

## A Brief History of Banking

Banking activities were sufficiently important in Babylonia in the second millennium b.c. that written standards of practice were considered necessary. These standards were part of the Code of Hammurabi – the earliest known formal laws. Obviously, these primitive banking transactions were very different in many ways to their modern-day counterparts. Deposits were not of money but of cattle, grain or other crops and eventually precious metals. Nevertheless, some of the basic concepts underlying today's banking system were present in these ancient arrangements. A wide range of deposits was accepted, loans were made, and borrowers paid interest to lenders.<sup>1</sup>

Similar banking type arrangements could also be found in ancient Egypt. These arrangements stemmed from the requirement that grain harvests be stored in centralized state warehouses. Depositors could use written orders for the withdrawal of a certain quantity of grain as a means of payment. This system worked so well that it continued to exist even after private banks dealing in coinage and precious metals were established<sup>2</sup>.

We can trace modern-day banking to practices in the Medieval Italian cities of Florence, Venice, and Genoa. The Italian bankers made loans to princes, both to finance wars and their lavish lifestyles, and to merchants engaged in international trade. In fact, these early banks tended to be set up by trading families as a part of their more general business activities. The Bardi and Peruzzi families were dominant in Florence in the 14<sup>th</sup> century and established branches in other parts of Europe to facilitate their trading activities<sup>3</sup>. Both these banks extended substantial loans to Edward III of England to finance the 100 years war against France. But Edward defaulted, and the banks failed.

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<sup>1</sup> Davies, G. (1994) *"A History of Money from Ancient Times to the Present Day"*, Cardiff, UK, University of Wales Press.

<sup>2</sup> Davies (1994) *op. cit.*

<sup>3</sup> Hoggson, N. F. (1926) *"Banking Through the Ages"*, New York, Dodd, Mead & Company.

Perhaps the most famous of the medieval Italian banks was the Medici bank, set up by Giovanni Medici in 1397<sup>4</sup>. The Medici had a long history as money changers, but it was Giovanni who moved the business from a green-covered table in the market place into the hall of a palace he had built for himself. He expanded the scope of the business and established branches of the bank as far north as London. While the Medici bank extended the usual loans to merchants and royals, it also enjoyed the distinction of being the main banker for the Pope. Papal business earned higher profits for the bank than any of its other activities and was the main driving force behind the establishment of branches in other Italian cities and across Europe.

Much of the international business of the medieval banks was carried out thorough the use of bills of exchange. At the simplest level, this involved a creditor providing local currency to the debtor in return for a bill stating that a certain amount of another currency was payable at a future date – often at the next big international fair. Because of the church prohibition on directly charging interest, the connection between banking and trade was essential. The bankers would take deposits in one city, make a loan to someone transporting goods to another city, and then take repayment at the destination. The repayment was usually in a different currency, so it could easily incorporate what is essentially an interest payment, circumventing the church prohibitions. For example, a Florentine bank would lend 1000 florins in Florence requiring repayment of 40,000 pence in three months in the bank’s London office. In London, the bank would then loan out the 40,000 pence to be repaid in Florence at a rate of 36 pence per florin in three months. In six months, the bank makes 11.1 percent – that’s an annual rate of 23.4 percent. It is also interesting to note that a double-entry bookkeeping system was used by these medieval bankers and that payments could be executed purely by book transfer<sup>5</sup>.

During the 17<sup>th</sup> and 18<sup>th</sup> centuries the Dutch and British improved upon Italian banking techniques. A key development often credited to the London goldsmiths around this time was the adoption of fractional reserve banking<sup>6</sup>. By the middle of the 17<sup>th</sup> century, the civil war had

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<sup>4</sup> Goldthwaite, R. A. (1995) *“Banks, Places and Entrepreneurs in Renaissance Florence”*, Aldershot, Hampshire, Great Britain, Variorum.

<sup>5</sup> Goldthwaite (1995) op. cit.

<sup>6</sup> Davies (1994) op. cit.

resulted in the demise of the goldsmiths' traditional business of making objects of gold and silver. Forced to find a way to make a living, and having the means to safely store precious metal, they turned to accepting deposits of precious metals for safekeeping. The goldsmith would then issue a receipt for the deposit. At first, these receipts circulated as a form of money. But eventually, the goldsmiths realized that since not all of the depositors would demand their gold and silver simultaneously, they could issue more receipts than they had metal in their vault.

Banks became an integral part of the US economy from the beginning of the Republic. Five years after the Declaration of Independence, the first chartered bank was established in Philadelphia in 1781,<sup>7</sup> and by 1794, there were seventeen more. At first, bank charters could only be obtained through an act of legislation. But, in 1838, New York adopted the Free Banking Act, which allowed anyone to engage in banking business as long as they met certain legal specifications. As free banking quickly spread to other states, problems associated with the system soon became apparent. For example, banks incorporated under these state laws had the right to issue their own bank notes. This led to a multiplicity of notes – many of which proved to be worthless in the all too common event of a bank failure.

With the Civil War came legislation that provided for a federally chartered system of banks. This legislation allowed national banks to issue notes and placed a tax on state issued bank notes. These national bank notes came with a federal guarantee, which protected the note-holder if the bank failed. This new legislation also brought all banks under federal supervision. In essence, it laid the foundations of the present-day system.

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<sup>7</sup> Klebaner, B. J. (1974) *“Commercial Banking in the United States: A History”*., Hinsdale, Illinois, Dryden Press.