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Introduction

The Question and the Argument in Brief

The same confidence which disposes great merchants and manufacturers, upon ordinary occasions, to trust their property to the protection of a particular government, disposes them, upon extraordinary occasions, to trust that government with the use of their property. By lending money to government, they do not even for a moment diminish their ability to carry on their trade and manufactures. On the contrary, they commonly augment it. The necessities of the state render government upon most occasions willing to borrow upon terms extremely advantageous to the lender. The security which it grants to the original creditor is made transferable to any other creditor, and, from the universal confidence in the justice of the state, generally sells in the market for more than was originally paid for it. The merchant or monied man makes money by lending money to government, and instead of diminishing, increases his trading capital.

—Adam Smith, *The Wealth of Nations*

National debts, *i.e.*, the alienation of the state—whether despotic, constitutional or republican—marked with its stamp the capitalistic era. The only part of the so-called national wealth that actually enters into the collective possessions of modern peoples is their national debt. Hence, as a necessary consequence, the modern doctrine that a nation becomes the richer the more deeply it is in debt. Public credit becomes the *credo* of capital. And with the rise of national debt-making, want of faith in the national debt takes the place of the blasphemy against the Holy Ghost, which may not be forgiven. . . . The state creditors actually give nothing away, for the sum lent is transformed into public bonds, easily negotiable, which go on functioning in their hands just as so much hard cash would. . . . At their birth the great banks, decorated with national titles, were only associations of private speculators, who placed themselves by the side of governments, and, thanks to the privileges they received, were in a position to advance money to the State.

—KARL MARX, *CAPITAL*

Concentration of money in banks, though not the sole cause, is the principal cause which has made the money market of England so exceedingly rich, so much beyond other countries.

—WALTER BAGEHOT, *LOMBARD STREET*

SPANNING ABOUT A HUNDRED YEARS, and representing somewhat different normative perspectives, the quotes above describe two closely related phenomena: the emergence of tradable public debt and the rise of private money and credit markets. The phenomena are related because both were based fundamentally on, in Smith's words, "the universal confidence in the justice of the state." The state was responsible for enforcing impersonal contracts, both between it and investors and among traders and other participants, and it was this role that was the subject of "universal confidence": in other words, the relationship between the state and investors was *institutionalized* in the sense that it was ultimately based on stable mutual expectations between the two parties. This state of affairs facilitated, among other things, the emergence of deposit banking on a large scale. Additionally, the fact that the state became implicated in guaranteeing the security of "public" credit and in being an arbiter and contract enforcer in the "private" money market necessarily created a direct link between the two. This form of institutionalization distinguishes markets of the kind that Adam Smith and Karl Marx describe from markets and networks in commercial paper per se predating the emergence of national states.[1]

Some of the characteristics of banking and credit systems without any state involvement—that is, in the absence of state-enforced rules and regulations—can be illustrated by considering the *hundi*, a particular kind of financial instrument that was in use throughout the Indian subcontinent during the eighteenth and nineteenth centuries and whose origins date back to at least the sixteenth century. This was a bill of exchange issued by merchant-bankers that was used extensively to finance endeavors such as long-distance trade. Merchants would discount each other's *hundis*, and hence make payments (including for insurance) and more generally adjust their obligations using this instrument.[2] In this way the *hundi* functioned as both a credit instrument and a medium of payment, but its circulation was limited to merchant-banker networks. Similarly, it was also the case that bankers (*sarrafs*) would accept money deposits and grant interest on them, which, in turn, led to the creation of credit money.[3] But what such deposits created was fundamentally private money inasmuch as their acceptance was completely predicated on bankers' reputations among merchants, who were generally the chief depositors, and as a result they circulated only among specific networks.

Indeed, networks are limited by their very nature in the sense that those outside them cannot avail themselves of the relationships (of exchange or any other kind of transaction) that constitute them. Yet such networks can be incorporated into the state when it provides explicit and *institutionalized* backing. This does not mean that the networks cease to exist: rather, they begin to function within the overarching context of impersonal rules that the state enforces. The legal backing of the state is what gives credit and banking their public character. To the extent that networks such as the ones described above existed outside the purview of the legal structure of the state, they could be called informal, to contrast with the formal state involvement implied in the chapter epigraphs.

To return to Adam Smith's quote, why is it that "the universal confidence in the justice of the state" occurred in only a small number of now developed countries during the eighteenth and early nineteenth centuries (including England and the United States)? Notwithstanding their substantial mercantile capital, a vast majority of emerging states, both independent and colonial, lacked these structures. For instance, despite the presence of an extensive class of merchant-bankers who traded in a variety of credit instruments and who were often creditors to British and other European merchants over the seventeenth and eighteenth centuries, neither precolonial nor colonial India would quite fit the description in the previous paragraph. Modern models of explicitly state-endorsed and state-supported money and credit markets did not exist in precolonial India, while the colonial period was characterized by a dichotomy between an informal—albeit substantial—native money and credit market and a formal, though severely limited, European market.

The association between certain kinds of state involvement and financial development (or, alternatively, modernization) should not be surprising for two related reasons. First, in the words of Richard Sylla, Richard Tilly, and Gabriel Tortella, "Long before private economic entities . . . came to require financing on a scale beyond the capabilities of individual proprietors and partners, governments had needs for large-scale finance."[4] State involvement consequently has the capacity to bring together large numbers of financial capital holders. Second, this, in turn, has the potential to facilitate the further development of impersonal state-enforced rules, since the network system on its own would not be able to sustain itself beyond a certain number of participants. Impersonal rules backed by state coercion can further facilitate the growth of such a system by increasing the numbers of people involved.

Given the significance of modern financial systems to subsequent industrial revolutions in states where such systems did develop—something that has not gone unnoticed in the economic history literature—the causes of their emergence are certainly worth investigating.[5] Attributing the poor development of financial systems to colonialism would seem to beg the question. Why should colonialism retard market development, especially since it is often credited with introducing European-style market institutions in the first place?[6] Also, this explanation does not account for the lack of an institutionalized financial system during the period immediately preceding colonization. But if, as according to Smith, "the same confidence which disposes great merchants and manufacturers . . . to trust their property to the protection of a particular government, disposes them, upon extraordinary occasions, to trust that government with the use of their property," an interrogation of sources of "confidence in the justice of the state" would seem to be a more promising beginning. Specifically, what were the conditions that enabled confidence? What did such conditions entail, and how and why, exactly, did they promote confidence?

The preceding questions—albeit in the context of property in general—have motivated much of the modern literature on property rights, which has linked economic growth to governmental protection of such rights.[7] The general framework may be stated as follows. Rulers provide protection or guarantee property rights (for their constituents) in return for payment or other resource assistance. But they also have the incentive to renege on their end of the implicit bargain by seizing property. The larger this probability, the less likely capital holders are to invest in the economy; lower levels of aggregate investment then result in underdevelopment.

Applied to financial systems, therefore, this property rights argument contends that although thriving debt and credit markets constitute an important financial resource that is advantageous to the state, such markets could not have a stable existence if participants do not expect rulers to carry out their end of the bargain. This includes expecting the state to honor debts—for example, by not unilaterally depreciating them—and not to seize or otherwise damage financial wealth. It follows that variation in the stability of financial systems can be explained by variation in the state's demonstrated willingness and ability to uphold financial compacts. Yet, assuming that both rulers and financial capital holders are rational egoists, creating and maintaining this expectation is no easy task.[8] As Douglass C. North and Barry R. Weingast argue, it is difficult even if there has been a history of interaction between rulers/states and investors, since rulers could always heavily discount the future (or the possibility of profitable future interactions) for a variety of reasons.[9]

The difficulty of creating stable expectations arises fundamentally from the fact that the preferences of the state and of the investors are independent of each other. But an arrangement that could somehow align their preferences, making them interdependent, would seem to largely mitigate the problem. Such an arrangement would be self-enforcing in the sense that neither party would have the incentive to unilaterally deviate from it (since deviating would entail unacceptable costs for both sides). Moreover, whatever the specific institutional form of this arrangement, it would also perforce be independent of the specific identities and interests of the individuals or groups involved. Indeed, the preferences of individuals or groups occupying certain institutional spaces could even be seen as partially endogenous to, or an outcome of, such arrangements. For all of the reasons underlined above, such an arrangement would constitute what North and Weingast term a "credible commitment" to potential investors.

North and Weingast base their argument on the case of England, where a formal public credit system and a money market emerged at the same time as the institutionalization of parliamentary supremacy and the establishment of a judiciary independent of the Crown. They therefore argue that these two innovations were parts of a credible commitment to investors, since they greatly constricted the ability of the Crown to act unilaterally against the interests of investors and creditors. A third institutional change they identify as part of this commitment was the incorporation of creditors into the state through the Bank of England, whose function, among other things, was to handle the government's accounts. Moreover, the bank's notes were backed by the government. Together, these developments constituted a commitment to investors (or creditors) because the government had essentially turned its payment functions over to its creditors in such a way that any failure to make interest payments would have constricted its ability to make payments for other purposes.[10]

The following chapter argues that this third constraint, rather than—as some have assumed—the other two, was crucial to the credibility of the commitment made by the state. It suffices here to observe that although such institutional commitments can greatly mitigate the problem of reneging on a pact, their very provenance requires explanation. Such commitments entail substantial costs in terms of restriction on one's (in this instance, the state's) freedom, essentially precluding courses of action that would otherwise be available. If both parties to a costly agreement are rationally egoistic (a usual assumption in the literature), it seems unlikely that one of them would be willing to bear most of the immediate costs of that agreement. Given these conditions, it becomes difficult to see how such an agreement would have emerged in the first place.

Put somewhat differently, under what conditions would one of the (rationally egoist) parties to an interaction make concessions that would seem to go against its immediate interest but that could result in the development of modern financial systems in the long run? The answer I advance in this book is that rulers were forced to make institutional concessions only when local merchants or financiers as a group became their only major resource for financing their activities. However, this did not happen often, either because land revenue tended to predominate as a source of financing or because, as tended to be true for many colonial situations, rulers could utilize foreign money and credit markets that had already emerged. The next chapter represents this kind of interaction as a bargaining situation between two rationally egoist groups where one (the rulers) had an advantage over the other (financial capital holders). These situations tended to be singularly uncongenial for the emergence of the kinds of institutionalized and integrated financial systems described above.

Thus, local merchants and bankers were not institutionally incorporated into the state either under the Mughal Empire (which derived the bulk of its revenues from taxes on land) or subsequently under the East India Company or the British state (both of which raised substantial capital from the London financial market). Indeed, although Sir James Steuart, the famous eighteenth-century economist and consultant to the East India Company, advised that the state should incorporate indigenous bankers and financiers in this way, the Company did not follow his recommendation—as the argument of this book would have predicted.

Despite many other contextual differences, the situation in the North American colonies prior to independence was fundamentally similar in that their reliance on the London market precluded the development of formal financial institutions. The Revolutionary War disrupted existing financial arrangements, and the exigencies of financing it led to the development of an institutionalized financial system connected to the state. As subsequent chapters show, taxes on land and property were far from sufficient to meet the requirements of the fledgling government. Colonial merchants were the sole group who were both able and willing to meet the state's financial needs. However, rulers had to assure them that their investment in the new state was secure. It was these efforts that entailed the institutional innovations that were a part of a credible commitment, referred to earlier. In contrast to the situation in India, North American rulers did not hold a bargaining advantage over financial capital holders and hence were willing to make credible institutional commitments.

A second part of my argument in this book concerns the effects of such commitments on the subsequent politics of market development. The very establishment of these institutions in the United States gave investors as a group both a common interest and the means of defending it. It gave them tangible and specific status quo positions to defend:

any policy move that enhanced the government's ability to *unilaterally* repudiate or devalue debt would unite investors in opposition. In addition, given the institutional set-up by that point, any step back toward the situation that existed prior to the emergence of an institutionalized and integrated money and credit system would have jeopardized the economy's entire system of payments, in the process also harming the government and many others. Thus, as Chapter 5 demonstrates, bankers and financiers were united in their opposition to policies that had the potential to increase direct and unilateral government influence over the total stock of payment medium (as well as over the question of what counted as such) in the economy.[11] For instance, despite their variant party affiliations and differing opinions on other policy questions, they were united in their opposition to any proposal that allowed the federal government to directly own banks. As some of them pointed out at the time, any such move would have damaged the government's credibility in the eyes of investors, thereby potentially endangering a substantial section of the economy. And even Andrew Jackson discovered that he would have to abandon his plan to replace the Bank of the United States with a bank founded on the federal government's credit if he was going to retain allies and succeed in his campaign to prevent the Bank from renewing its federal charter.

Yet the fact that Jackson succeeded in his battle against the Bank of the United States also indicates another phenomenon. In the context of an already existing institutionalized financial system, rulers or executives can have considerable freedom of action vis-à-vis investors and financiers as long as some of the system's basic institutional features remain unaffected. In practice, this translates to the freedom to propose policies that, rather than uniting capital holders in opposition, are likely to divide them by having differential impacts on various groups of financial investors. As the history of the first and second Banks of the United States demonstrates, relevant groups of people were implicitly aware of the importance of depicting policy measures as either injurious or irrelevant to vital institutional features of the financial system and hence to financial capital holders as a whole.[12] Supporters of the two Banks would try to portray them as linchpins of the entire banking and financial system and therefore beneficial to all investors, while opponents would retort that the Banks were irrelevant at best (and harmful at worst) to the interests of investors as a whole and that they unfairly advantaged one subset of financiers over all others.

As the next few chapters demonstrate, focusing on the emergence of credible commitments not only helps to account for the emergence of modern, institutionalized money and credit systems; it also makes sense of many aspects of the politics that such institutions actuate. Thus, it helps to explain the policy proposals, conflicts, and changes that subsequently occur within these systems. For instance, comprehending the origins of the United States' financial system also illuminates the nature of the struggle over the two Banks of the United States and the progressive lowering of entry barriers to banking during the first third of the nineteenth century.

This book is organized as follows. The next chapter delineates its theoretical framework, explaining how the emergence of modern, state-connected money markets was the result of a certain kind of power relationship between rulers and financial capital holders that forced the two groups to cooperate and how certain kinds of financial systems represented the institutionalization of this cooperation. In doing so, this chapter provides a definition of power that explains how it can influence the incentives of otherwise rationally egoist actors or groups to cooperate with one another. The chapter also considers alternative arguments about the specific institutions that demonstrate credible commitment, arguing that one strand of the literature has identified such institutions incorrectly. It then discusses other explanations for the developments in the U.S. money and credit market during the first third of the nineteenth century, including the establishment and demise of the two Banks of the United States. While the argument I proffer can accommodate explanations that highlight the role of non-egoistic motivations in policy outcomes, this chapter points out that such explanations remain incomplete or inadequate if they do not account for relative bargaining power, and hence the nature of existing institutions (since extant institutional rules affect relative bargaining power). It further observes that assessing the role of bargaining power implies considering how egoistic (or gain-seeking) motivations interact with nonegoistic (or, loosely stated, ideological) ones. The chapter concludes with a discussion of the methodology used in this book, including the issue of empirically substantiating counterfactual propositions.[13]

Chapter 3 explains the lack of capital markets in the North American colonies by tracing this to an asymmetric power relationship: the relationship of dependence between colonial merchants and their British creditors. It demonstrates why it was rarely in the interests of either the capital holders of the metropole or the rulers who depended on them to allow the formation of a local capital market. This chapter then explains the emergence of a state-connected capital market in the aftermath of the American Revolution, showing that the war put an end to the dependency that had inhibited such a system.

Chapter 4 offers a sketch of the situation in India under the later Mughal rulers and accounts for the lack of an *institutionalized* cooperative relationship between these rulers and the substantial commercial and mercantile community of the subcontinent. This chapter then explains why the advent of the British East India Company state also precluded the emergence of a formal state-connected capital market. Here it considers one notable juncture, very early in the period of Company rule, when cooperation with indigenous capital holders and the Company state could have been institutionalized: while this was indeed contemplated, it was eventually rejected by the Company state because, owing to its superior bargaining position, the Company could disregard the interests of native financial capital holders.

Chapter 5 comes back to the United States to explain subsequent developments in the money market, especially its changing structure. Here, my major objective is to account for the gradual lowering of the market's entry barriers, culminating with the Jackson administration's refusal to renew the charter for the second Bank of the United States.

Chapter 6 concludes by considering other cases where the theoretical framework elaborated in this book might apply and exploring the further implications of various arguments concerning the lack of economic development in certain colonies. In particular, it casts some doubts on arguments that link institutional features like property-rights protections and limited government to long-term economic growth. These doubts arise in part because the specific institutions that the literature identifies as important, such as a legislative body and a judiciary independent of the executive, may not have had the powers attributed to them.