MODULE 1 – The Evolution

Introduction

This module will discuss the evolution of the banking system throughout recorded human history, from antiquities to contemporaries to modern times. The role of each participant in this process—whether person, organization or political entity—will be explored and discussed, and also the role that different economic models and trading activities played in shaping the operation of the global banking system into what we see today.

Objectives

Upon successful completion of this module, the student should be able to:

- Describe the role that the ancient civilization played in formulating the foundation of international banking (IB).
- Describe the role of the European dynasties in the evolution of IB.
- Describe the role of the various religious organizations in the evolution of IB.
- Examine and articulate the role that various economic models played in this undertaking.
- Differentiate between the operation of the banking system prior to and after globalization of financial and economic processes and interactions.

One cannot go through the educational process and complete a curriculum without gaining knowledge in the science of banking and finance, especially the fascinating evolutionary process and history of international banking (IB). It is a mistake to assume that the science of IB and its history is something contemporary. On the contrary, the history of IB goes way back to the time of Hammurabi, the Babylonian king. The code drawn by him contained comprehensive rules and codes pertaining to trading activity and payment agreements. For further information, please see Footnote #1.

Utilization of some sort of medium of exchange as a form of conducting trade started with the past civilizations of the east and the west which evolved to become a form of money as a standard measure for transacting goods and services. Many entities contributed to the standardization of economic transactions and financial activities. To name a few, the Egyptians, Babylonians and Greeks in ancient times were the agents of change in this regard. The Byzantine Empire, the Levantines and the Jews were responsible for the development of private banking and the usury laws. The Bank of Venice, the Bank of England and the Bank of Amsterdam made significant contributions to the development of the banking system and introduction of the usage of precious metals for economic/banking purposes. For further information, please see Footnote #2.

Ironically, the foundation of IB was set by medieval bankers in the middle ages. As industrialization and economic transactions expanded, so did the need for various entities to perform exchange and conversion activity. This ultimately led to the creation of a financial system with two forces determining the borrowing and lending protocol, and the required level of liquidity in the market to satisfy the expected demand for loans. For further information, please see Footnote #3. Through this beginning, Italian merchants thrived in trading activities,
and the impact of that activity had a ripple effect throughout the northern and southern European continent. Various credit entities were involved in this evolutionary process. Historically, international banks were predominantly responsible for the expansion of trade, commerce and infrastructures on the European continent and beyond, connecting major ports and cities together and facilitating trading activities between east and west.

Summarizing the early contribution of different civilizations to the process of IB, we can name the Romans and the Greeks, as late as the 11th century. At the same time, we cannot ignore the role of the Crusaders and the western European nations in abandoning localized trade and expanding it beyond their own frontiers. Further, the contribution of the Knights Templar to the development of IB is worthy of mention. For further information, please see Footnote #4.

The European continent was where the Industrial Revolution began. With that came the expansion of economic transactions and financial needs which, in turn, required the creation of intermediaries to facilitate such an expansion. The proximity of southern European ports to each other in that era facilitated trading activity, not only in that region, but it was also responsible for the growth of banking activity beyond European frontiers. The expansion of commercial activity in the southern European continent eventually reached to the eastern Roman Empire and Islamic societies, which influenced the eventual involvement of the Byzantine and Italian merchants in the area of commerce and industry, in both rural and urban areas, with the rest of the European continent. For further information, please see Footnote #5.

Because of the reciprocities, many European points of trade became important places for expanding trade, and they became major hubs and gathering places for traders between northern, southern and eastern Europe. This process resulted in the development of a credit system between important players in those areas. Even though these activities played an important role in the development of IB, one cannot overlook the role of European merchants, especially the Medicis of Italy and the Rothschilds of Germany. For further information, please see Footnotes #6 and #7. These families were not only responsible for the evolution of IB, but also contributed to the expansion of art, architecture and science, especially the Medicis, who patronized famous individuals such as Leonardo Da Vinci and Michelangelo. The first commercial bank was born as a result of the contributions of these famous merchants and bankers.

The development of IB was dominated first by Italians, who pioneered something known today as universal banking. In other words, their banking activity went beyond just deposit taking and lending activity. This practice was followed by other northern Europeans, and the eventual relocation of trading activity from southern European ports to northern European ports took place. Colonialist nations, such as the British, Spanish, Dutch and Portuguese, extended their colonial activities to the Far East from the discovery of a new trade route by Vasco da Gama from the Horn of Africa to India and beyond. For further information, please see Footnote #8.

A major shift in the financial evolution of IB from the south of the European continent to the north and the west, made cities like Antwerp to become Europe’s financial centers, which facilitated trade between the Baltic and Atlantic regions. Eventually, with the help of Portuguese navigators, the route from Antwerp to the Spice Islands in Asia was established around 1560 A.D., and the era became known as the Age of Exploration. For further information, please see
Footnote #9. Furthermore, Antwerp became a center for international bankers. As we mentioned before, aside from the Italians, there were major northern European family bankers who contributed towards the evolution and expansion of IB. Antwerp declined as a major port for trade and banking activity as a result of the following: 1) the escalation of religious animosity between Catholics and Protestants, and the attack by the Spanish ruler, Philip II, which ruined the city; and 2) bankruptcies declared by major borrowers, some of whom were part of European royalty. For further information, please see Footnote #10.

Antwerp declined as a result of wars and bankruptcies, and Amsterdam replaced Antwerp as a major financial center at that time. This did not happen by coincidence, since Dutch colonialists were already commanding the high seas looking for trading routes and exploring the resources of the Far East. The combination of the decline of Antwerp and trade specialization by Dutch navigators brought economic and financial prosperity to Amsterdam and caused their influence to spread throughout Southeast Asia, the Caribbean and South America. The first Exchange Bank and the Stock Exchange Center were established in Amsterdam. The period of Amsterdam’s financial and banking prosperity became known as its “Golden Age.” For further information, please see Footnote #11.

Eventually, Dutch dominance in IB and finance faded and London emerged as the center for international credit and banking. The Bank of England evolved to become an important financial entity during the 1700’s and 1800’s. The original orientation of commercial banking in taking deposits started with the Bank of England. England’s political and economic stability initiated and helped industrial reform in Europe, and predominately in England. For further information, please see Footnote #12.

Since Britain was the super-power of the time, their laws and regulations concerning finance and trade were imposed globally, such as the Gold Standard. The influence of the British banking system was especially dominant in setting rules and regulations for currency exchanges, and eventually its dominance resulted in a global agreement on currency valuation based upon the price of gold at the time. This resulted in London becoming a major center for trading gold bullion. As a result of this, British banking prospered financially from being able to issue securities worldwide. This activity by British banking facilitated borrowing and lending in the capital market. It is amazing to know, again, that the ingenuity of a small group of investors, known as the Quakers, was a catalyst for the expansion of Merchant Banking in England, particularly the one that eventually evolved to become Barclays Bank, which is a major international bank today. For further information, please see Footnote #13.

Liquidity problems and financial risks taken by the British banking system eventually caused its influence to decline, and its dominance was replaced by the American banking system.

The evolution of IB in the United States has its roots in the late 19th and early 20th centuries. Fundamental changes in the U.S. economy were the catalyst for the expansion of the banking system in the U.S. The eventual rise of the U.S. banking system began with the establishment of the central banking system under the auspices of the Federal Reserve Bank, which was established in 1913. For further information, please see Footnote #14. Ironically, the enactment of the Federal Reserve Act was brought about by three wealthy conspirators – Frank A.
Vanderlip, J.P. Morgan, and John D. Rockefeller. The story goes, because the financial market’s volatility of the time threatened the economic and financial interests of the said families, extensive lobbying of the U.S. Congress on their part led to the introduction and eventual passage of the 1913 bill.

Decentralization of the banking system prior to 1913 was the responsible agent for many economic downfalls and financial panic. With no central banking in place, financial transactions and commercial activities were conducted without a firm regulatory authority. Major dominance of American banks began after World War II, since the U.S. became a major economic, political and financial power. Eventually, the U.S. economy became the largest in the world, which necessitated the expansion of U.S. international banks throughout the planet to facilitate trading and financial activity for American corporations. Enactment of the Marshall Plan and issuance of federal government securities to raise the necessary capital for implementation of the Plan brought the U.S. banking system more into the daily life of the American political and economical decision making processes.

After World War II, the creation of a new order in international economy, commerce and finance was inevitable. Consequently, a conference was held in Bretton Woods, New Hampshire, to establish a new, worldwide agreement on the operation of the banking system. For further information, please see Footnote #15. All economic models of the time, such as the Keynesian model, supported the need for such an agreement, which was advocated by two prominent economists of the time, John Maynard Keynes and Harry Dexter White. The model advocates the involvement of central banking in expansion and contraction of the money supply during difference phases of the business cycle. The business cycle is a result of the deviation that occurs in major macroeconomic variables and requires central banking’s involvement to correct the said deviations (recessionary and inflationary phases). The agreement was the catalyst for establishment of the International Monetary Fund, the World Bank, and the General Agreement on Tariff and Trade. For further information, please see Footnotes #16, #17 and #18. So, international monetary and commercial cooperation for the successful implementation of economic activity began.

The orientation of the World Bank was to provide technical assistance for economic development matters to developing nations. Coincidentally, it became so appropriate, since after World War II an enormous amount of redevelopment was needed. The efforts of the World Bank, coupled with the GATT agreement, were major catalysts for the expansion of trade and economic development. GATT eventually became known as the World Trade Organization (WTO). These entities played an important role in facilitating trading and payment activity that could be considered as having had a positive impact on the overall wellbeing of emerging market societies. At the same time, they were alleged to have promoted the political and economic interests of large capitalistic societies. As a result, they are facing major opposition from every facet of life, predominantly from the populous of developing nations. The question arises: why is it that every time there is a gathering of the WTO members and other international monetary authorities, such as the IMF and World Bank, there are protests that sometimes have erupted into violence? For further information, please see Footnote #19.
The Bretton Woods system reluctantly accepted the Gold Standard (currency backed by gold), as long as the U.S. participated in accepting the monetary system of the Gold Standard. The U.S. participation in the Gold Standard faded and eventually in 1971 President Nixon removed U.S. dollars from the Gold Standard. Consequently, the Bretton Woods system became irrelevant and was replaced by the G-7 industrial countries (United States, Japan, Germany, United Kingdom, France, Canada and Italy) - by the way, they have reluctantly allowed the Russians to have representation in their meetings, since they possess 20,000 nuclear warheads -- with all of those, I would let them participate in any event!) that meet on a regular basis to coordinate international policies on monetary and trading issues.

The expansion of IB and its involvement in trade and cross-border lending activity resulted in a transfer of a large sum of U.S. dollars overseas, especially to their subsidiaries, agencies, offices, branches, etc. The existence of this large sum of deposits, devoid of the reserve ratio required by the Federal Reserve, created an environment of profit taking for international banks. These deposits eventually became known as Eurodollars, and the securities that were issued by international banks for raising capital became known as Eurobonds. For further information, please see Footnotes #20 and #21.

The invention of these two markets was the result of the significant expansion of IB activities after World War II. These two markets were also responsible for the explosive growth of U.S. business and commercial activities around the planet. The Marshall Plan (a major reconstruction effort in Europe) was another catalyst for the transfer of U.S. currencies to European financial centers. For further information, please see Footnote #22.

The Eurodollar became a significant financial instrument, since it was not subject to the regulatory limitations of the Federal Reserve that are imposed on domestic reserves of the U.S. banking system. The absence of regulatory limitations caused the Eurodollar to play a significant role in the reconstruction activities in Europe and facilitated cross-border lending for trading purposes. The above contribution of the Eurodollar eventually led to the creation of the London Interbank Offered Rate (LIBOR - an international interest rate). For further information, please see Footnote #23.

The OPEC (Organization of Petroleum Exporting Countries) oil cartel imposed an oil embargo against major industrial societies which caused a shortage of the oil supply, and consequently the price of this commodity increased. This process increased revenue for the oil producing nations and, in turn, these revenues were deposited in major U.S. and European banks. So, we can say that the oil embargo, with all its economic negativity, was a catalyst for the expansion of revenue by the international banks, and created fierce competition amongst them for loan syndication to developing and emerging market societies, predominantly Asian, Latin American and African nations.

The Savings and Loan Association debacle/crisis in the decade of the 80’s, coupled with the expansion of European and Japanese banks, caused a decline in the competitiveness of the U.S. banking system in relation to the rest of the world. For further information, please see Footnote #24. The cultural issue that ties economic entities to those in many other societies was also responsible for the expansion of IB in the said societies. For instance, the human side of
economic activity in Japan brought interdependencies among Japanese corporations, their banks and the government, which caused collaboration among the above entities. This led to the expansion of the Japanese economy, thus the banking system, which posed fierce competition to other IB systems. For further information, please see Footnote #25.

In modern times, with globalization impacting every aspect of human life, including economics and finance, major banking systems such as the Bank of Japan and the Bank of China were compelled to join the existing multinationals in shaping the evolutionary processes of IB. One also cannot ignore the contribution of the European Union Central Banking System since the inception of the European Union. For further information, please see Footnotes #26 and #27.

The globalization of the financial market and economic system that brought the whole planet together like a neighborhood, coupled with political, social, cultural and economical interdependencies, rapid expansion and utilization of the Internet, and deregulation of the international capital market, caused a major expansion in the IB and trading activities in the decade of the 90’s.

It is amazing to see how IB evolved from the middle ages to the present time. Who could have imagined that someday the exchange banks, merchant banks and pawn banks of the Middle Ages would be replaced by multinational banks such as Citibank, Bank of America, Chase Manhattan, and large Japanese, Chinese and European banks?

**Conclusion**

In this module, you learned about the evolution of IB and how each participant contributed in this endeavor. You became familiar with various benefits and consequences of the policies and procedures that were in place at each stage of the development of IB. And finally, you learned about the role of international trade in shaping the operation of the banking system in different periods throughout history.
FOOTNOTES

(1) Hammurabi’s Code:
http://www.ushistory.org/civ/4c.asp

(2) General History

(3) Banking in the Middle Ages
http://www.faculty.umb.edu/gary_zabel/Courses/Phil%20281b/Philosophy%20of%20Magic/Dante.%20etc/Philosophers/End/bluedot/banking.html

(4) Knights Templar
http://www.middle-ages.org.uk/knights-templar.htm

(5) Urban Economy

(6) House of Medici
http://www.newadvent.org/cathen/10120a.htm

(7) Mayer Amschel Rothschild family

(8) History – Vasco da Gama (c.1460 – 1524)
http://www.bbc.co.uk/history/historic_figures/gama_vasco_da.shtml

(9) Antwerp
http://www.newadvent.org/cathen/01588e.htm

(10) Philip II
http://www.nndb.com/people/229/000092950/

(11) Amsterdam
http://www.amsterdam.info/netherlands/history/

(12) Bank of England
http://www.banking-history.co.uk/history.html

(13) Barclays – Company History
http://www.baronage.co.uk/bphtm-02/moa-07.html

(14) Federal Reserve
http://www.federalreserveeducation.org/about-the-fed/history/
(15) 1944 – Bretton Woods Agreement: Developing a New International Monetary System
http://www.federalreservehistory.org/Events/DetailView/28

(16) International Monetary Fund
http://www.imf.org/external/about/history.htm

(17) The World Bank

(18) General Agreement on Tariffs and Trade

(19) What is the WTO?
http://www.wto.org/english/thewto_e/whatis_e/whatis_e.htm

(20) Eurodollars
http://wfhummel.cnchost.com/eurodollars.html

(21) Eurobond
http://www.businessdictionary.com/definition/Eurobond.html

(22) For European Recovery: The Fiftieth Anniversary of the Marshall Plan
http://www.loc.gov/exhibits/marshall/mars1.html

(23) LIBOR
http://www.investorwords.com/2797/LIBOR.html

(24) Savings & Loan Crisis
http://econlib.org/library/Enc/SavingsandLoanCrisis.html

(25) Japanese Banking System
http://www.sjsu.edu/faculty/watkins/jfin.htm

(26) Bank of China
http://english.cri.cn/855/2005/09/04/269@16815.htm

(27) European Central Bank
http://en.wikipedia.org/wiki/European_Central_Bank