2017–18

ECON2547
Economic History
John Powell

7: Financial system: 17^{th}–19^{th} Century
Evolution or revolution? *[week 11]*

for detailed ***reference list*** *see*
www.economicstoolbox.com

Reading

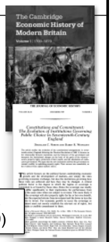
- * Murphy *in* Floud et al (2014)
- Michie and Mollan (2011)
- Rogers (2007)
- Thorpe (2010)
- Bank of England (2013)
- Reinhart and Rogoff (2009)

See economicstoolbox.com

Outline and learning outcomes

- Introduction
  - *Recognise context of change in Britian's financial system*
- Evolution of public finance
  - *Understand some components and changes in the financial system*
  - Goldsmith bankers
  - Bank of England and government securities
  - Levels of public debt
- Finance in the industrialising economy
  - *Review debate regarding effects of financial system upon the economy*
  - Overend Gurney collapse
    - *Recognise significance and wider impact*
- Review

Introduction



- *"During the late seventeenth and early eighteenth centuries a financial revolution transformed both the British state's ability to raise funds and the investment habits of a nation"* (Murphy, 2014:321)
  - primarily driven by war
- Debate over whether economic development was hindered, given the domination of state needs in shaping the financial system (ibid)
  - Capital market benefited:
    - instruments of public debt
    - shares in *"great monied companies"* (ibid) – including the Bank of England
  - *But: "…restrictions in size, scope and experience of the financial system"* (ibid:322)

eg see North & Weingast (1989)

Introduction [print]

HISTORY & POLICY
Policy Papers

- Nonetheless, we must recognise that the evolution of the banking system was one largely without *"active"* state direction (Michie and Mollan, 2011)
  - Bank of England was founded in 1694 as a private institution by William Paterson and continued to be a private, shareholder-owned company until nationalisation in ______ (Bank of England, 2013)
- Where *active* direction was evident, it was often in response to financial crises
  - The Economist (2014) suggests that financial institutions *"are not the products of careful design in calm times, but are cobbled together at the bottom of financial cliffs. Often what starts out as a post-crisis sticking plaster becomes a permanent feature of the system."*

Evolution of public finance

british banking history society

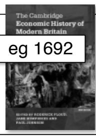
The GOLDSMITHS' Company

'Goldsmith bankers' (Thorpe, 2010)

- By the mid-17th century, goldsmiths had become *"recognisable and reliable keepers of money and valuables for people without their own safe custody facilities"*
- exchange of goldsmiths' receipts for deposit – 'promissory notes'
  - Effectively the birth of paper money (ibid)
  - Became *"an efficient system of private banking in London"* (*ibid*)
  - some developed into famous banks still existing today

Coutts

Evolution of public finance



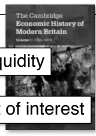
- However, public finances were weak (could the state repay its debts?) and the financial system was disorganised (Murphy, 2014:323-4)
- Saved only by *innovation* in ways of raising funds that facilitated longer-term borrowing, including the foundation of the Bank of England (*ibid*: 324)
  - though relatively small impact on national finance
- But did represent a **pivotal change** in methods of raising public finance and *"a significant change in the structure of Britain's public debt"* (ibid:326)
  - Instruments that had wide appeal and could draw on a broader range of investors
  - ***Secondary market*** in government securities that emerged during the 18th century – helped create trust amongst investors (ibid:331)

eg 1692

9.5% of state borrowing 1688–1702 (Dickson, 1967 – cited in Murphy, 2014:324-6)

Pelham's '3% Consols'

Evolution of public finance [print]

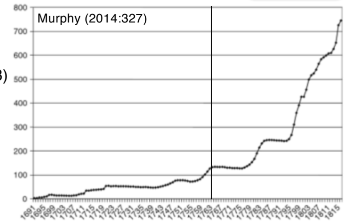


Levels of public debt, 1691–1815 (millions £)

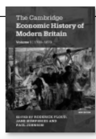
- Increasing sophistication of secondary market (role of 'stock jobbers' and brokers)
- Increasing dominance of Bank of England
  - managed 70% of government debt by 1764 (Murphy, 2014:333)
  - Many *failed* attempts to legislate debt market (18 attempts over 1694–1773; *ibid*)

liquidity

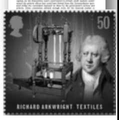
conflict of interest



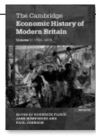
Finance in the industrialising economy



- Murphy (2014) highlights the lack of recent work on the development of the banking industry – much commentary is drawn from Pressnell (1956), Dickson (1967) with 'recent' work being Brewer (1989) and Neal (1990)
  - Temin and Voth (2005–2013) make a case for state 'crowding out' out of private investment for industry (but look at only a single bank over 1702–1862) – *see* Murphy (2014:334-5)
  - Murphy argues that this may have *"superficial appeal"* (2014:335) – Richard Arkwright being turned down for a loan by Nottinghamshire bankers (cited in Allen, 2009:203) is a 'classic' illustration
  - But not irrefutable evidence…



Finance in the industrialising economy



- Strong **counter case** to 'crowding out'
- *"Although the Bank of England's monopoly did certainly retard the development of banking over the latter part of the eighteenth century, the provision of financial services expanded considerably"* (Murphy, 2014:336)
  - Development of 'country banks' – provincial (ie non-London) banks (nearly 400 in England by 1802 – Pressnell cited in ibid:337)
  - Banker-industrialists (Murphy cites Hudson)
  - Discount houses which connected country banks to London *"grew to become a significant pillar in Britain's financial architecture by the early nineteenth century"* (Murphy, 2014:337)

Finance in the industrialising economy [p]

Foreign capital

- Murphy concludes that there is clear *"evidence of a wide-ranging, adaptable and innovative financial services industry that provided value for the domestic and international economy"* (2014:338)
- However, "there were fundamental problems rooted in the structure of the system" (*ibid*)
  - Frequent crises (eg see The Economist, 2014)
  - Banks vulnerable to panics and runs due to small scale (limited to partnerships of 6 until 1826 when joint stock banks were permitted)
    - *"The counterpoint of being too big to fail is being too small to survive"* (Michie and Mollan, 2011)
  - Bank of England emerged as *"arbiter of the country's financial system and the lender of last resort"* (Murphy, 2014:338)

Reinhart & Rogoff (2009:15) – *this-time-is-different syndrome*

Finance in the industrialising economy [p]

Overend Gurney collapse 1866

- Marked culmination of B of E's transition to a 'mature' central bank, building on the role defined by the Bank Charter Act of 1844
  - Overend Gurney = *"the country's wealthiest bank, after the Bank of England"* (Rogers, 2007)
  - failed in May 1866 with liabilities of nearly £10m
    - *"poor asset management and risky lending practices"* (Murphy, 2014:341)
  - Balance sheet was *"approximately ten times that of the combined balance sheets of the Midland and the Westminster Banks, two of the biggest in the country"* (Murphy (ibid) citing Capie, 2002)
- B of E refused to intervene and let the bank fail
  - lender of last resort, without risking moral hazard

Reinhart and Rogoff (2009:11) – banking crises: ***Type I*** (systemic) and ***Type II*** (finanical distress)

Review

- The needs of the state played a fundamental role in shaping the nature of Britain's financial system over the 18th century
- The mid-19th century marked a transition to a system more broadly responsive to the wider economy, but reflecting a more concentrated banking market
- By the last quarter of the 19th century the Bank of England was clearly the central bank and had taken on the responsibilities that the role implies

- Next:
  – w15 lecture: 20th century economy
  – w16/17 tutorials: financial crises