks to the ample labour supply. This situation was to persist until the early 1960s, with the approach of full employment in conjunction with the rise of trade union activity. Unlike Britain, Italy in the 1950s still had a large pool of unemployed and under-employed people and it seems reasonable to assume that the higher supply of labour compared to demand was instrumental in keeping wage demands low.

Another factor conspired in allowing the country to experience rapid growth. Though the need for military self sufficiency in the pre-war period had stimulated the growth of large scale firms in the staple industries, such as iron and steel, by the end of the war the industrial character of the country was still undecided, unlike that of other countries of older industrialisation like Britain. Thanks to the co-existence of a multitude of small firms and of a large pool of agricultural workers, the country was

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<sup>12</sup> Baffi, 'Monetary Stability', pp. 15-23.

able to enter new industrial sectors, in the change over from war to peace production. These new industries included petro-chemicals (plastics, detergents, synthetic rubber and fibres), electronics and some branches of engineering (scooters, office-machines, white goods) and the pharmaceutical industry (anti-biotics).

Nevertheless the presence of these factors is not sufficient to explain the phenomenon of Italy's rapid growth and stability, if the role of savings and investments is not taken into account. The 1950s were marked by a growth in real incomes of about 6% annually<sup>13</sup>, but this increase was not matched by an increase in the propensity to consume and, as a consequence, savings rose, aided also by monetary stability. De facto convertibility was achieved in September 1957, non-resident convertibility in December 1958 and official convertibility in January 1960. Private savings were channelled by the banks towards investments both in the public and private sectors through the sale of ICS bonds, as described in Chapter 6, and directly to firms through advances, as the banks' liquidity increased. Between 1949 and 1959 advances to the manufacturing sector increased, in real terms by more than 200%<sup>14</sup>.

## 2. Slowdown 1961-1973

The expansionary phase was arrested in mid-1963. The years preceding 1962 had seen rapid economic growth, a high degree of price stability and a surplus on current account. In 1960 industrial production increased by 8% and in 1961 by 11%, while

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<sup>13</sup> Zamagni, Dalla periferia al centro, p. 430.

<sup>14</sup> to put this figure in perspective consider that during the same period of time advances to the manufacturing sector in Britain increased by 54%.

inflation remained very low, 0.2% for wholesale prices and 2% for retail prices<sup>15</sup>. At the end of 1961 prices began to rise and continued accelerating<sup>16</sup>. The labour market tightened as full employment was approached and wage increases began putting pressure on enterprises' liquidity, already strained by heavy investment outlays. As a consequence of the price and demand increases, the balance of payments surplus diminished throughout 1962 until it disappeared at the end of the year. A surplus was regained in 1964 when inflation was reduced. Nevertheless the growth of GDP had slowed down to a rate lower than 3%.

Why did the 'miracle' of Italy's rapid growth stop? One explanation concerns the supply of labour. During the 1950s Italy's economy benefited from a large supply of labour and from wages that were lower than the European average<sup>17</sup>. By 1960 demand and output were still growing but at a faster rate than the supply of labour. As the country approached full employment shortages of qualified labour appeared and the Trade Unions increased their strength.

Table 7.3. Italy - Contractual real wages and salaries for industry and the public sector. % change

Year	
1959	2.4%
1960	0.7%
1961	2.4%
1962	8.6%
1963	8.9%

Source: F. Forte, La congiuntura in Italia 1961-65, (Torino, 1966), pp. 34-35.

<sup>15</sup> M. Mengarelli, Politica e teoria monetaria nello sviluppo italiano (1960-74), (Torino, 1979), p. 25.

<sup>16</sup> Percentage change of price indices

	1961	1962	1963	1964
Wholesale	0.2	3	5.2	3.4
Retail	2.1	4.7	7.5	5.9

Source: Mengarelli, p. 25.

<sup>17</sup> F. Forte, La congiuntura in Italia, 1961-1965, (Torino, 1966), p. 13.

Not only did wages increase between 1959 and 1963, as shown by Table 7.3, but an interesting indication of the tightening of the labour market lies in the fact that in 1961 the wage increase for female factory workers was higher than that of men<sup>18</sup>.

Nevertheless labour was still moving from the countryside to seek jobs in towns. Until 1960 about 200,000 people left agriculture for manufacturing or the tertiary sector each year. In 1961 this movement had increased to more than 400,000. At the same time migration continued with about 150,000 people leaving the country each year between 1960 and 1963. These figures show that the supply of labour was still abundant but it also suggests that the agricultural sector was suffering a drainage of its labour force and, in fact, compared to industrial production, agricultural output was growing much more slowly (about 1.5% in 1960-61<sup>19</sup>). One reason was the slow haemorrhage of workers, not replaced by capital-intensive systems of culture, especially in the centre-south part of the peninsula. In the long run the agricultural sector was to prove one of the country's weakest points, as the demand for food, and especially meat, increased as the standard of living improved.

The stance of policy remained expansionary up to the third quarter of 1963. The Banca d'Italia extended credit liberally to the commercial banks and reserve requirements were lowered, for the first time since 1947, to 22.5 percent at the end of 1962, thus increasing the banks' liquidity and their lending capacity. Another important measure influencing the creation of the monetary base was the abolition, in November 1962, of the obligation of banks to maintain at least a net balanced position in foreign exchange vis-a-vis non-residents. This allowed the banks to run an unlimited

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<sup>18</sup> Forte, La congiuntura, p. 35.

<sup>19</sup> Forte, La congiuntura, p. 42.

net debtor position, and as a consequence there was a massive inflow of banking funds which more than offset the drain from the current account<sup>20</sup>.

The foreign sector contributed, along with the Treasury, to the growth of the monetary base, which was running at an annual rate of 17% in the six quarters between the beginning of 1962 and the middle of 1963. This extremely rapid rate of base creation was seen at the time as a necessary evil. By leaving scope for financing the sharp increase in wages and other costs, the monetary authorities hoped to preserve high employment, thereby giving the newly formed coalition government (the first centre-left government ever) an opportunity to settle in. As a measure of expansion of credit, the ratio of advances to deposits is a useful indicator. This was 71.7% in December 1961, 74.4% in December 1962 and 78.9% in September 1963<sup>21</sup>. Unfortunately the deterioration in the balance of payments, worsened by increasing inflation and capital flight as confidence in the lira decreased, stimulating speculation on international money markets<sup>22</sup>, put an end to the expansionary policies before their potential effects could be assessed<sup>23</sup>.

Monetary policy was tightened in September 1963 when the freezing in the net debtor position vis-a-vis non-residents was announced. This action restricted the banks' liquidity, de facto imposing a reduction on their capacity to grant credit<sup>24</sup>. The aim

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<sup>20</sup> Banca d'Italia, Annual Report 1962, (Roma, 1961), (English version), pp. 93-96.

<sup>21</sup> much higher than in Britain where it was lower than 50%.

<sup>22</sup> Forte, La congiuntura, p. 197.

<sup>23</sup> A criticism of these policies may be found in F. Modigliani, G. La Malfa, 'Inflation, Balance of Payments Deficit and their Cure through Monetary Policy: the Italian Example', in Banca Nazionale del Lavoro Quarterly Review, 20 (1967).

<sup>24</sup> Mengarelli, Politica e teoria, p. 44.

of this policy was to reduce the borrowing capacity of individuals and firms, therefore reducing internal demand and inflation. The impact of the credit restrictions is hard to evaluate as the ratio of advances to deposits kept increasing, reaching 81% in December 1963. The squeeze became more drastic in the first half of 1964 as, though the increase of advances had slowed down<sup>25</sup>, the balance of payments was still in deficit and prices were still rising. Capital flight and speculation worsened the position of the lira to the extent that in March 1964 the IMF had to intervene with a loan and speculation was checked. By May 1964 the balance of payments had gone back into surplus and exports increased by 40% compared to the previous year. Some commentators have attributed this rise to the effect the credit restrictions had in reducing demand, therefore freeing products for the export market<sup>26</sup>.

Investments in manufacturing declined from 2,500 billions of liras in 1963 to 1,500 in 1965, and the indexes of industrial production of most manufacturing sectors decreased. Almost 140,000 workers lost their jobs between 1963 and 1965 (employment returned to 1963 levels only in 1967)<sup>27</sup>. Notwithstanding the reality of these data, it is hard to establish how much this recession was due to restrictive monetary policies or to a general negative conjuncture, partially due to the country's loss of competitiveness as wages rose.

Which category of firms suffered most from the credit restrictions and which category of bank was the most hit by the reduction of liquidity? It might have been

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<sup>25</sup> G. Mengarelli, 'La politica monetaria in Italia (1960-1975)', in G. Franco, Sviluppo e crisi dell'economia italiana, (Milano, 1979), p.79.

<sup>26</sup> Mengarelli, 'La politica monetaria', p. 82.

<sup>27</sup> Graziani, L'economia italiana, pp.81-82.

easier for the larger firms to maintain their lines of credit, as their contracting power with the banks was stronger. On the other hand the large banks were those whose foreign indebtedness was largest.

As shown in Table A6.7 in the Appendix to Chapter 6, advances to many sectors of the economy were reduced in 1964, following the onset of the credit restrictions. In manufacturing only the 'Metalworking' and 'Paper' sectors did not suffer a reduction in advances. In terms of establishing whether large firms or small firms suffered the most, the data contained in Table A6.7 are not very informative. Nevertheless, though the total amount of money lent decreased between 1964 and 1965, Table A7.1 in the Appendix to this chapter shows that the banks in fact increased the total number of advances made to most manufacturing sectors, except for 'Wood' and 'Leather'<sup>28</sup>, therefore indicating that, though they were lending less, they were still trying to meet demand coming from firms who were suffering due to the negative conjuncture. This behaviour is in fact the opposite to what the British banks were doing, as the evidence presented in Chapter 4 showed.

By looking at lending by type of bank, more interesting facts are revealed which support the hypothesis that a segmented banking system will defuse the impact of credit restrictions.

Table 7.4. Italy Advances to the manufacturing sector by type of bank. (Constant values - 1955. Million of lire)

	1961	1962	1963	1964	1965
National	990	1197	1443	1395	1366
Public Law	709	923	1087	1071	1088
Ordinary	775	931	1039	1012	1060
Peoples	395	466	511	491	515
Savings	343	410	483	433	438

Source: My calculations from data in: Banca d'Italia, Bollettino Statistico, various years.

<sup>28</sup> By 1966 the total number of advances granted to all sectors had increased to more than 4.6 million

Table 7.4 shows that in real terms each type of bank reduced its advances between 1963 and 1964, though only the largest banks, the three Banks of National Interest, continued to reduce advances in 1965.

Table 7.5. Italy - Number of loans to the manufacturing sector by type of bank (000).

	1963	1964	1965
National	74	75	72
Public Law	95	96	101
Ordinary	161	160	166
Peoples	116	115	120
Savings	179	188	192

Source: same as Table 3.

Table 7.5 shows that the banks which did not reduce the number of advances granted to the manufacturing sector were the Savings banks and the Public Law banks, banks with a strong regional identity. These data confirm that, though in money terms advances were reduced, the fact that there were local banks allowed the number of firms receiving funds to increase, tempering the effect of the economic downturn. Furthermore, the segmentation of the banking system had another positive effect since while the banks reduced their advances between 1964 and 1965, the Special Institutes did not, as shown by Tables 7.6, 7.7 and 7.8 below.

Table 7.6. Italy - Advances by Special Institutes (all sectors)  
(Constant values - 1955. Million of lire)

1963	4.355
1964	4.811
1965	5.219

Source: Banca d'Italia, Bollettino Statistico, 1964 and 1965, (March).

Table 7.7. Italy - Advances by Special Institutes (Industry and Public Works)  
(Constant values - 1955. Million of lire)

1963	2.657
1964	2.938
1965	3.199

Source: same as Table 6

Table 7.8 Italy - Advances by Special Institutes to Small Manufacturing Firms - (Constant values - 1955.  
Million of lire)

1963	259
1964	330
1965	387

Source: same as Table 6

These three tables show that, throughout the credit squeeze, the Special Institutes continued to supply firms (and small firms), with medium and long term credit, thus diminishing the long term effect of the restrictions on investment. Again this can be compared with what happened in Britain, where there was no institutional alternative to the commercial banks for supplying finance to the smaller firms. Furthermore Chapter 4 highlighted how one of the effects of the credit restrictions in Britain was to reduce firms' confidence in the future availability of capital, therefore undermining investment decisions.

Fiscal measures and a reduction in public spending were also applied in order to reduce demand and the final result was that inflation decreased from 7.5 percent in 1963 to 5.9 percent in 1964. It was back at 2 percent in 1966.

It is interesting to note that during this period interest rates were not increased and this would seem at odds with the government's need to regain the markets' confidence in the lira. The reason is once again to be found in the political climate of the period. The stability of the government, threatened by right wing pressures, required that the 'social pact' between the political class, industrialists and the labour force, was seen to be intact. In this context an increase of interest rates would have sent a negative signal throughout the system. This interpretation is confirmed by the fact that between 1963 and 1964 the Governor of the Banca d'Italia denied the existence of restrictive measures and that in the Bank's Annual Reports for these years there is no mention of the credit restrictions. All the measures described above were meant to be known only by the financial operators and not by the general public and

in fact their existence was strenuously denied<sup>29</sup>. This is not as absurd as it may sound. Clearly some bank customers or prospective borrowers were aware, through transactions with their banks, that credit had become tighter. Nevertheless as no official, public statement was made regarding the credit restrictions, the existence of them remained an unconfirmed rumour and therefore unchallengeable.

Thanks to foreign demand, the balance of payments became positive again in 1964 and industrial production resumed its growth. Investments in manufacturing rose again and reached 1962 levels in 1968. To stimulate exports and sustain recovery, the tax load of firms was reduced and a series of Keynesian policies were implemented (more public works, pension increases and subsidies for housing). As the balance of payments became positive again, more liquidity was poured into the system thus increasing that of the banks. Table A7.1 in the Appendix to the chapter shows how total advances to most sectors had increased by 1965 and how advances to the manufacturing sector were all showing a positive change.

By 1966 recovery was completed and industrial production increased by 10 percent during the year. Investments and gross profits also grew. This positive trend was to continue until 1968 thanks to the continued rise of exports and the increase in public spending and pensions. Nevertheless, the real extent of the country's growth was under-estimated and at the end of 1968 a number of measures (mostly of a fiscal nature) were implemented to boost the economy. These measures, coupled with massive labour unrest, started an inflationary spiral which led to a deficit in the balance of payments, and a drop in production and investments. Industrial production

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<sup>29</sup> G. Mengarelli, Politica e teoria monetaria nello sviluppo economico italiano (1960-1974), (Torino, 1976), p. 34.

dropped in 1969 by 3 percent and the negative conjuncture started a static phase that lasted until the end of 1971<sup>30</sup>. Though interest rates rose and the Banca d'Italia attempted to reduce the liquidity of the banks, the absence of other financial intermediaries meant that, as firms lost profitability and reduced their capacity to generate funds internally, the banks were called in to supply finance to keep the industrial system afloat<sup>31</sup>, as shown by Table 7.9.

Table 7.9. Italy - Advances to manufacturing by type of bank - (Constant values - 1955. Million of lire)

	1970	1971	1972
National	2092	2229	2421
Public Law	1637	1744	1899
Ordinary	1978	2128	2340
Peoples'	871	965	1071
Savings	863	898	978
<b>Total</b>	<b>7441</b>	<b>7964</b>	<b>8709</b>

Source: Banca d'Italia, Bollettino Statistico, 1971 and 1973.

High inflation rates nullified the increases in interest rates (these became negative in real terms in 1972) and as wages continued to rise the 'social pact' was kept afloat by the fact that industrialists would tolerate high wages in the certainty that credit would not be restricted and was made, in real terms, very cheap by the rise of inflation. The story ends here, before the great deflation of 1973 and the long period of stagflation.

### Conclusion

The evidence presented in this chapter does not show conclusively that a segmented banking sector reduced the impact of the credit restrictions. However the activity of some of the banks (especially the local ones) and of the Special Institutes suggests that

<sup>30</sup> Mengarelli, Politica e teoria, pp.82-96.

<sup>31</sup> Mengarelli, Politica e teoria, pp.96-97.

by continuing to increase their lending they did diffuse, in some measure, the impact of the negative economic conjuncture. The uniformity of the British banking system and the absence of alternative sources of finance prevented this from happening. The next chapter will look closely at the lending behaviour of two Italian regional banks.

## **Appendix to Chapter Seven**

### Tables

Table A7.1

Italy - Number of Advances by sector (000)		1963	1964	1965
Pers+Proff		2707	2849	2853
Local Authorities		23	26	27
Banks, etc.		9	8	9
Transport		43	44	45
Communications		0.2	0.3	0.3
Shipping		2	2	2
Electricity		0.9	0.8	0.7
Gas & Water		1	1	1
Entertainement		6	6	6
Hotels		26	26	27
Building		124	139	148
Agric.		519	486	481
Food		171	161	163
Wood		78	76	78
Mining		23	24	24
Mineral process.		29	29	31
Oil refin.		12	13	14
Iron & Steel		22	22	22
Mechan.		117	119	125
Chemicals		24	24	25
Rubber		3	3	4
Paper		19	20	21
Leather		26	26	25
Textiles		58	60	61
Various		27	24	25
Retail		291	304	309
Total		4361	4493	4527
Source: Banca d'Italia, Bollettino statistico, 1963 to 1966.				

## Chapter Eight

### Banking in an Italian region

This chapter describes the structure of local banking in one of Italy's regions. More specifically the chapter analyses the role played within the region by two local banks, the Cassa di Risparmio di Torino and the Istituto Bancario San Paolo. The aim is to show the contrast in behaviour between local Italian banking institutions and the British banks described in the first part of the thesis, especially during periods of credit restrictions and economic downturns. The last section of the chapter will use network theory, as presented in Chapter 1, to interpret the lending practices of one of the two banks<sup>1</sup>.

The region chosen is Piedmont, in the North West part of the country. This is one of the regions of older industrialisation where firms such as Fiat and Olivetti started their activity at the beginning of the twentieth century. Despite the presence of these firms, the region has always maintained a large proportion of small and medium sized businesses<sup>2</sup>. The region's most important centre is the town of Turin, the capital of Savoy before the unification of Italy in 1861.

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<sup>1</sup> The data presented in this chapter are of a rather disparate nature, especially those referring to the two regional banks. Differently from the English banks, these two banks do not have formal archives and the collection of information has been dependent on the different degrees of goodwill of bank officials.

<sup>2</sup> In 1950, 99% of all manufacturing firms in Piemonte employed less than 100 people and firms employing less than 500 people accounted for 99.8% of all firms. By 1970 firms with <100 employees accounted for 98.5% of all firms, and the share of firms with <500 had not changed. In terms of employment, in 1950 small firms with <100 accounted for 39% of total employment, while firms with <500 accounted for 60%, in 1970 these percents had changed to 33% and 49% respectively.

## 1. The Piedmontese banking sector

Table 8.1 Number of Piedmontese banks and branches

	Number of banks	Number of branches
1950	53	779
1960	52	888
1970	49	1001

Source: Banca d'Italia, Bollettino Statistico, 1951, 1961, 1971.

Table 8.1 shows the number of Piedmontese banks and branches that had to share the same, relatively small, regional market, an area of about 25,000 square Km, slightly larger than Wales. The total number of banks was actually higher than that shown, as the table takes into account only the banks whose head office was in Piedmont, those banks that can be considered as truly local banks. The category with the highest number of branches was that of the Savings Banks, with more than 40% of the total number of branches over the period.

The activity of the largest banks was concentrated in the areas with the largest towns, whereas the activity of the smaller banks such as the Peoples' Cooperative banks and of the Savings Banks was more decentralised, and more focused on smaller urban centres.

Table 8.2. Piedmont - Percentage of advances granted in the region by type of bank

	1950	1960	1970
National	28	22.6	22.6
Public Law	24.2	25	27.4
Ordinary Credit	13.6	14.5	12.5
Peoples' Coops.	20.3	16.3	10.1
Savings	13.6	21.1	27.1

Source: My calculations on data in: Banca d'Italia, Bollettino Statistico, 1951, 1965, 1971.

Table 8.2 shows how the regional market was dominated by different types of banks, depending on the period. At the beginning the National Banks, the least 'local', held the largest share of the market, followed very closely by the Public Law banks. By 1960 the latter type had taken over as the main lender in the region and by the end of the period the Savings banks held almost the same share of the market as the Public Law banks.

Within the region the other sources of capital for firms were the Special Institutes, the special sections of the banks created to deal exclusively with long term loans, and the Mediocredito Piemontese<sup>3</sup>, whose activity was, and is, restricted to medium and long term loans to small and medium sized firms.

The Mediocredito Piemontese was the first of those regional bodies created by decree in 1950 for financing the capital needs of small manufacturing firms as described in Chapter 6. During the first four years of its activity (which effectively started only in 1953) less than 100 loans were granted, mainly because of the diffidence of local businessmen, who had until then only relied on the commercial banks. After 1958 the activity of Mediocredito increased, favoured also by laws, such as the Legge Colombo of 1959 and the Legge Sabatini of 1968 that institutionalised the granting of loans at a subsidised rate, for certain categories of investments, as described in Chapter 6. Loans could be held for a minimum of 18

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<sup>3</sup> These institutions were joined, in the early 1980s, by FidiPiemonte, a cooperative of banks and small firms sponsored by the regional authorities (these three groups own the shares of the association in equal parts). This association negotiates loans for firms and uses its capital to guarantee loans for those small firms whose capital is not large enough to be granted substantial loans, but whose prospects are good. In the context of regional economies and networks the case of FidiPiemonte (and of similar associations in other regions) is very interesting but its activity will not be examined as it falls outside the time period covered by this research.

months and a maximum of 10 years.

Between 1953 and 1977, 85% of all advances authorised by Mediocredito were granted to firms with less than 100 people employed, of these 66% were firms with less than 50 employees. The engineering and metal working sector, received the highest percentage of loans over this period with a maximum peak of 49.8% in 1960, reflecting the industrial specialisation of the region. The relative importance of Mediocredito can be gauged by the number of applications accepted. Between 1952 and 1962 Mediocredito granted a total of 1,040 loans to small firms mainly in manufacturing. This number increased to 4,420 in 1972. To measure the impact of Mediocredito's activity, the number of loans granted can be compared with the number of small manufacturing firms (between 10 and 500 employees) in Piedmont. These were 6,306 in 1961 and in 1971 the number had increased to 6,683. This comparison shows how, especially after the Legge Colombo was passed, the Mediocredito Piedmontese played quite an important role as a lender within the region. However, the following pages will concentrate on the activity of two commercial banks, so that comparison with the English banks can be made<sup>4</sup>.

## 2. Two Piedmontese banks

The intent of this section is to analyse the lending activity of two Piedmontese banks, the Cassa di Risparmio di Torino, a Savings bank, and the Istituto Bancario San Paolo, a Public Law bank. Though the lending activity of commercial banks in Italy, and therefore in Piedmont, is defined by law as short term and is restricted to advances for working capital, as described in Chapter 6, in practice banks 'roll over' advances,

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<sup>4</sup> Mediocredito Piemontese, Il Mediocredito Piemontese, (Torino, 1978), pp. 20-39.

allowing their customers to use them for capital investments. This practice has been confirmed by the bank officials of the two banks in this study<sup>5</sup>. These two banks were, and still are, among the largest local credit institutions in Piedmont and thus cannot be said to be wholly representative of the population of credit institutions within the region. Nevertheless the intent of these pages is not to calculate how important these two banks were, in terms of loans to small firms, but instead to show how two local banks, who are assumed not to have been any different from the other 50 local banks, acted within the confines of a small market. .

The importance of these two banks in the local economy in the post-war period was quite different as in the early 1960s San Paolo accounted for 29 percent of total advances in the region, whereas the Cassa di Risparmio di Torino (hereafter CRT) accounted for 14 percent (San Paolo's deposits were 33 percent and 23 percent for the Cassa). San Paolo, though a bigger bank in terms of advances and deposits, had fewer branches than CRT (146 to 160). The distribution of branches through the region was also different, as CRT had more branches in rural areas than San Paolo.

## 2.1. The Cassa di Risparmio di Torino - CRT

The Cassa di Risparmio di Torino was founded in 1827 by the municipal authorities of the city of Turin, and like most Savings banks, its initial role was to stimulate 'an

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<sup>5</sup> Interviews with Luciano Giannatempo, Head of the Advances Section of the Cassa di Risparmio di Torino, 16th March 1993 and with Marco Bisio, Head of Ordinary Loans section of San Paolo, 17th March, 1993.

For a comparative analysis of how banks turn short term loans into long term finance in Britain see: D.M. Ross, 'The clearing banks and the finance of British industry, 1930-1959', PhD Thesis, (London School of Economics and Political Science, 1989). The same practice in France, Germany and Italy is analysed in G. Nardozzi, Sistemi creditizi a confronto: Banche ed economia in Francia, Germania e Italia, (Bologna, 1983).

attitude to savings amongst the working classes<sup>6</sup>. The CRT developed its activity very much along the same lines as those of the other Savings banks in the country. These traditionally became the holders of the savings of farmers, manual workers and artisans, investing these savings mostly in state guaranteed bonds and in the public works of the local authorities. The Banking Law of 1936 confirmed the Savings Banks' role of administrators of savings. As their shares were held by the municipal authorities and by the customers of the bank (one share per customer) the Savings Banks did not have to maximise profits for shareholders but what profit a bank could make from the differential between lending and borrowing rates was returned to the community, either as an investment in local infrastructures or as donations to charities. The Law also excluded the possibility of the Savings Banks operating outside the boundaries of the region in which they were based, as described in Chapter 6. As the main regional collectors of medium term savings (the Savings Banks opened current accounts only in the mid 1960s) the Savings Banks acted as one of the main sources of financial resources inside the regions, transferring funds from the local private sector to the economic activities of the region, at first mainly to agriculture and later on, as the country industrialised, more in favour of artisans, small manufacturers, building and development activities promoted by the local authorities.

The composition of the Board of Directors of CRT reflected its municipal nature, as the directors were elected by the municipal authorities from a group of people prominent in the political, financial and economic circles of the region. At the same time the members of the Board occupied important positions in regional

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<sup>6</sup>Archivio del Municipio di Torino, Ordinati 1827, vol.XIV, n.33, Notificanza 4-7-1827. In Italian in the original.

institutions, like the Chamber of Commerce of Turin.

At the end of 1946 CRT's liquidity was distributed as follows: cash 46.30%, short term investments 21.43%, stocks and shares 20.96% and medium term investments 11.31%. The high percentage of the bank's cash availability was due to the imbalance between the increase in deposits after the end of the war and the demand for funds within the regional economy. Despite the fact that the largest manufacturing firms, the local authorities and the hospitals had, if anything, increased their demand for finance<sup>7</sup>, the region's industrial structure was still too disrupted for production to recover<sup>8</sup>. In 1946 CRT had 136 branches, 16 in Turin and the rest scattered around Piedmont.

In 1947, the Italian government, to stop inflation and restore confidence in the lira, applied a series of monetary restrictions, some of which included bank lending, as described in the preceding chapter. Following these measures inflation decreased and production (aided by a stable currency, cheap and abundant labour and foreign loans) increased. The effect of the credit restrictions on bank loans is not clear; nevertheless the increase in the advances of CRT<sup>9</sup> confirms that, if the credit restrictions had any effect, this must have been confined to a reduction in the use of

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<sup>7</sup> CRT, Board Minutes, vol. 38, p.35.

<sup>8</sup> Turin, where most of the regions' industrial production was based, was heavily bombed by allied forces between 1940 and 1944. At the end of the war 74% of all dwellings had either been damaged or destroyed, 293 factories had been completely destroyed (among which those belonging to Westinghouse) and 795 heavily damaged. By 1943 two thirds of the city's population had left to seek refuge in the country. See: Citta' di Torino, Annuario Statistico, (Torino, 1946), pp. XIV-XVIII; and IRES, Panorama Economico e Sociale della Provincia di Torino, (Torino, 1959), p.33.

<sup>9</sup> Advances as a whole (bills discounted, overdrafts and loans) increased by 8% between 1947 and 1948, whereas overdrafts increased by 84%.

bank funds for stockpiling<sup>10</sup>.

In the following years CRT intensified its role as a lender to the economy of the region. It concentrated its activity in those sectors which were at the forefront of the region's development: mechanical, metal working, textiles and food production. The bank's aim was to help every enterprise with potential for growth, especially small and medium sized ones<sup>11</sup>. The reasons for this behaviour were not merely social. In fact the bank soon realised that its deposits were no longer coming just from manual workers or farmers and were not just the manifestation of a desire to save and provide for the future. Deposits increased by more than 550% between 1947 and 1958 (in 1955 constant prices) as the smaller productive units were using the bank to deposit their cash and use it as working capital. These firms were the bank's main source of funds and their well being was dependent on the prosperity of the region. For this reason the whole regional economy had to be supported and CRT used its large reserve of funds not only for advances to various sectors of the local economy (advances increased by more than 400% between 1947 and 1958 in real terms) but also to finance the development of the region's infrastructure. CRT in those years, apart from acting as the treasurer of the finances of the Municipality of Turin<sup>12</sup>, was also investing in hospitals, motorways, local authorities, electricity companies, schools, the university, public housing, etc<sup>13</sup>. The fostering of the local economy and of small

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<sup>10</sup> CRT, Board Minutes, vol. 38, p. 337.

<sup>11</sup> CRT, Annual Report, 1949.

<sup>12</sup> CRT, Board Minutes, vol. 40, p. 101.

<sup>13</sup> CRT, Board Minutes, 1949, vol. 39, p. 625; 1951, vol. 41, p. 637; 1952, vol. 42, p. 53 and p. 248.

and medium sized firms helped the development of what in Italian is called the 'classe media'<sup>14</sup>, the traditional source of private and business deposits for Savings banks<sup>15</sup>.

In 1952 to further its impact on the local economy, CRT took a majority share in the Mediocredito Piedmontese, established by the government to provide small and medium sized firms with long term capital.

It is interesting to note that CRT, because of its nature as a non-profit maximising organisation, had a policy of charging lower interest rates than the other, profit maximising, banks, to act as a barrier to inflation and to help the smaller borrowers<sup>16</sup>. According to the bank this was not an 'aggressive' attitude towards the other banks but it was meant as a measure to keep the cost of capital low across the region so as to help: "tutte le sane iniziative incrementative e produttive, di nuove fonti di lavoro (all those healthy, and growing, productive enterprises, producers of new jobs)"<sup>17</sup>. The benevolent attitude of the bank towards firms must be put into context. The bank's advances were never more than about 20% of total assets<sup>18</sup>, and included finance for the local authorities and public works. The largest share of the bank's assets were in state guaranteed securities. Thus though the bank was not maximising profits by refusing to exploit the monopolistic position it had with many

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<sup>14</sup> this term, though it translates into 'middle class', has a much broader coverage than the English equivalent.

<sup>15</sup> G. Dell'Amore, 'Il contributo della Casse di Risparmio allo sviluppo economico nazionale', in G. Dell'Amore, Saggi, (Milano, 1968), p. 239.

<sup>16</sup> CRT, Board Minutes, 1955, vol. 45, p. 189; 1956, vol. 46, p. 99, p. 247; 1957, vol. 47, p. 40.

<sup>17</sup> CRT, Annual Report, 1960, p. 8.

<sup>18</sup> In the case of San Paolo the percentage was much higher, almost double.

small firms by charging higher interest rates than it did, it was also safeguarding its depositors' money by having most of it invested in state securities. The ratio of advances to deposits was always less than 30%, lower than the region's average, about 60%<sup>19</sup>. It must be remembered that the Savings banks could pursue this strategy of low interest rates because they did not have shareholders.

Notwithstanding its rather conservative attitude, the bank's role as a lender to small firms cannot be disregarded. Though CRT had amongst its clients large firms like STET, Ruminanca and Montecatini, it also granted very many small loans for amounts smaller than five million lire and, despite the risk involved, the bank had very low bad debt<sup>20</sup>. In 1959 it increased its contribution to the Cassa per il Credito alle Imprese Artigiane (a Special Institute for loans to artisan firms)<sup>21</sup> and it started cooperating with some local municipal administrations to provide credit to very small artisan firms that could not offer enough collateral to back their requests for loans<sup>22</sup>.

Apart from the case of artisan firms, CRT's policy when authorising a loan was

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<sup>19</sup> Within the region the banks with the highest ratio were the private banks, the ordinary credit ones, with about 70%. These were mostly small banks whose preference for advances over other forms of investment denotes a risk-taking attitude coherent with the view of a small market in which buyers and sellers are locked together and where large profits can be made by banks by exploiting the absence of other sources of finance. This of course raises the question of how stable the whole system is, how much it relies on a generally favourable economic climate, on the accumulation of savings and ultimately on the role of the central bank as a preserver of confidence and stability. These are fundamental questions but they cannot be pursued any further within the context of this research.

<sup>20</sup> CRT, Board Minutes, vol. 46, p. 202; vol. 48, p. 310; vol. 49, p. 247; vol. 50, p. 22. N.B. The level of bad debt is not given. The minutes just state that it is very low.

<sup>21</sup> Artisan firms are those that employ less than 10 people.

<sup>22</sup> G. Biraghi, B. Cerrato, 'Artigianato', Piemonte che cambia, (Torino, 1976), p. 376.

to consider the firms' operative record and past performance rather than the type of collateral it could offer. The reason for doing this was that the bank knew that collateral, in the case of small firms, tended to be rather small, and, in the event of default due to bankruptcy, would not cover the firms' total loss<sup>23</sup>.

The Annual Reports and Board Minutes of CRT relate how, between 1958 and 1963, advances increased by more than 200% in real terms. As described in the preceding chapter the growth of the Italian economy slowed down after 1963 and, though CRT's advances never decreased in absolute real terms, the increase between 1963 and 1973 was only of 30%.

Italy's 'economic miracle' ended with the rise in salaries which in turn increased inflation. This was coupled with a decline in the confidence of international operators in the lira, following the election of the first coalition government including the Socialist Party in 1963. All these elements induced the first deficit in the balance of payments since 1947. In 1963, as described in Chapter 7, the government, to put a stop to inflation, introduced credit restrictions. The response of CRT to these measures was to restrict mortgages but to continue increasing its short term lending activity to avoid harming the local economy<sup>24</sup>. Nor did the bank stop the financing of the Special Institutes, such as the Mediocredito Piedmontese and the Credito Agrario (for loans to agriculture). This policy must have helped small firms as these had become, by 1961, the sector in which the bank had most of its business clients<sup>25</sup>.

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<sup>23</sup> CRT, Annual Report, 1959, p. 7; Board Minutes, 1959, vol. 52, p. 514 and Board Minutes, vol. 44, p. 403; vol. 45, p. 236.

<sup>24</sup> CRT, Board Minutes, 1963, vol. 50, p. 9.

<sup>25</sup> By 1968 90% of the bank's advances was below 20 million liras. See, CRT, Annual Report, 1968, p.14.

Though the banks had been advised by the Banca d'Italia to reduce total lending, the decrease in industrial investments during this period was not due, according to local contemporary observers, to a scarcity in the supply of credit but to a decline in competitiveness due to the increase in labour costs<sup>26</sup>.

Demand for credit in Piedmont remained slack until 1966, when exports picked up again and employment increased, overtaking the levels achieved in 1964. CRT increased its advances not only because demand was buoyant again but also thanks to a policy of decentralisation of decisions at branch level. Small businesses had been badly scared by the adverse conjuncture and had to be made aware of the possibilities of credit offered to them. To do this the branches, especially the more peripheral ones, were given a higher level of autonomy and managers encouraged to find new business to speed up their promotion to larger branches<sup>27</sup>. The success of this strategy resulted in "una massa ingente di finanziamenti a migliaia di piccole imprese di ogni settore, in vivace espansione (a large amount of advances being distributed to thousands of small firms, in every sector and in rapid expansion)"<sup>28</sup> and a marked increase in the volume of overdrafts (traditionally used by the smaller firms). These increased by 31%

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<sup>26</sup> Associazione Piemonte-Italia, L'economia piemontese nel 1964, (Torino, 1965), p. 38.

<sup>27</sup> This strategy of decentralisation was being applied by many other Savings Banks and it was changing the traditional role of these banks, from simple collectors of savings to active intermediaries between markets. See, F. Tedeschi, G. Trapani, 'Riforma della legislazione delle Casse di Risparmio e dei Monti di Credito su Pegno', Atti del X Congresso dell'Associazione delle Casse di Risparmio, (Milano, 1971), p. 9.

<sup>28</sup> CRT, Annual Report, 1967, p. 17.

between 1966 and 1967 and by 31% again between 1967 and 1968<sup>29</sup>. By 1971, 45% of advances to the business sector consisted of overdrafts.

In 1969 the situation became difficult again, following the beginning of the season of intense strikes which hit the country's manufacturing sectors. Car manufacturing was the worst hit sector and this was particularly damaging for the Piedmontese economy, traditionally reliant on the car industry. Once again the rise of salaries and inflation eroded the firms' capacity for investments and their export base. In order to encourage the demand for credit CRT reduced its interest rates by 0.5%, compared to those of its competitors. However this strategy could not be pursued for a very long time without dangerously reducing the earning capacity of the bank (also faced with increasing labour costs) as the rates on deposits could not be decreased, without running the risk of losing customers<sup>30</sup>.

A longer term strategy was pursued to support businesses through the negative conjuncture. A service for business research was set up for foreign operators interested in business relations with local firms and for customers of the bank interested in possible export opportunities. This service was particularly advantageous for smaller businesses as they were the ones which found it most difficult and costly to enter in contact with new, foreign buyers. The bank attributed its actions to a desire to keep the local economy, and local employment, afloat. Incidentally this strategy was also instrumental in preserving the bank's clients and deposit base<sup>31</sup>.

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<sup>29</sup> CRT, Annual Reports, 1967 and 1968 and Board Minutes, vol. 56, pp. 37-38. No data are available on the amount of bad debt.

<sup>30</sup> CRT, Board Minutes, vol. 65, p. 489.

<sup>31</sup> CRT, Annual Report, 1972.

In 1973 inflation had risen above 12%, the highest level in 20 years. Nonetheless gross fixed investments in Piedmont increased by 7% and CRT attributed this to the possibility firms had of borrowing from banks, since the firms had had their profits eroded in the preceding years. Small and medium-sized firms was the sector to receive most help. This sector had "found in the Institute understanding for its financial problems and a valid assistance in their solution; this help was given at an extremely delicate stage in the economic situation when a possible difficulty in obtaining banking credit could have meant a halt in production recovery with truly disastrous effects. Small firms have a reduced bargaining power and have greater difficulties in obtaining bank credit. For this reason the CRT has been supportive"<sup>32</sup>. Apart from banking rhetoric and the scarcity of clear data to back the bank's assertions, except for the steady increase of advances, the fact remains that in 1974 a survey done on local businesses revealed that these thought of their bank as a "stable reference point in the planning of their development, and not merely as a source of finance"<sup>33</sup>.

## 2.2 The Istituto Bancario San Paolo di Torino

The qualitative data available for this bank are much less detailed than those available for the CRT as no documentation from the minutes of the meetings of the board of directors was made available. Furthermore the annual reports are much more general than those of CRT and do not contain any sort of description of the regional economy and of the bank's role within it. On the other hand, the quantitative data are more

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<sup>32</sup> CRT, Annual Report, 1973, English edition, p. 14.

<sup>33</sup> CRT, Annual Report, 1974, English edition, p. 15.

abundant than in the case of CRT, as it has been possible to reconstruct the bank's Classification of Advances, presented in Table A8.1 in the Appendix to the chapter.

San Paolo's origins are much older than those of the CRT as it was founded in 1563 by seven citizens of Turin, making it an institution much embedded in the history of the region. The first role of the bank was that of a pledge bank as it was created with the intent of fighting usury while supporting the credit needs of the poorer classes. The capital of the pledge bank was provided by a local nobleman, by the city of Turin and by the ruler of the duchy, Carlo Emanuele. Until after the plague of 1630 the bank's activity remained limited to that of granting interest free loans to poor people on the pledged value of their goods. From the early seventeenth century the bank changed its role, becoming one of the main lenders to the duchy and increasing its activity as a collector of deposits. By the beginning of the nineteenth century, the bank had become the main purchaser of government bonds in the years during the wars against Austria, which culminated in 1859 and whose outcome was to give Vittorio Emanuele, the ruler of the duchy, the throne of the newborn Italian state.

San Paolo passed unscathed through the bank crises of 1893 and 1930, thanks to the conservative nature of its operations. It did not venture into speculative activities like other, larger banks, as its direct involvement with industry in these years was limited. The core of its business was personal loans and investments in government securities.

The Bank Law of 1936 meant, for a provincial bank like San Paolo, that its regional boundaries were institutionalised. Though it had offices in towns outside the region, like Rome, Milan and Genoa, the Law decreed that its role was to be contained

inside the Piedmontese economy.

The size of San Paolo (which, together with the Banca Popolare di Novara, was one of the largest banks in Piedmont) meant that it could offer services also to medium-large firms. The very large firms like Fiat and Olivetti were to use San Paolo for their day to day banking necessities but would also look for finance to institutions like Mediobanca, created by the three banks of National Interest, to provide medium and long term loans to industry.

Table A8.1, in the Appendix to the chapter, shows San Paolo's advances (overdrafts and short term loans) by sector in real terms. In the years immediately following the end of the war the marked weight of the mechanical sector (this accounted for 38% of the bank's total advances) is indicative of the high demand for advances of the most important manufacturing sector in the region. After 1949, when other channels of finance for metal working and mechanical firms were opened thanks to direct government intervention, the distribution of advances became more even. Throughout the period this work is concerned with, the most important sectors for the bank were 'Personal and Professional', mechanical metal working, building (which includes public building), agriculture and food manufacture, and textiles (with clothing), though not necessarily in this order. Manufacturing as a whole was consistently the sector to which the bank lent the most.

The bank's distribution of advances reflects the importance of the various sectors in the local economy. Metal goods and mechanical products were, together with textiles and food, the main products of the traditional industrial district. All these sectors had a mix of large, medium and small firms and, on the basis of this data, it is not possible to define which type of firm San Paolo targeted. However it seems

unlikely that the bank concentrated its lending on large firms, especially because of the large percent of loans to the 'Personal and Professional' sector, a proxy for small firms. The secondary literature suggests that the bank was involved in large investments especially in the building sector. San Paolo adopted a precise long term strategy for local development, deciding to concentrate a high share of its advances in the building of the city's infrastructure and the construction of motorways<sup>34</sup>. The creation inside the bank of a special section to deal exclusively with long term loans for these purposes reflects this choice. No data on these long term loans are available, but the trend of advances shown in the table is indicative of the bank's policy.

As shown in Table A8.1 in the Appendix to the chapter, the credit restrictions of 1947 did not have any effect on advances as these increased, in real terms, by more than 60 percent between 1947 and 1949. This confirms the view that the government's monetary measures did not effect the supply of credit, at least not at a local level. Unlike the case of CRT, San Paolo's advances did decrease during the second credit squeeze, between 1963 and 1964, but it is difficult to determine to what extent this reduction was the effect of the monetary measures imposed on financial institutions by the government to reduce inflation or to the negative conjuncture, though the bank, in its Annual Report, imputed the reduction of the level of advances to the latter reason. Industrial investments were checked by the recessionary climate and this had a negative effect on demand for credit<sup>35</sup>. As the economic climate improved so did the level of advances: these increased, in real terms, by more than 26 percent between 1964 and 1966. San Paolo was quick to attribute to its credit activity a predominant

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<sup>34</sup> S. Cingolani, G. Maradini, San Paolo: da Banco a Bank, (Milano, 1989), p. 100.

<sup>35</sup> Istituto San Paolo (from now on ISP), Annual Report, 1964.

role in helping the region's economic recovery<sup>36</sup>. In the following years the bank experienced high levels of internal liquidity which were attributed to the slow erosion of competitiveness in the manufacturing sector, particularly in cars and engineering, due to the rise of labour costs<sup>37</sup>. In this adverse climate the bank's role had to change. The recessionary climate of the late 1960s and the slowdown of the beginning of the 1970s showed that especially small and medium-sized firms were undercapitalised and had relied for too long on low labour costs. Their important role in the local and national economy meant that the bank had to initiate a programme of support to help introduce these firms to the capital market<sup>38</sup>. How successful this activity was is not known: nonetheless advances increased overall, in real terms, by more than 34 percent between 1970 and 1972, and by 30 percent in the 'Personal and Professional' sector, which grouped many owners of small firms. The bank's policy in these difficult years was to continue to support manufacturing, especially the most technologically advanced sectors and those more oriented towards export markets, including small firms, together with a commitment not to burden firms further by recalling debts, as long as these firms managed to maintain their turnover<sup>39</sup>.

As remarked in the section on CRT, the 1960s were marked by a higher degree of competition between banks, as the economy grew at a slower rate than during the previous decade and the demand both for advances for working capital and for investments was reduced, as shown by Table A8.1 in the Appendix. Competition was

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<sup>36</sup> ISP, Annual Report, 1966.

<sup>37</sup> ISP, Annual Report, 1968-1972.

<sup>38</sup> ISP, Annual Report, 1972.

<sup>39</sup> ISP, Annual Report, 1974.

manifested in a reduction in the differential between rates for deposits and advances, thus squeezing the bank's profit margin. Though rates were regulated by the Interbank Agreement this was periodically broken in order to attract customers<sup>40</sup>.

These pages have described the activity of two regional banks with the aim of showing their commitment to their local markets. These markets were small and banks were restricted by law in their ability to expand them. Furthermore the high concentration of banks within a small market made competition fierce but within the confines of cooperation, dictated by the need to keep the regional economy strong, as the banks relied on the economic well being of the region for their own survival. Within the confines of these small markets local banks had to develop assessing and monitoring techniques to avoid incurring excessive risks.

The next section of this chapter will show how, within a local economy, a bank could use networks of information to reduce the transaction costs connected to assessing potential customers and monitoring their activity. These networks of information were, and are, both formal and informal. The formal connections between the banks and other bodies within the region, such as the municipal authorities, the Chamber of Commerce, industrial associations and other financial intermediaries, such as the Mediocredito, were institutionalised by joint membership to the various boards of directors and boards of councillors and were used to acquire information about customers. These formal links and other connections will be explored in the following pages, using data from the Istituto Bancario San Paolo and the theoretical framework described in chapter 1.

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<sup>40</sup> ISP, Annual Report, 1966 and 1968.

### 3. A local bank within the local network

The Istituto Bancario San Paolo, has always been an integral part of the economy of Piedmont by virtue of its history and of its role as one of the main local providers of finance. The links with the region are also institutional as, since the end of the Second World War, the board of the Compagnia di San Paolo (the foundation that controls the bank) has been elected by the municipal authorities of Turin. The members of the Board have been bankers but also the members of the municipal authorities and of other regional institutions such as the Association for Small Firms (a lobbying body), or the Association of Machine Tool Manufacturers. Historically the members of the bank's board have sat on the board of the Chamber of Commerce, creating a tight network of interconnecting interests.

The procedure for the assessment of businesses used by the bank is based both on quantitative and qualitative analysis. Information about a firm that can be quantified includes the data from the balance sheet, cash flow, forecast, investment plans, the number of clients and suppliers, the order book, the sales structure, the structure of imports and exports, the pension scheme run by the firm, and finally the number of people employed. The qualitative analysis includes the study of the management characteristics of the firm, its structure, the personnel training, research and development, the technological level already achieved, the firm's marketing strategy and what prospects the bank has of offering the firm more services in the future.

The source of information for the quantitative data is internal to the firm, whereas the qualitative analysis is complemented by other external sources such as the firms operating in the same sector or in complementary ones; the suppliers to the firm; other banks used by the firm; the firm's clients and other sources such as the local

Chamber of Commerce<sup>41</sup>.

Especially in the case of new small firms, a loan is an investment the bank makes on the reputation of the entrepreneur and in this case the most useful information will come from external sources. Though the creditworthiness of the potential customer can be assessed through interviews, the most important source of information available is the environment in which the entrepreneur operates. Thus, suppliers, clients and other institutional actors such as the Chamber of Commerce<sup>42</sup> and other banks are used as sources of information for the evaluation of the identity of the applicant. These sources are considered by the Istituto to be fundamental in the minimisation of risk<sup>43</sup>.

In the case of an established firm, the bank's policy when authorising a loan is to consider the firm's operative record, measured both in quantitative terms and by the reputation of the firm, and its performance in the past more than the type of guarantee it can offer. Furthermore, the final decision to grant a loan rests on the human factor, as evaluated through interviews and the information collected from those external sources mentioned before<sup>44</sup>.

In theory, the information provided by these sources external to the firm should

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<sup>41</sup> Istituto Bancario San Paolo, Servizio Fidi, 'Instruttoria Pratiche di fido', (Torino, 1992).

<sup>42</sup> In Italy membership of the local Chamber of Commerce is compulsory, for all businesses and the Chamber is an invaluable source of information.

<sup>43</sup> Interview with Renato Maino, Head of the Research Unit, Istituto Bancario San Paolo, Turin, 19 December, 1994.

<sup>44</sup> Interview with Marco Bisio, Head of Ordinary Loans section, Advances Office, Head office and Anna Repetto, Head of Ordinary Loans section, Advances Turin Area, Istituto Bancario San Paolo, 17 March, 1993.

be readily accessible by any type of bank. Nevertheless, a regional, local bank is at an advantage, compared to a national bank, because through time it has created links with these sources that are historical and have become institutional. These factors cannot be replicated in the short term and would require, on the part of banks wishing to enter these local markets, long-term vision and investments, such as the taking over of a local bank, to use its existing network<sup>45</sup>.

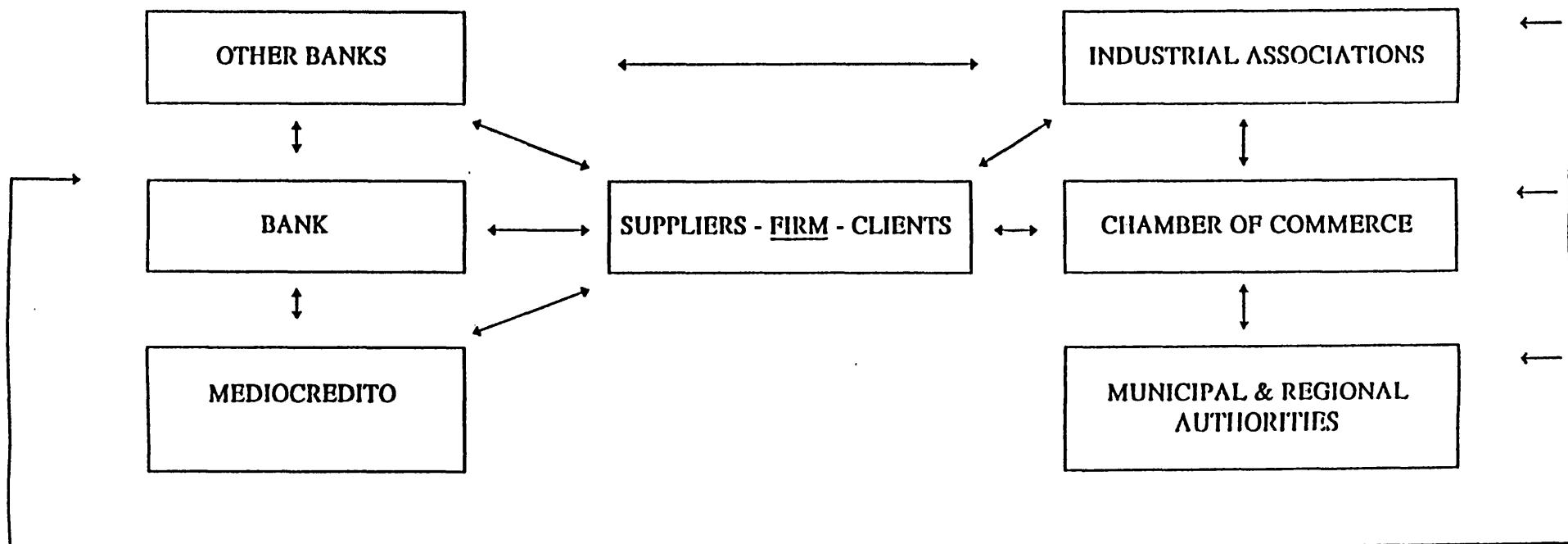
San Paolo, as a local bank, can monitor its customers more easily than a national one as bank managers tend to be local people and have a deep, almost ingrained, knowledge of the general economic conditions of the area and of the productive sectors that operate in the region and can, on the basis of this knowledge, assess the prospects and prosperity of a firm<sup>46</sup>. The collection of information and monitoring to avoid moral hazard are aided by the connections existing between bank, customer, suppliers and institutional actors described in Figure 8.1., connections that national banks do not have.

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<sup>45</sup> In the 1990s, after deregulation, the national banks were not able to encroach on the local banks' market, as they lacked the established network, of trust and information. Therefore, to access regional markets they have resorted to buying the local banks. For details of one of the latest mergers, that between Credito Italiano (a national bank) and Credito Romagnolo (a local bank), see Financial Times, 13 April, 1995.

<sup>46</sup> Interview with Luciano Giannatempo, Advances Office, Head Office, Cassa di Risparmio di Torino, 16 March, 1993.

Figure 8.1. Information flows within the local network



All the elements in the diagram are linked together and information flows between them. The **bank** (San Paolo in this case, but it could be any of the local banks) is likely to be the banker not only of the **firm**, but also of the firm's suppliers and clients. By virtue of the daily repetition of contacts with these customers the bank manager, aided by his general knowledge of the state of the local economy, has an overview of their activity. As all these businesses are linked together, malfeasance on the part of one will damage the whole group, thus creating the potential for peer monitoring. The other banks are an important source of information because Italian firms tend to be in debt with more than one bank. The risk of opportunistic behaviour on the part of the other banks when asked for information is avoided by the fact that all the banks are confined to the same, relatively small market, and that they inevitably have to rely on each other for information. The banks and Mediocrediti are connected as the banks own the shares of Mediocrediti, and the banks pass onto Mediocredito those customers in need of long term loans for specific types of investments. Banks and industrial associations like the Association of Small Businesses (API), or the Association of Machine Tool Manufacturers, are linked because these institutions participate in the choice of the members of the bank's board and because these institutions represent the firms within the local economy, those firms that provide the banks' profits. Linked directorships connect the bank with the Chamber of Commerce and the Municipal and Regional associations. These associations are important sources of reliable information on the activity of potential and existing customers.

The links are not only formal, but also, informal. All the elements of the diagram are connected as they share the same geographical space and the same economic and social environment. It is these linkages that allow for the reduction of

transaction costs: crooks are weeded out, not by price or by credit rationing, but by their known reputation. Furthermore in such a small market such as the regional economy reputation is a very important asset and firms are unlikely to want to spoil it for the short term gains bought by opportunistic behaviour.

The absence of formal archives has made it impossible to verify whether the lending practices of San Paolo in the 1950s and 1960s were the same as those described for the 1990s. Nevertheless in a banking textbook published in 1965 Giordano Dell'Amore, professor of Banking at the Universita' Bocconi and chairman of CARIPLO (Italy's largest Savings Bank) confirmed that in the evaluation of small firms the personal factor, the morality of the entrepreneur, was very important and the best judge of it was the branch manager, thanks to his connections with the local economy. Though small firms had to provide some collateral to back their request, loans could be granted on the basis of the owner's 'honour' (prestiti sull'onore)<sup>47</sup>. This practice had not changed substantially in the 1970s when the Advances Department of CARIPLO used the branch managers' knowledge about a businessman's commercial morality and professionalism to judge his creditworthiness<sup>48</sup>.

### Conclusion

By looking at the activity of two regional banks this chapter has shown that local banks have a direct commitment to the economy in which they operate that national banks do not have. Of the two banks studied here, the smaller one, the Cassa di

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<sup>47</sup> G. Dell'Amore, Economia delle aziende di credito, (Milano, 1965), vol. 1, pp. 734-735.

<sup>48</sup> G. Dell'Amore (ed.), La Cassa di Risparmio delle Province Lombarde 1923-1972, (Milano, 1973), p. 1040.

Risparmio di Torino, did not decrease its lending during any of the credit squeezes imposed by the government, confirming that a segmented banking system does diffuse the impact on firms of a negative conjuncture. Furthermore this chapter has demonstrated how local banks strived to reassure small firms of their support during negative periods and pursued active strategies to increase their share of the local market. This can be compared with the profit-satisficing attitude of the British banks thus allowing us to give an answer to the counterfactual question "would small firms in Britain have been better served by a banking system comprising also local banks?".

The analysis of the assessment procedure used by one of the local banks has shown the importance of local sources of information in the assessment of creditworthiness and the minimisation of risk. This type of information can be costly to collect as it is not easily formalised. Italian regional banks are placed within a network of connections between local economic actors that allows for easy access to this type of information. This ease of access is not solely connected to the fact that information is often no more than a phone call away but also to the reliability of the informants. The information produced within the network can be trusted because the ties that connect the elements of the network are created not only by opportunity but also by historical custom. The evidence presented in this chapter on the use made by local banks of the network to reduce transaction costs can be compared with the centralised organisational structure of the British banks that made the use of the information generated locally impossible.

## **Appendix to Chapter Eight**

### Tables

Table A8.1

Istituto Bancario San Paolo																		
Classification of Advances																		
Constant values (1955) - Million of lire *																		
		1946	1947	1948	1949	1951	1952	1953	1954	1955	1956	1957	1958	1959	1960	1961	1962	1963
Transport		165	102	140	237	359	463	423	709	1195	1577	1969	3358	3468	4285	5735	5986	5639
Telephones**		423	261	433	412	342	1077	1525	300	452	2811	3404	2641	1738	3388	2081	998	
Elect.+Gas		446	275	280	324	595	1387	822	2711	2427	5240	2874	4074	5651	3975	2483	4155	4139
Building		641	395	672	1240	1958	3253	4231	4727	4468	5228	6285	7265	10030	15687	21802	22963	27728
Agric+Food		865	534	2206	3251	4553	5910	7314	8849	10602	10052	10526	11780	16195	16898	20858	23437	25601
Wood+Coal		93	57	169	1046	434	530	753	899	960	1003	1388	1316	2046	2237	3582	3559	4156
Metalworking		362	223	752	1030	366	1403	718	1138	2433	1298	1640	2673	3226	3612	4099	6469	8436
Mechanical		3605	2225	4419	4380	5359	6696	4664	5564	4755	6231	6869	7739	7083	10659	15559	24820	28225
Paper		38	23	155	254	298	277	561	541	613	568	734	827	862	1264	1888	2125	2344
Textile		247	153	888	1494	3169	3010	5042	5455	4343	3711	4519	4931	4955	7219	9085	12160	13758
Chemical		190	117	506	568	657	1265	1557	1120	1348	2798	3696	3539	3888	299	4666	6091	8512
Other banks***		330	204	2026	3884	3342	3754	7086	9411	5350	7169	8228	8754	9220	10590	13774	16910	21274
Public Authorities		691	427	365	350	406	1416	1767	1458	1448	977	1539	2694	3378	2889	4026	4353	3675
Personal and Proff.		1444	891	3015	5042	6216	5642	6054	5828	10958	12492	14687	17741	20556	32064	44926	52858	56386
Total		9553	5895	16036	22827	28060	36089	42527	48717	51359	61163	68365	79335	92301	117793	154570	186888	209877

\* no data are available for 1950; \*\* only until 1963; \*\*\* these are short term loans to other banks.

Source: Istituto Bancario San Paolo, Annual Reports, various years.

Table A8.1 (cont.)

	1964	1965	1966	1967	1968	1969	1970	1971	1972
Transport	5375	4547	5398	6291	8343	8010	8629	10373	15814
Telephones**									
Elect.+Gas	3722	1640	388	1825	3345	1490	1823	7878	12627
Building	29792	31632	32681	37248	46630	60856	50374	56539	55751
Agric+Food	24008	23835	29617	38664	44697	41185	37564	34842	39264
Wood+Coal	3271	3548	4221	4285	4721	5121	5067	5224	5917
Metalworking	7910	11948	18262	20808	20545	19403	22189	20754	31259
Mechanical	24669	24378	32958	36359	36942	41957	51104	47864	61772
Paper	2583	3187	3476	4076	5358	7202	8679	6925	7908
Textile	12332	12579	15121	16593	15076	16378	19884	21478	21957
Chemical	7594	7187	9862	10467	11831	13664	22473	22188	26349
Other banks***	20153	24808	40356	38520	44608	44578	39705	61536	86371
Public Authorities	4178	6133	6352	8733	9628	9354	8268	8318	8303
Personal and Prof.	52139	50725	51118	58446	72112	81975	92935	97301	121641
Total	197733	206151	249814	282321	323839	351019	368701	401225	494933

## Conclusion

The aim of this research has been to show how, in the 1950s and 1960s, monopoly distortions created by concentration, cartels and regulations restricted the supply of banking finance to small firms in Britain.

This research was motivated by the belief that banks have an advantage over other financial institutions as they can assess, monitor and risk-manage loans where information is partial and asymmetric, as in the case of loans to small firms. This thesis has demonstrated that in the 1950s and 1960s British banks were foregoing this advantage and actually preferring to lend to the most risk-free clients, such as large firms, who least required such services and had alternative sources of finance, whilst neglecting demand from small firms. This research has shown that one of the reasons for this neglect was the organisational structure of the banks themselves.

By looking at the relationship between banks and customers, and more specifically at the relationship between decision centres and the periphery, this research has established the nature of information asymmetries regarding small firms. Furthermore by comparing a centralised and concentrated system, such as the British one, with a segmented one, as in Italy, this work has revealed that the cost of reducing these asymmetries was lower for local banks with local decision centres where bank managers could make use of informal types of information.

Information is the main variable with which this research has been concerned: or more specifically how information was transmitted within organisations and the link between transaction costs and information. The analysis of the lending activity of the Piedmontese banks has shown how the creditworthiness of small firms and the validity

of their projects could be assessed more easily by people who had a first hand experience of the local economy in which these small firms operated. In the process of assessing, monitoring and enforcing, regional banks used qualitative information which, although not easily formalised, could be gathered locally from sources within the network. The section on Piedmontese banking reconstructed the regional network and demonstrated the links that existed between banks, firms and other institutional sources of information such as the local chambers of commerce. These links allowed information to flow and be accessed by other elements of the network.

By contrast, the chapters on British banks have shown how, by centralising decisions when assessing a request for a loan from a small firm, transaction costs increased as the application form had to be processed by a number of offices, from the periphery to the centre, before the loan could be granted. To expedite the process and reduce costs (and risk) information had to be put in a standardised form and therefore the informal information allowing a reduction of information asymmetries was lost.

Thus the conclusion that can be drawn from this research is that British bank and British banking were not structured in such a way as to facilitate the supply of finance to small firms. The following pages will be dedicated to expanding this point in the light of the comparison between the two banking systems.

This thesis makes the case that British commercial banks behaved more like satisficers than as profit maximisers in the period under study, and these pages have shown that it was the centralised structure of British banks and the cartelized structure of British banking that prevented demand from small firms from being satisfied. Centralisation increased the cost of gathering information about the smaller, more peripheral customers, while also making the monitoring and enforcing of loans more

problematic. In fact, centralisation encouraged the commercial banks in their lending to the larger customers. Furthermore cartelization prevented the survival, and subsequent emergence, of provincial financial institutions that could use information from local sources to reduce asymmetries without increasing transaction costs.

The chapters dedicated to the Italian banking system have concentrated on showing an 'alternative model' in which, though small firms still suffered from price discrimination, the supply of finance was assured by the structure of the system itself. During the period under study, state intervention and regulation created a system where small, local banks operated alongside large, national ones, but providing finance to different markets. Thus local economies and small firms could have a reliable source of capital. Different categories of customers, artisans, farmers, small manufacturing firms, large concerns and private people required a different lending specialisation, and the different types of Italian banks, from the Rural Banks to the Artisan Banks, to the Co-operative Banks, the Savings Banks and the Mediocrediti Regionali, all possessed, by nature of their history, this specialised knowledge.

Despite the existence of local banks small firms in Italy suffered from price discrimination in the same way as their British counterparts. In fact the data in Chapter 6 shows that the interest rate differential between large and small firms was larger in Italy than in Britain. To some extent price discrimination in Italy, as much as in Britain, was the result of small firms not having alternative sources of finance but we can also assume the Italian local banks were taking more risks than their British counterparts and pricing them accordingly. Nevertheless, the issue pursued in this thesis has been the availability of finance rather than its cost to the customer. Crucially this research has shown that availability is linked to the structure of the banks as this

determined the cost of processing the transaction, and the decision as to whether the loan would be granted at all.

The chapter on the organisational structure of Barclays, Midland, and Lloyds has shown the nature of the transaction costs involved in the business of lending. The structure of the banks, especially in the cases of Midland and Lloyds, made the granting of many loans to small firms more expensive than authorising one large loan, simply in terms of the many levels within the structure which had to check and process the request. The evidence presented suggests that, to varying degrees, the three British banks studied preferred a quiet life, i.e. lending to large firms rather than taking the option of lending to many small customers though these would have brought higher returns as small firms were charged higher interest rates. In a sense high cost and high perceived risk might have been sufficient reasons to justify the attitude of the British banks towards small loans. But let us assume that all banks, regardless of nationality, would want a quiet life; that all banks, especially in a regime of low competition such as the British and Italian ones, would act as satisficers. Then Italian local banks were in the better position because small firms were high return, low risk and low cost thanks to the assessing, monitoring and enforcing qualities of the network, explored in Chapters 1 and 8. The comparison between the two systems once again highlights the importance of structure, when the problem of the availability of capital to small firms is addressed.

The historical character of this research is reinforced by the investigation into the activity of the three British banks and the two Piedmontese ones during the periods of credit restrictions imposed by the governments of the two countries to control inflation and the balance of payments under the Bretton Woods system. The archival

material from the British sources revealed that, contrary to the existing literature on the subject, demand from small firms during these years existed, and that credit restrictions harmed small firms as the national banks allocated what funds they could make available to their larger existing customers. By comparison the segmented nature of the Italian banking system allowed it to diffuse the effect of restrictions. To some extent regional banks did restrict credit, but they nevertheless carried on lending to the majority of their local customers while the fringe of excluded firms could still rely on other local sources such as the Mediocredito or the Istituti Speciali.

The importance of the structure of the banking system in diffusing the impact of the credit squeeze has been confirmed by the observation that the lending activity of the British banks followed different patterns depending on their organisational structures. Barclays restricted its lending less, and resumed it sooner, than Midland and Lloyds did. The evidence found suggests that this was due to the decentralised structure of Barclays and the closer involvement of its regional boards with local economies. Interestingly this pattern of lending during the period of credit controls was mirrored by Martins Bank, the only provincial bank left at the time, as shown in Chapter 4.

Therefore, the attitude of Barclays' regional districts could be compared to that of the Piedmontese banks, as described in Chapter 8. However, this comparison cannot be taken much further, as this research has shown that there is at least one other crucial difference between the British banks and Italy's regional banks. This difference might prove to be the key to the different performance of small firms in the two countries.

This difference was the reliability of supply. Italian firms knew that their local

banks would continue to lend them money even during economic downturns. The evidence presented in Chapter 8 shows how important for the local economy the banks were especially during recessionary periods. Reliability of supply allowed firms to pursue long term plans in the expectation that their cash requirements would be fulfilled. Though the Italian banks, as much as the British ones, did not lend for capital purposes, the practice of rolling over overdrafts released money within the firm that could be used for capital investments.

British small firms could not base their investment plans on bank lending. Stop-go policies had shown that the banks could not be trusted to maintain overdrafts during difficult periods, nor did these banks make much effort to pursue potential small business customers.

The chapters dedicated to the genesis of the British and Italian banking system described how, behind the structuring of both systems, there was a more or less implicit political design. Both banking structures were shaped by governments' views on the future industrial structure of the two countries. State ownership and direct control in Italy created a rigid structure where each segment of the market could have access to finance. Even cartelization and price fixing made sense within the logic of preventing the elimination of small banks, since these were thought to be fundamental for the prosperity of small and local economies in general. The survival and development of local economies was (and is) one of the cornerstones of Italy's political economy and the banks had to play an active role by sustaining these economies.

Conversely the pages dedicated to the history of banking in the UK suggested that the decline of small firms in Britain was not induced solely by the structure of the

banking system but also by the sentiment that allowed that structure to develop, i.e. the belief held by politicians, policy makers and businessmen alike that the industrial future of the country rested with large scale businesses. In 1969 within this vision of development the Bolton Committee could accept that supply discrimination and high transaction costs were a "fact of life" for small firms, and that there was no need for the creation of alternative sources of finance, since no failure in the supply of finance to small firms could be identified, as described in Chapter 2. This attitude can be compared with the precise political will to provide for small firms that led, in Italy in 1950, to the creation of the Mediocrediti Regionali, institutions designed with an inbuilt local nature aimed at reducing transaction costs and promoting investments.

Despite the emphasis placed in these concluding pages on the virtues of Italian banks, this thesis does not want to be an eulogy for Italian banking. This system had many limits that have not been solved by liberalisation in the early 1980s. Compared with their European counterparts Italian banks continue to be overstaffed and the technology used by branches to supply services has low capital intensity. While the high profitability of the smaller banks makes Italian banking overall one of the most profitable systems in Europe, the amount of international services provided to clients is very small<sup>1</sup>.

While using the Italian case as the "counterfactual model" this thesis has addressed only some of the issues related to the development of Italian banking. The restrictions placed on the availability of data make a detailed analysis of the role played by Italian banks in the process of industrialisation very difficult, but this

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<sup>1</sup> F. Bruni, 'Banking and financial reregulation: The Italian case', in J. Dermine (ed.), European banking in the 1990s, (London, second edition, 1993), pp. 247-252.

research needs to be continued, especially in the context of comparative European economic history.

The aim of this thesis has been to address a much debated question, whether British banks have failed industry, in a new way: firstly by looking at a specific group of firms and their environment, and, secondly, by questioning the effectiveness of the overall structure of British banking, and the internal structure of the banks, in reducing information asymmetries. The comparative approach has allowed us to identify a structure better suited to reducing these asymmetries and fostering transactions. Without using this comparative method it would not have been possible to identify the weaknesses in the structure of British banking.

As more archival material is made available, this research could be extended further to see whether the banks' attitude to small firms changed after competition was introduced in Britain in the late 1960s. Recent surveys on regional economies have suggested that the absence of local sources of finance might still be a problem for small firms<sup>2</sup>.

Using a comparative approach and drawing on a wide range of archival sources and different theoretical approaches, this thesis has aimed at providing a different perspective on the relationship between banks and industry. The conclusions reached indicate that the debate on the alleged failure of British banks adequately to supply finance must continue in the wider context of the study of how the political economy developed in the post-war period. Banking structures were shaped also by the belief

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<sup>2</sup> Financial Times, 'West Midlands Industry Survey', October 19th, 1995.

held by successive governments that large enterprises were the best suited to promote growth within an economy that was perceived as being 'national' and where the specificity of localism had ceased to matter.

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