FINANCE COURSE

The History of Banking

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1 Introduction

In the modern world we live in today banks have taken on a major role as a crucial component of an economy. It is said that a bank is like a heart in the economic structure and the capital provided by it is like blood in it.[1] Britannica defines a bank as an institution that deals in money and its substitutes and provides financial services.[2]

Bankers play very important role in the economic life of the nation. The health of the economy is closely related to the soundness of its banking system. Although banks create no new wealth but their borrowing, lending and related activities facilitate the process of production, distribution, exchange and consumption of wealth. In this way they become very effective partners in the process of economic development. Today modern banks are very useful for the utilization of the resources of the country. The banks are mobilizing the savings of the people for the investment purposes. If there would be no banks then a great portion of a capital of the country would remain idle.[3]

Two major types of banks are central and commercial banks. The primary function of the central bank is to control money supply in the economy. It is the central authority responsible for issuing of currency on behalf of the government. Commercial banks are organized financial institutions that deal with the business of credit (borrowing and lending of money) with the objective to earn profit. The commercial banks are financial intermediaries between savers and investors.[4] Simply put, the primary function of commercial banks is to put their account holders' money to use by lending it out to others.[5] Banks accept deposits and make loans and derive a profit from the difference in the interest rates paid and charged, respectively.

2 The History of Banking

The necessity for banking has been present among humankind for the period of several millenniums and, surprisingly, it has been constantly conducted in some form or another. Preceded only by two other, the profession of banking is regarded as one of the oldest known to historians. The invention of banking precedes even the invention of coinage by several thousand years. Banking has simultaneously evolved along with the mankind. This essay will walk you through the main points and major breakthroughs in the history of banking.

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2.1 18th Century BC

Oldest clues show the use of banking in ancient Mesopotamia and Egypt. Early civilizations used gold as means to store wealth, trade and make transactions. Naturally, wealth kept in this form had to be hidden for protection and safekeeping. The most reliable place for such need consisted of temples. Constantly attended, solid building with a sacred character which itself may deter thieves, lived up to this task. However, banks contribute to the efficient functioning of an economy by helping smooth and proper allocation of funds, and temples kept the wealth idle.

The development of banking was initiated out of the need of the trading communities and governments for funds. Hence, in Babylon at the time of Hammurabi, in the 18th century BC, there are records of loans made by the priests of the temple. This is a sign that the concept of banking was initiated. Discoveries also include preserved clay tablets that were used to record transactions carried out between two parties. Code of Hammurabi which is among the earliest recorded laws concerns regulations within the banking industry. Other remains showed that at the very first stages of the „evolution“ of banking, modern practices such as deposits, interest, loans, and letters of credit already existed. The aforementioned clay tablets were a predecessor of more modern paper money systems that emerged in China by 900 AD and in Western culture by the 18th century. What differentiates these two is that the clay tablets were issued by a private sector unlike the latter.

Egypt also had an emerging banking industry at the time. The government offered to store the wealth of citizens in form of grains within the state's warehouses. In return, the citizens would be issued a note, a "deposit receipt", as a confirmation of their stored wealth. The receipt could be further used to trade, pay taxes and make donations to the gods. This practice evolved into a general method of payment during the Ptolemy era and continued to be even after the introduction of the metallic monetary system, as far as local transactions are concerned. Naturally, stored grains in Egypt meant little to a foreign party elsewhere, hence, precious metals had to be used in international trade and military conquests. This is the well-known two-tier monetary system of Egypt. Grain as a medium of exchange, however, completely dropped out of use in the Roman era.

Modern day credit emanated from this capacity to store wealth that further lead to the ability to borrow. It would be a great challenge to imagine a functioning economy without this practice. But the influence of the developing banking industry went far beyond this. It is safe to say it cultivated the evolution of civilization and modern society. The banking industry and the monetary system fostered international trade, and thus, interaction among people and different nations as well.

2.2 4th Century BC

Greece has taken banking to the next level making the industry more varied and sophisticated. The role of private entrepreneurs rose greater and they became a major player in financial transactions, in addition to temples and public bodies that were main contributors in earlier cultures. Taking deposits, making loans, exchanging currencies, and testing coins for weight and purity became common practices. The vast number of new practices also included the use of book transactions. This minimized the risks that coupled with transfers of large quantities of coins and minimized the costs, both in the sense of transportation costs and in the sense of time needed for transporting, as moneylenders gained the possibility to accept payment in one place and arrange a credit in another.

Soon after, the profession of money changers emerged as well. As coinage became standardized within Greece the need for foreign exchange grew due to the differences in weight of various coins. Even the Bible testifies to the extent of importance banking industry and foreign exchange dealers had at the time. There is a mention of the situation where Christ overturns the tables of the money changers in the Temple of Jerusalem (Matthew 21.12). Aforementioned tables that were used in the trade were trapezium in shape and usually marked with a series of lines and squares used in calculations. The word “trapezitai” which is used for Greek bankers originates from the shape of these tables. Today, the internationally used word is “bank”. This word is also derived from the tables used by bankers, but it comes from the Italian word “banca” meaning bench or counter.

Banking started to emerge in cities throughout the ancient world. The island of Delos was specific, however. Unlike Athens and most of the other cities at the time where banking was conducted mainly on cash basis, Delos was the first to deploy an actual system of credit receipts and payments. Each client would have their own account and the ability to order transfer of funds to another client’s account. This was the first instance of offshore banking as well. This island possessed very few natural resources so its development had to rely only on its natural harbor and the rich temple of Apollo. With the expansion of the Roman empire, the enemies of Delos, Carthage and Corinth were eliminated, hence, allowing Delos and it’s banking system to develop and prosper. This gave the Romans a well designed banking system to imitate.

The Romans, well-known for their administration skills, adopted Greek banking practices and regularized them. They took banking out of temples and formalized it within distinct buildings that we call “banks” today. Although moneylenders still continued to operate within the Roman Empire, majority of banking was conducted legitimately through an institutional bank. In the 2nd century AD public notaries were being appointed to record transactions of loan payments and official discharges of debts when the owed sum would be paid off. Julius Caesar introduced another law which allowed banks to confiscate the land of a debtor in case of inability to pay the loan. This was a crucial step in the development of banking industry due to the major shift of power in the relationship between debtors and creditors. In earlier times noblemen in debt were untouchable and the practice was to pass the debt on to descendants until either the creditor's or debtor's lineage died out.

2.3 12th Century AD

After the aforementioned major steps in the development of the banking industry, the progress was stopped with the fall of the Roman Empire. Banking services were continued mainly by the papal bankers that emerged in the Holy Roman Empire, and with the Knights of the Temple during the Crusades as they were needed in order for financing of the wars . Moneylenders still tried to have their share in the industry, however, the Christian church would prosecute them with charges of usury which they considered to be morally offensive. One anonymous medieval author declares vividly that 'a usurer is a bawd to his own money bags, taking a fee that they may engender together'. In addition, the fall of the Roman Empire caused the collapse of trade as well which in turn made bankers less necessary.

A primary stimulus for banking requirements was none other than the Crusades. Basic banking requirements emerged out of the necessity to make payments for supplies and equipment. Waging international war was something that could not be accomplished without banking facilities that would enable the safe and speedy means of transferring huge sums of cash. It was the Knights Templar that began to provide such banking services based upon the Italian model.

The aforementioned prohibition that the Church made gave opportunity to Jews to enter the banking industry. However, they were not able to prosper as people often perceived them as a suspicious sect and, hence, mistrusted them. The Knights Templar order faced the same issue.

2.4 13th – 14th Century AD

In 13th century the holes in the banking industry were being filled by bankers from the north of Italy who were known as Lombards. They gradually started to dominate the industry. Although they were the followers of Christian religion, they were wisely avoiding the charges for usury. They presented the collected interests either as a voluntary gift from customers or as a reward for the taken risk. Two other important practices that were introduced during this period were double-entry book-keeping and the use of bills of exchange. Although some forms of bills of exchange were present even in the earlier times, Italians sophisticated it. These bills of exchange were similar to the cheques being used today. These practices allowed banking to prosper in number of cities in Italy. However, the major beneficiary was Florence whose financial power was mainly derived from its currency. The florin became widely recognized and highly trusted allowing the bankers to heavily engage in international finance. Two most influential families were Bardi and Peruzzi who earned an immense wealth by offering financial services not only in Italy, but in number of major cities outside the borders of Italy through their own branches. The downfall of these families came when they loaned immense sum of gold florins to the ruler of England Edward III. It was a common practice to offer financial services to foreign rulers and governments, but the expensive war that Edward III engaged in prevented him to repay the loan.

Nevertheless, Florence was strong enough banking center to recover the industry only half a century later when Medici and Pazzi houses became the most powerful financiers of the city.

2.5 15th Century AD

As Medici house got heavily involved in politics, the German dynasty Fuggers took the opportunity to take over the Medici's title of Europe's greatest banking dynasty. Their earnings mainly came from loans given to the governments and rulers. They used their sharp negotiation skills to increase the interest rates from 12%, which was the norm, up to 45% when the situations allowed them. In order to secure the repayment of loans they were taking interest in government's mines and rights to certain portions of government's revenues. They became both revenue collectors and managers of state assets. In time they seized to take part in financial risk-taking after several disastrous ventures.

2.6 16th Century AD

In the 16th century the government of Venice took initiative and opened the Banco della Piazza di Rialto. Its purpose was to serve the needs of merchants to store funds and make secure financial transactions without the physical transfer of coins. This practice already existed for quite a while, even in ancient Greece, but it involved high possibility of bankruptcy of moneylenders who individually carried out these risky services. Banking industry gained popularity as the government stood behind the newly opened bank to provide security to merchants who used the bank's services.

As banking practices developed, the customer's knowledge of it expanded as well. They learned about the hidden potential of their deposits. At this time the bank's profit became the difference between the rates of interest paid to depositors and the interest demanded from debtors.

Many moneylenders that still operated soon started to transform into private banks. Traditionally goldsmiths would accept money on deposit for safekeeping. When they discovered the potential for earning interest, they started loaning part of the deposits. At the point when they realized the full potential for profit making they made banking their main business.

2.7 17th – 18th Century AD

Like the most successful banking dynasties before, the Banco della Piazza di Rialto got itself into problems by making insecure loans. In order for this issue to be solved the Banco Giro was established. It was founded on the principle that the government's creditors accept payment in the form of credit with the new bank. Apart from solving the aforementioned problem, the new bank created opportunities as Venice got a mechanism for raising public finance on the basis of guaranteed credit.

The logical extension of this concept is a national bank, established in some form of partnership with the state. The bank of Sweden was the first example. The next to come was the Bank of England that eventually undertook various tasks that are now associated with a central bank. These tasks included organizing of the sale of government bonds when funds needed to be raised and acting as a clearing bank for government departments, facilitating and processing their daily transactions. Furthermore, it became the banker to other London banks that used it as a source of credit in crisis. With the rise of the British Empire, the banking center migrated to London where modern banking finally emerged. To this day, London has remained as the primary financial center within Europe.

In year 1776 Adam Smith publicized his well-known theory, the theory of the "invisible hand". Smith advocated self-regulated economy. His ideas were adopted by moneylenders and bankers who were able to limit the state's involvement in the banking sector and the overall economy.

This free market capitalism and competitive banking found fertile ground in the New World, where the United States of America was getting ready to emerge.

2.8 19th Century

The first major bank to emerge in the USA banking industry was J.P. Morgan and Company that was standing as the leader among the merchant banks during the late 1800s. The power of this bank resided on its direct connection to London, the financial center of the world at the time.

Although the dawn of the 1900s had well-established merchant banks, it was difficult for the average American to get loans from them. These banks didn't advertise and they rarely extended credit to the "common" people. Racism was also widespread and, even though the Jewish and Anglo-American bankers had to work together on large issues, their customers were split along clear class and race lines. These banks left consumer loans to the lesser banks that were still failing at an alarming rate.

2.9 20th Century

In the early 20th century the Federal Reserve Bank still did not occur. When the banking industry encountered significant issues due to the collapse in shares of a copper trust that further lead to huge withdrawals of money out of banks and investments, J. P. Morgan used it's political power to gather all the major players on Wall Street to maneuver the credit and capital they controlled, just as the Fed would do today.

This event lead to the formation of the Federal Reserve Bank, commonly referred to today as the Fed, in 1913. Government wanted to ensure that no private banker holds such supreme power in the U.S. economy again.

Even with the establishment of the Federal Reserve, financial power, and residual political power, was concentrated in Wall Street. When the First World War broke out, America became a global lender and replaced London as the center of the financial world by the end of the war. Unfortunately, a Republican administration put some unconventional handcuffs on the banking sector. The government insisted that all debtor nations must pay back their war loans which traditionally were forgiven, especially in the case of allies, before any American institution would extend them further credit.

This slowed down world trade and caused many countries to become hostile toward American goods. When the stock market crashed in on Black Tuesday in 1929, the already sluggish world economy was knocked out. The Federal Reserve couldn't contain the crash and refused to stop the depression; the aftermath had immediate consequences for all banks. A clear line was drawn between being a bank and being an investor. In 1933, banks were no longer allowed to speculate with deposits and the FDIC regulations were enacted, to convince the public it was safe to come back. No one was fooled and the depression continued.

World War II may have saved the banking industry from complete destruction. WWII, and the industriousness it generated, lifted the American and world economy back out of the downward spiral.

For the banks and the Federal Reserve, the war required financial maneuvers using billions of dollars. This massive financing operation created companies with huge credit needs that in turn spurred banks into mergers to meet the new needs. These huge banks spanned global markets. More importantly, domestic banking in the United States had finally settled to the point where, with the advent of deposit insurance and mortgages, an individual would have reasonable access to credit.

3 Conclusion

As with all things in life, the development of the banking industry has had its side effects. The process of providing credit allowed leverage to be reintroduced into the modern world. While leverage allows an individual to purchase items today using tomorrow's future earnings, it also tends to create greater levels of inflation. Throughout the monetary history of the world, leverage has provided through the means of credit the boom and the bust effect within the economy. With it, the business cycle inevitably over-expands and over-contracts aid largely by credit. The greater the amount of credit, the higher the volatility within the monetary system. Nonetheless, the absence of banking and credit discourages human interaction and thus acts an impediment to economic and social growth. Too much debt and credit runs the risk of destroying the very foundations of civilization as witnessed by the fall of Athens and Rome. If there is one lesson to be learned from history, it is that need for moderation in both directions of the economic pendulum.

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