HISTORICAL TRENDS IN THE EVOLUTION OF EARLIER TWO-LEVEL BANKING SYSTEM AND BANKING CRISIS

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The article provides an insight into the historical background of crisis situations in the banking system; there is a focus on historical trends in the development of two-level banking systems in Western countries; historical nature of such economic categories as “bank”, “crisis”, and “banking crisis” is defined.

Nowadays there is a great variety of interpretations of what a crisis in general and a banking crisis in particular is like. The word crisis is of Greek origin; it means *judgment, decision taken on an issue.* The word can also mean *resolving a conflict, for example a military conflict.* These days, crisis in its original meaning is mainly used by medical workers. According to R. Koselleck, “crisis is a hardly measurable crucial point, when a life-and-death decision is taken”. In the 17th and 18th centuries, *crisis* began to refer to social processes, e.g. military or political processes. Since the 19th century the word has been used in the economic context. From the classic economic point of view, crisis means an undesirable and dramatic stage in the capitalist economic scheme affected by fluctuations and negative phenomena. In this sense of the word, crisis has dominated conjuncture theories in the development of economics for a long time. Thus, the Spiethoff’s cyclic scheme features the following stages: recession - primary rise - secondary rise - boom -capital storage - crisis. However, this definition doesn’t take into consideration many schemes and development stages of economic functioning. Therefore the classic definition of crisis was replaced by a more polysemantic *economic crisis.* According to F. Machlup, economic crisis is caused by the undesirable state of economic relations, unbearably critical state of major strata of population and manufacturing industries. W. Sombart defined the economic crisis as “an economically negative phenomenon affecting the society’s economic life”.

A thorough analysis of various literature and scientific sources shows that the term bank was introduced into the economic vocabulary about 400 years ago. Thus, linguistic and economic scholars share the opinion that the word *bank* comes from Italian *banco* or French *banque* meaning *bench* or *table* used by moneychangers to put their coins onto. In other words, *bank* initially meant a particular working place of a banker living in the Early Middle Ages. This period of the Western countries’ development is characterized by great demand in mutual settlement of accounts, credit operations, and stronger economic relations between countries.

These days a bank is referred to as a special public money-and-credit institution which accumulates funds and capitals, provides loans and fund transfers, discounts bills, issues currencies and securities, holds foreign exchange and gold transactions, regulates cash and non-cash payment cycle and performs other functions which are assigned to it by the legislation.

The main function of the bank is to mediate the movement of temporary surplus funds (including loanable funds) at various stages of social reproduction and in various social and economic structures characterized by commodity-money and bargaining (excluding barter) relations. The bank is an autonomous, independent, commercial credit-financial institution because its duty is to perform certain production activity. Bank products are: money supply formation; regulation of currency circulation in the country, including currency issuing; various specific services such as providing credits, bonds, warranties, consulting, inventory management, etc.

The fact that banks don’t produce any tangible products doesn’t mean that they are not producers in the proper sense of the word. In the process of manufacturing a product ordered

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by a customer the bank incurs intellectual costs while using certain equipment (computing and communications facilities) with the aim of making temporary surplus funds to be applied in economic turnover. Without bank “labor” this process would be impossible.

In this connection it should be noted that according to the RF legislation, the bank is a credit institution which has the exclusive right to perform the following banking operations: to attract to bank deposits the money of individuals and businesses, to place this money in its own name and on its own account on a reward, maturity, repayment and target basis, to open and operate bank accounts of individuals and businesses.

The prototypes of banks as money-credit institutions appeared in the Middle East during the 7th-8th centuries B.C. (it was the period of the New Babylonian Empire). Thus, from extant manuscripts we can learn about business houses handling considerable volumes of banking and financial operations. Early bankers were familiar with depositing and keeping funds, with non-cash transfers between clients, with lending money on documents and against receipt, with discounting. Bankers were proficient enough to act as investors in transactions and to settle bills. Examples of this kind of institutions are Murashu and Egibi trading houses established in the Babylonian Empire in the 7th-8th centuries B.C. Major clients of these business trading houses were merchants engaged in international trading.

In ancient times temples were considered as the most reliable places to keep and exchange money because even the worst crooks didn’t dare to cheat in the face of God.

Obviously such important area of the society’s business life as financing and crediting could not remain uncontrolled for a long time. Gradually the state assumed the right of the legal regulator in this field of economic relations. With the development of barter payment agreements direct payments using metal coins slowed down transactions because it took much time to weigh the coins. The development of money economy promoted the interests of both the government and business houses as the government was to adopt means of payment whereas business houses’ major function was to mediate these payments. Money transactions have become the privilege of trading and business houses; they exercised this duty through issuing special gudu receipts circulating like metal coins.

According to statistical data, in Ancient Rome there were about fifty large money associations and about 800 money changing and money landing offices competing with associations for small borrowers.

The prototype of the modern commercial bank appeared in Italy in the Middle Ages. The House of St. George in Genoa started in 1408 as a consortium of public creditors. Later, giro banks (from Italian *giro - circulating*) were opened in Venice and Milan; they specialized in non-cash payments. For the first time, the official definition of the bank (Banco di scritta) as an institution transferring money from one account to another appeared in the Banking Act of Venice in 1318.

Fostering foreign trade encouraged Italian bankers to open branches abroad and promoted the development of banking systems in other European countries. By the early 17th century, the system of banks and banking offices had been established in England, France, Germany, Spain, and the Netherlands. In the middle of the 17th century, banks appeared virtually in all economically developed countries.

The late 17th-early 19th centuries were challenging for the banking legislation: the development of early bourgeois economic relations (industrial commodity production) and the bourgeois revolutions forced it to secure industrialization of the bourgeois society.

In the 17th-18th centuries, Italian trade cities were losing their dominant position in the European economy to Antwerp and Amsterdam. Since the end of the 17th century, London has become Europe’s financial and banking center. Banks in England were the first to introduce versatile banking tools - they started to trade bills in the banking business on the continent. Initially (in the 12th century), the bill of exchange was the only form of bills.

Industrialization and production growth gave impetus to the formation of banking systems. The Royal Charter was granted on July 27, 1694 to found the Bank of England with 19 employees. In exchange for loans the bank provided to King Charles II it acquired the sole right to issue money. In 1709 it was granted a quasi-monopoly by a decree of Parliament that no other corporation or partnership of more than six persons should issue demand notes in England. 1709 Act banned the establishment of any other joint-stock banks. (This degree was annulled in 1827.) Since 1751 the Bank of England has been managing the national debt. In 1827 the Bank of England was granted a monopoly of administration Crown accounts and revenue collection.

Since 1709, about 140 new banks have been set up. Major banks included London Joint-Stock Bank, Westminster Bank, West India Bank, Union Bank, etc. Banking institutions in Great Britain were charted as private banks and banking houses; they offered services to particular client groups:

♦ West End banks provided services mainly to big landowners (the provincial nobility).

♦ London City banks offered their services to big merchants and manufacturers, managed current accounts, credited sales and handled bills.

♦ Provincial banks worked with small manufacturers and entrepreneurs. Initially, only a few banks provided services of this kind; industrial growth and natural demand in circulating funds made them a necessity.

The banking crisis of 1847 had a negative effect on the system of joint-stock banks and their number was gradually decreasing. By the end of the 19th century, England had finally established both its banking system and banking legislation providing a model for other European countries. Fig. 1 shows the structure of the British banking system at the end of the 19th century.

The British legislation followed a specialized approach to banking regulation. Thus, there were several types of banks:

♦ deposit banks kept deposits and provided short-term loans;

♦ specialized banking firms (bill brokers and discount houses) were responsible for discounts;

♦ merchant banks distributed foreign loans and credited trade companies;

♦ colonial banks offered their services in British colonies.

In the 18th-19th centuries, France was the second largest country in terms of banking growth. By the beginning of the 18th century, credit institutions of the mixed type had formed the core of the country's banking system - banks used to provide all kinds of banking services. There were attempts to set up a unified national issue center: in 1718 the Finance Minister John Law established General Bank (Banque générale, later the royal bank). In 1776, Finance Minister A. Turgo established a limited partnership. However, neither Law's bank nor Turgo's partnership were successful - the result was uncontrolled banknote issue, hyperinflation and financial crisis.

In 1800 the Bank of France (Banque de France) was established as a government institution; its commercial activity was strictly limited. The Bank of France issued currency, supported money circulation in the country. It should be noted that Emperor Napoleon I greatly contributed to the country's banking system development because he considered rich French banks vitally important for national security. Address-

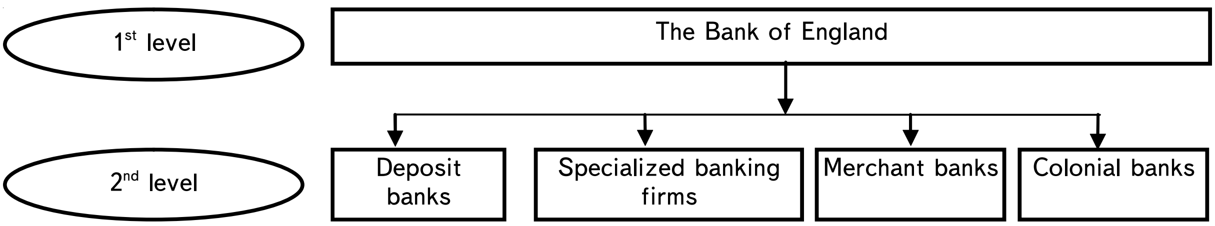

Fig. 1. **Two-level structure of the banking system at the end of the 19th century**

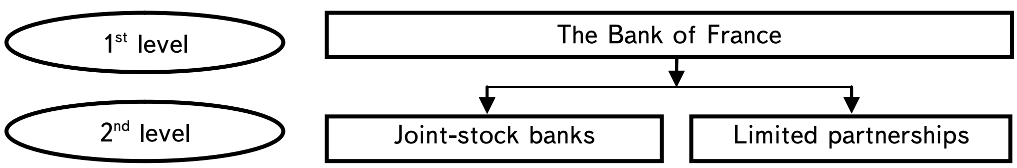

Fig. 2. **Two-level structure of the French banking system at the beginning of the 19th century**

ing the Council of State in 1860 he emphasized that it's important to create a social stratum familiar with the word and the concept of banking. At that time French private banks were closely related to British and German capital. Thus, James Rothschild, the head of the largest Parisian banking house (founded in 1814) and Nathan Rothschild, the head of the London banking house were the sons of Mayer Amschel Rothschild, the founder of the Rothschild family international banking dynasty.

Fig.2 shows the structure of the French banking system at the beginning of the 19th century. We can see that at that time there were two organizational and legal forms of banking institutions:

♦ Joint-stock banks which like British merchant banks specialized in crediting foreign trade, distributing foreign loans, making foreign payments. In full compliance with the 1807 Commercial code they could be established only with the consent of the Council of State.

♦ Limited partnerships focused on short-term crediting; no permission was required to set up these banking institutions.

Joint stock banks were mainly situated in Paris, whereas limited partnerships were established both in the capital and in the provinces; the financial services these banking institutions rendered to their clients were different.

The 1847 financial crisis made a dramatic impact upon the developing banking system - only a few major joint stock banks in Paris survived. The French economic system was on the brink of collapse.

The second half of the 19th century was a period of establishing major banks as a result of the industrial boom, primarily in railway construction.

In 1859, *General Association of Industrial and Trade Crediting* was established known as *Trade and Industrial Credit*. The bank was owned by French manufacturers and British bankers. It combined credit functions with investing in new businesses. In 1863, the bank *Lion Credit (Crédit Lyonnais)* was founded by French and Swiss railway owners.

In May 1864, Emperor Napoleon III approved the charter of the *General Association for Promoting Trade and Industries* (known as *Trade and Industry Promotion Bank*). This bank formed the core of the national banking system.

By the end of the 19th century, there had been four major banks in France: *General Association for Promoting Trade and Industries, Lion Credit, Trade and Industrial Credit and Discount Bank*.

The history of the German banking system goes back to the 18th century. Rapid industrial growth gave a strong impetus to the establishment of banks all over the country. Newly founded banks credited coal and ore mines, factories and plants. The first joint-stock bank was Schaffhausen banking-house (founded in 1848). To provide the institution's sustainability it was turned into a joint-stock bank on the initiative of the Prussian government.

Until the 1870s, banks in Germany had been rejected to go public. For that reason bankers had to establish joint-stock banks in other lands or to use organizational legislation forms which did not require government approval (limited partnerships and cooperative credit unions). By the mid-19th century, there had been over 30 banks in Germany. Most banks exercised issue right. Gradually they were being rejected the power to issue money. In compliance with the law passed in 1875 this right was transferred to the *Bank of Prussia* founded in 1845 as a governmental institution and reorganized into *Reichsbank* in 1876. In 1870-1872, the number of banks rocketed to 500 due to the 'Grunder establishment fever' when every shopkeeper aspired to be a bank founder. By the end of the 19th century, only 100 banks had survived (the largest banks were *Deutsche Bank* and *Dresden Bank*). These laid the foundation for the contemporary national banking system.

In the United States the first bank was established by the Congress after the War of Independence (1775-1783). In February 1791, the *First Bank of the United States* received a unique national charter for twenty years; federal authorities were not allowed to grant the document acting both as a charter and a license for banking activity. In 1811 the *First Bank of the United States* was liquidated and gave place to 400 new banks. Lack of a unified system of bank clearing (payments offsetting) was a serious barrier to bank functioning. To remove this obstacle, *the Second Bank of the United States* was established in 1816. Its charter expired in 1836.

The *Second Bank of the United States* was vested the right to open branches and divisions in states without local authorities' consent. By the early 1830s, President Jackson had come to thoroughly dislike the *Second Bank of the United States* because of its fraud and corruption. The *Second Bank of the United States* was left with little money and, in 1836, its charter expired and it turned into an ordinary bank in Philadelphia. Five years later, the former *Second Bank of the United States* went bankrupt. The number of commercial banks increased greatly. The bank crisis caused serious troubles for the banking sector - up to the beginning of the Civil War (1861-1865) there had been as many as 6000 types of banknotes in circulation. The National Bank Act of 1864 was to systematize the procedure of chartering new banks. However, some systems problems concerning the regulation of banking activity remained; to solve them the *US Federal Reserve System* was conceived by several of the world's leading bankers in 1910 and enacted in 1913, with the passing of the Federal Reserve Act.

From what has been said above we can state the following trends in the evolution of earlier two-level banking systems and earlier banking crisis in Western economies:

The first stage: absolute competition in banking with all kinds of banking institutions; banking legislation is still in its infancy; there is no unified national issue center.

The second stage: one bank is dominating over smaller banks acting as an issue center; the government imposes a ban on charting credit institutions fulfilling the same functions.

The third stage: governmental influence on banking is weakening; main barriers are being removed.

The fourth stage: banking boom in the country; numerous credit institutions are being established.

The fifth stage: 'Self-cleaning' of the banking market - banking institutions which fail to remain competitive are going bankrupt; the process is generally triggered by banking crises causing hyperinflation.

The sixth stage: consolidation of bank structures with few large banks forming the national banking system.

Conclusion: Banking systems of Western economies in their present form have been established since the second half of the 19th century. The core of each system is the issue (usually government) bank; groups of commercial (private) banks compete for clients and give credits.

The abovementioned trends typical of Western banking can be easily traced in the development of the Russian banking system. A detailed study of separate historical facts related to the evolution of foreign banking systems will enable us to forecast the development of the Russian banking sector and to use required mechanisms and methods for preventing probable future crisis situations.

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