SUMMARIES OF LECTURES in ECO 303Y1:

the Economic History of Modern Europe, to 1914

for the Academic Year: 2012 - 2013

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VII: Week no. 7: Lecture no. 7, part a: on 24 October 2012

Banking and Finance before and during the Industrial Revolution

(1) **English Business Organization: 1550 to 1720:**

a) **Functions:** to provide both the lubricant (medium of exchange) and fuel (capital: both working and fixed capital) for the economy

b) **Private Partnerships:** the predominance form of business organization

i) an ancient form of business, dating to Greco-Roman times (in a European context)
ii) Unusual English feature: that a partnership was limited, by Common Law, to 6 members
iii) other basic features:
(1) partnership contract valid only so long as all partners participate in the common business venture: dissolution of the partnership on the withdrawal (sale of partnership share) or death of any partner
(2) profits and losses shared proportionally: in ratio of capital invested
(3) unlimited liability for debts, law suits, claims, etc: for all partners: collectively and severally (individually - that each individual liable for all debts, if others default)

c) **Joint Stock Companies:** an English innovation dating from the 1550s

i) **ability to raise far larger capitals:** than could any 6-member partnership: through the sales of stock or shares of ownership
ii) **collective business venture operating with a common capital that was permanent:** unaffected by death or withdrawal of any stockholders

iii) **negotiability of stock:** i.e., the right of stockholders to sell or transfer their shares to third parties

iv) **attractive features of negotiable stock:**
(1) to reap capital gains if the stock value rose
(2) in the meantime, to receive dividends, as proportional share of disbursed profits
iv) Board of Directors: elected by the stockholders: one vote per share owned
(1) Directors responsible for management and organization of the company
(2) declared dividends to stockholders: disbursement of profits (partial or total)

d) **Historical Origins of the English Joint -Stock Companies:**

i) **crisis of the English cloth trade on the Antwerp market in the 1550s:** collapse of cloth exports led to widespread unemployment

ii) **government response:** to promote immediate overseas commercial diversification to lessen dependence on both cloth exports (accounting for 90% of total export values) and on Antwerp (accounting for 90% of cloths exported)

iii) **New Overseas Joint-Stock Trading Companies:** which required vastly larger initial capitals for long-term long distance trade (ventures lasting 2- 3 years), requiring capital in ships, warehouses, inventory
(1) Muscovy Company: to Russia (1553)
(2) The Levant Company: to the Ottoman Turkish Empire (1581)
(3) The East India Company: to India and South Asia (1600)
(4) the Royal African Company: for the African slave trades (1662)
(5) the Hudson's Bay Company: for North American (1670)
iv) Other companies: from the 1690s (next day)

c) **Problems or Limitations of the New Joint Stock Companies:**

i) **Liability:** those lacking a charter of incorporation, making the company a corporate entity separate from its shareholders, were subject to partnership law, and thus to unlimited liability
(1) All of the new overseas trading companies had such parliamentary charters of incorporation, and thus limited liability for investors, along with charters of monopoly rights in trad
(2) But all the new companies from the 1690s, for domestic trade, finance, and industry, did not (except the new Bank of England, in 1694)

ii) **Markets for Shares:** lack of an organized secondary market for shares
(1) hindered the ability of shareholders to sell their shares to third parties, without a broker having connections
(2) solution: formation of the London Stock Exchange (by such brokers) in 1695
(3) followed by a proliferation of new joint stock companies

2. **The Rise of Private Banking in England: the 17th century Goldsmiths:**

a) **The twin foundations of modern banking:** kept separate before the Goldsmiths banks

i) **Bills of Exchange banking:** the creation and province of merchants in long-distance trade:

(1) bill of exchange: a command by a principal to a banking agent abroad to make payment on his behalf

- European financial instrument designed to finance international trade (or remit funds abroad)
- four-party letter: two principals in city A: the borrower and the lender
- and their two agents abroad, in city B: the payer (acting for the borrower) and the payee (acting for the lender)
- Principal 1 borrows money (or buys good) from principal 2 in city A
- uses those funds to finance his trade: shipping goods to city B, where his agent arranges the sale of the goods and deposits the proceeds in his bank account
- Principal 1 (borrower) 'draws a bill of exchange', or writes a letter commanding his agent in city B (the payer, or drawee) to accept the bill and make payment to the payee on a specified date, using the funds in his bank account
- Principal 2 (lender) similarly instructs his agent in city B, with a copy of the bill, to receive payment on the maturity date; and then to remit the funds to him in city A, by drawing another bill
- obviated the necessity of transporting precious metals over long distance: payments made in the local

currency of each city

- also a means of evading the usury doctrine (the universal prohibition against lending money at interest): by disguising the interest in the exchange rate
- Most important European financial innovation in medieval & early-modern Europe: had no antecedents in the ancient world, and was not borrowed from the Arabs or Chinese (etc).
- Later called the 'acceptance' bill: because of the crucial role of the drawee or payer, in 'accepting' the bill and thus being obligated to make payment

(2) deposit and transfer banking: the creation and province of money-changers

- note: each prince, ruler of state or principality issued his/her own coins, usually denying legal-tender status to foreign coins
- thus a money-changer was necessary to exchange foreign coins for domestic coins, delivering the foreign coins to the ruler's mints
- From ancient Greek times (4th century BCE) money-changers became bankers, because they had to safeguard their inventory of coins and precious metals: so that others left their coins and precious metals, etc. with them for safe-keeping
- as bankers, these money changers soon realized that they could safely lent out a proportion of the coins placed with them on deposit: hence, fractional-reserve system of leading
- these money-changer-bankers also allowed depositors to pay other bank clients by making book account transfers: by which the debtor client instructed the bank to debit his account and credit the account of the creditor client with the agreed-upon sum.
- in medieval Europe, such book-account transfers were effected (as today) by using cheques
- after dying out in late Imperial Rome, such deposit-transfer banking was revived by money-changers in 12th century Genoa and Lombardy (Italy): and spread to Catalonia (Spain), France, Flanders – but not England
- Why did medieval and early-modern England not have deposit bankers: because money-changing was a royal monopoly (Royal Exchanger), whereas elsewhere money changing & deposit banking was a private enterprise, though licenced by the state

b) **The 17th-century Goldsmiths and the beginnings of English deposit banking;**

i) **The London Goldsmiths became the first real English bankers:** after the Civil War era (1642-60)

- they were originally a 14th-century London guild of jewellers and precious-metal artisans, i.e. goldsmiths
- but subsequently, many (or most) goldsmiths found it more profitable to trade in precious metals, even though trading in bullion, and especially exporting bullion (without a licence) was illegal
- So long as the Royal Exchanger exercised a crown monopoly on money-changing (and so long as the bans on exporting both bullion & coin remained in force), the Goldsmiths could not function as deposit bankers, as private money-changers had long done on the continent
- I have found documents as late as 1626 prosecuting goldsmiths for exporting bullion and for engaging in money-changing against the monopoly privileges of the Royal Exchanger

ii) **The Goldsmith Banks in The Restoration era:** from 1660

- Civil War era, from 1642 to the Restoration of the Monarchy (Charles II) in 1660: the office of the Royal Exchanger was evidently abandoned, since the crown could not enforce the monopoly (not after the execution of Charles I in 1649), and Parliament had no reason to uphold it
- The Goldsmiths, or family firms and private partnerships of Goldsmiths, were now free to engage

in money-changing

- and thus in deposit-and-transfer banking, as had long been practised on the continent

iii) **Banking functions developed by the Goldsmiths, 1660 - 1700:**

- deposit and transfer banking: with current (non interest) chequing accounts and time-deposit savings accounts (paying interest), without cheques
- lending: on the fractional reserve system, which meant a three-fold potential expansion in the credit money supply, with a reserve ratio of one-third (reciprocal of the reserve ratio)
- discounting: commercial paper – by far the most important function
- note issue: the issue of paper bank notes, which not immediately but later became printed bank notes for rounded sums (£20, £10), made out to bearer – and fully negotiable

iv) **Discounting commercial paper:** bills of exchange, inland bills, promissory notes, etc.

- discounting is the sale or 'cashing' of a commercial bill before its stated date of maturity
- therefore, the amount of the redemption, 'the amount cashed', is discounted: the face value less the amount of interest due between being cashed and is maturity or redemption value
- The medieval usury ban had prevented discounting: which thus became legal only when interest payments became legal – in England, from 1571 (Elizabeth I - up to 10%).
- In the example given in the handout: a cotton spinner (factory owner) sells 1000 yds of cotton yarn in a forward-sales contract with 90 days delivery, receiving in payment a promissory note for £100
- the cotton-spinner immediately sells or cashes the note with his local banker, for £97
- he uses these funds for the working capital needs of his spinning mill (raw materials, wages, rent, heat, administrative costs) – but not for machinery (fixed capital)
- the banker collects the full £100 owing on the note's maturity from the issuer: thus earning 12.5% interest for the 90 days

v) **Negotiable (and thus transferable) credit instrument developed by the Goldsmith bankers, by 1700:** serving as acceptable substitutes for coined money, though not legal tender, so long as those holding these instruments were confident that they could be exchanged for real money, in the form of coin

- the cheque (negotiated by endorsement)
- discounted bills: bills of exchange, inland bills, promissory notes (IOUs)
- bank notes: finally in printed form, made out to bearer, for rounded sums
- discounted bills: inland bills, bills of exchange, promissory notes
- paper bank notes

3. **The Bank of England:** 1694 - 1797: its role in the English Economy

a) **Major Factors in the Formation of the Bank of England, in 1694:**

i) **Financing Warfare:** with France, 1689-1715
(1) Glorious Revolution of 1688: brought to the throne Mary II (daughter of deposed James II0 and her Dutch husband Prince William of Orange, as William III (1688-1702)
(2) He thus involved England in his ongoing war with Louis XIV
(3) Problem: crown's credit rating was so poor that it had to pay up to 14% to borrow money
(4) Parliament had asserted, with the Glorious Revolution, that it controlled 'the purse strings' – crown finances
ii) **Creation and Management of Permanent National Debt:** beginning with million pound loan of 1693
iii) **monetary scarcity (for reasons explained earlier):** requirement that a new bank print legal-tender

banknotes

b) **Formation of Bank of England in 1694:**

i) William Paterson, a Scottish entrepreneur, his London banking associates, and Sir Charles Montagu, Chancellor the Exchequer provided the government with a permanent loan of £1.2 million, at 8% interest
ii) in return: received a dual monopoly: on government banking and on joint-stock banking (i.e., as the only legal joint-stock company bank allowed in England, so that all others were partnerships/family firms.)
iii) How the loan was made:

- in theory, the loan was to be raised by the sale of stock in the Bank of England
- but stock sales were initially at 10% down, on margin: took years to complete
- so the Bank immediately furnished the £1.2 million in the form of its own legal tender notes
- ‘monetizing the debt’: did cause some temporary inflation in the later 1690s

iii) Bank Act of 1707: Parliament closed loop-holes to confirm its monopoly on joint-stock banking

c) **Functions of the Bank of England:** nothing succeeds like success:

i) **as the government’s sole bank:** accounting for 7% of its business incomes

- handling all gov’t banking and financial operations, at home and abroad
- supplying bullion to the royal mints
- discounting Exchequer Bills (like Canadian Treasury Bills): allowing gov’t to buy goods and services on credit, and allowing creditors to discount these bill

ii) **as a private commercial bank:**

- performing the same functions as the London Goldsmith banks, in competition with them: for lending and discounting
- most of the Bank’s clients were, however, other banks and financial/commercial institutions

iii) **as a Lender of Last Resort:** embryonic role as a Central Bank

- The Dutch financial crises of 1763, 1773, 1783, 1793: revealed the impotence of its chief rival, the Wisselbank van Amsterdam (Exchange Bank of Amsterdam), which was not a credit bank
- in these crises, the Bank of England rescued its Dutch as well as English clients
- thus a movement of banking and finance from Amsterdam to London
- 1793 French invasions of the Dutch Republic ended role of Wisselbank
- 1797: threatened French invasion (Napoleon) and liquidity crisis led Bank of England to extent rediscounting privileges to all British banks and financial institutions, while also suspending convertibility of bank notes into gold ==> ‘era of the paper pound’ (to 1820)

d) **Strengths of the Bank of England:**

i) steady flow of government interest income on Bank’s loans:

- 1694 - 1709: 8%
- 1709 - 1742: 6%
- 1742 on: 3% plus annual management fee of £4,000 = 3.75%

ii) payments for various government financial services

iii) earnings from discounting Exchequer and other bills

iii) sole right to issue legal tender banknotes

iv) public trust and confidence, from its tripartite functions: as the government's bank, as Parliament's bank, and as a private joint-stock company bank, with full support of London financial community