

Gothenburg Research Institute

GRI-rapport 2016:2
Bank Management

Banks and their world view contexts

Sten Jönsson



UNIVERSITY OF GOTHENBURG
SCHOOL OF BUSINESS, ECONOMICS AND LAW

© Gothenburg Research Institute

All rights reserved. No part of this report may be reproduced without the written permission from the publisher.

Gothenburg Research Institute
School of Business, Economics and Law
at University of Gothenburg

P.O. Box 600
SE-405 30 Göteborg
Tel: +46 (0)31 - 786 54 13
Fax: +46 (0)31 - 786 56 19

E-post: gri@gu.se

ISSN 1400-4801

Layout: Henric Karlsson

Banks and their world view contexts

**By Sten Jönsson
Gothenburg Research Institute (GRI)
School of Business, Economics and Law
University of Gothenburg**

Contents

Introduction	8
1. Preliminaries	13
1.1. Theoretical orientation	13
1.2. What is a bank anyway?	15
1.3. The changing nature of arbitrage	16
1.4. A quick tour of the world views that set the stage for banking	18
2. Greed, arbitrage, and decency in action	22
2.1. Greed – the original sin!	22
2.2. An overview of wealth and the afterlife during the first centuries AD	24
3. Scholasticism – guiding individuals to proper use of their free will	26
4. The most prominent banks – watched by the scholastics	32
4.1. Medici	32
4.2. Fugger	37
5. Mercantilism – the origins of political economy and, consequently, of economic policy	42
5.1. The glory and decline of merchant banks	45
6. Neoliberalism started with the Austrian School	59
6.1. Modernism and crumbling empires	59
6.2. The context in which the Austrian school developed	61
6.3. The Vienna circle as the birthplace of neoliberalism	63
6.4. A brief review of some neoliberal activist texts	67
6.5. The practice of neoliberalism – deregulation	75
6.6. A bank under neoliberalism	80
7. Instead of a conclusion	91
7.1. The relevance of worldviews	91
7.2. The issue of the nature of banks	93
7.3. Arbitrage in space and time	95
7.4. Can the corporatist view help?	98
7.5. Recapitulation	100
7.6. With such increasing complexity and contradiction – what kind of banking do we need for the future?	101
References	104

"First. That these loans should only be made at a very high rate of interest.... Secondly. That at this rate these advances should be made on all good banking securities, and as largely as the public ask for them. The reason is plain. The object is to stay alarm...." (Bagehot, 1873, on how Bank of England should avert a banking crisis)

"Only a crisis – actual or perceived – produces real change. When the crisis occurs the action taken depends on the ideas that are lying around." (Milton Friedman, University of Chicago, 1982)

"Fairness demands the end of a system that privatises gains but socialises losses." (Mark Carney, Bank of England, 2013)

Introduction¹

The quotes above illustrate how authorities, be it the central bank or other institutions, at different times have stated principles on how the context of banks should be ready to help avert banking crises. Banks need support since they have not done very well at times, or maybe too well in the eyes of context actors. It is therefore reasonable to assume that banks, throughout history, will pay attention to what arguments best justify their existence and their maintenance of their “good name”. Most banks have long histories of survival in adverse conditions and of surfing on good tides. At the same time the recent crisis has demonstrated that many banks (and government agencies) failed to see what was coming and take appropriate action. In fact my starting assumption in the work on this essay has been that most failures in this crisis can be labelled managerial failures, ethical as well as instrumental. Over time I grew convinced that it is more complicated than that. It is not that bank managers do not make grave mistakes, they certainly do, but it is also that the contexts in which banks have to find their model of survival and prosperity there are also wills and strategies at play. The context is not a passive generator of data to be used for forecasting, it is rather an active player, who, to the extent that it finds it worthwhile to pay any attention to banks, will assert power to make banks employ a “logic of appropriateness”. That concept (the logic of appropriateness) was introduced by March & Olsen (1984, 2009) into organizational discourse in the form of “new institutionalism” deals with the simple but fundamental question: “What should a person like me do in a situation like this?” That question is not only about “who am I? (a person like me)” but also “what kind of situation is this?” (the context), and “What actions are possible?”(do). The normative factors at play at a given time and place must be discerned and acted upon for the person in question to do the appropriate thing, not only the person’s self-interest but also socially sanctioned values contained in the dominating ideology. Of course the person can rebel, but this is done better with appropriate knowledge of the values that are celebrated here at this time.

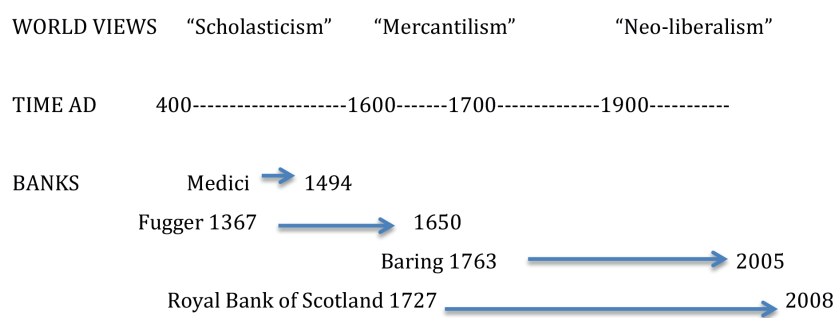
By bringing the influence from the context in view we also bring in the concept of power. We need not dwell on the huge literature on power – the traditional definition; Power is exerted when a person A induces another person, B, to do what B would not otherwise do. If we think about banks as being immersed in a sea of societal and other values while employing a logic of appropriateness, we will want to look upon banks and their action in different times with different dominating world views to discern what values might have played a role (as good arguments for action) at different times. We cannot observe the rendition

¹ The author is grateful for constructive critique in the seminars of the Bank Management program of the GRI. Special thanks to Roy Liff for comment on the final draft and to Henric Karlsson and Lise-Lotte Walter for their work in editing the manuscript for printing.

of arguments directly, of course, but we can map a sequence of different world views (ideologies) in history and lay out the biographies of selected (prominent) banks in parallel. By such an exercise I hope to see what kind of power the context asserted at the time. This is interesting because now, in the wake of the recent financial crisis, the appropriate level of regulation is at the very centre of the debate. From the assertion by neoliberals, that regulation can only introduce more inefficiency, to socialist views that ownership by the State of system critical banks would further stability. These views and arguments are based in value systems that are largely incompatible – they fail to persuade each other – can history make us any wiser?

Therefore my project is to lay out some of the major ideologies in history and place some prominent banks along the time line to see if anything can be discovered concerning the interaction between banks and their value contexts. I have chosen Scholasticism (around 400 to 1600 AD), Mercantilism (the 1600s), Liberalism (1700 – 1900), Neoliberalism (1900 until today). I could have paid more attention to the apex of state prominence in the form of the welfare state in the West and the socialist states in the East, but since banks played a more modest role then (in this time of maximum regulation) I have saved work and effort by skipping over those periods. I also pay relatively little attention to Liberalism since those days provided an abundance of opportunities for banks (regulation beyond what the Law said was not on the agenda). For banks I have chosen Medici of Florence, Fugger of Augsburg, Baring of London, and Royal Bank of Scotland of Edinburgh. They were among the most prominent of their times, but also went bankrupt (or were dismantled in other ways) as their activities came out of step with what others considered to be appropriate.

Figure 1:



This essay is written against a background belief that banks are important agents in the building of societies. This is because they the function of (re-)allocation of financial resources to and from “real” actors in that society. Therefore they need to be attentive to the values and the appropriate reasons for doing things that are valid in that society. The allocation function of banks is mainly driven by the

arbitrage opportunities that offer themselves – if there is a profit in transferring money from one place to another, it will be done. Transferring money in time (giving loans) involves the risk of not being paid back (credit loss), which makes judgment of character and property an integral part of banking. This was done on an individual level under the guidance of church pronouncements on what is appropriate. When the pre-modern state was being established during the 1600s, the 30 years' war being a devastating expression of different princes' striving to gain control of territory large enough to carry the burden of an expanded state administration, banks had to orient their judgments differently. Now the state was an expression of a more permanent, bureaucratic power that had to be included in all strategies.

Mercantilism, consequently, has come to represent the concern with the flows, in and out of the country, of money and precious metals. Banks and other actors had to make deals with the state for privileges and protection. All in the service of the balance of payment and the maintenance of a strong state.

With modernity came science and technology, which offered almost endless opportunities for investment. Britain, having stayed out of much of the war-making in Europe, could take a giant leap forward on the basis of its dominance at sea and technology. Let the entrepreneurs free! was the slogan presented most persuasively by Adam Smith. Mercantilism was just an expression of organized interests. Now the free choice of strategies to be pursued would make everybody better off. Pareto showed that, if actors in the market are left free to choose, an equilibrium will be reached. An equilibrium that is ("Pareto") optimal, meaning that no market participant can improve his/her lot. Liberalism provided a golden age for most banks, especially if you were located in London, where deal making on financial matters was easy. With many actors there were markets for many types of financial instruments with capacity to accommodate large projects.

However, the industrial society created by these large projects, also generated differentiation in standards of living. Socialism gained footholds in many communities arguing for different principles of resource allocation and justice. Liberalism and socialism, left and right, became the value depositories from which debaters found their arguments. Power again came to the forefront as states stumbled into two World Wars as political leaders sought domination to be able to change the world in their utopian direction. Banks had to virtually close down business during the two wars and struggled in the des-organization of society in between them. But neoliberalism, an amalgamation of scientific and social values, articulated its ideas of the free market with state oversight to the extent that it came to dominate the debate from the 1980s and onwards. Banks had to find their ways under the auspices of de-regulation. Many failed in 2008.

So much for the larger picture, but how does it work? How do I connect the larger picture to the details of the world view developments, and the calamities of individual banks? I have chosen the sociological theory "Corporatism" (e.g., Streeck and Schmitter, 1985) to depict how the centre of gravity of good

arguments for regulation of society move as events are interpreted and acted upon. Such moves provide space for new configurations of values and their related arguments that can be labelled “mercantilism” or “neoliberalism” etc. Under those labels there is variety in concepts and linkages giving rise to debates on how the world should be understood and dealt with. These debates use words combined into narratives intended to impose the right way of thinking on people. The communication we engage in all the time has organizing effects (Cooren, 2000). A promise is a promise because we interpret it as such under the circumstances it is given. A narrative is a story with a purpose (to reveal a certain value or promote a certain attitude). The authors of biographies of banks have purposes that guide their accounts. Economic historians have methodological training to avoid bias, but total fidelity to what really happened is an illusion that can never be reached. We have to be satisfied with what respected professionals tell us – even if we were present ourselves at the time of the events, we would not understand much! So one should be careful not to draw too extensive conclusions from narratives about the life of banks in relation to the ways of understanding the world dominating the general debate at the time. What we can see is an increasing space for strategic choice and an increasing complexity over time. Can we understand banks today and for the future with the historical insights that this exercise might give? My answer is probably! We can see that some old values/good arguments remain in our vocabulary today as sediments of the old world views, others have been replaced by new inventions. The “weakness of the will“ (akrasia) of Aristotle is perhaps being replaced by “phishing for phools” (Akerlof & Shiller, 2015). ”Plus ça change, plus c’est la même chose”. We must never stop searching for a better understanding. That is what justifies this effort.

In most societies the intercourse between individuals, e.g., buyers and sellers, is regulated in texts and conventions as part of the social compact. A fair price has been defined as the price, which men of character (*vir constans*) can agree on. This is how it was in Aristotle, Roman Law, and Scholasticism. *Vir constans* is a person who is not easily intimidated. Part of the definition of a fair price was that the will of either party should not be unduly weakened (akrasia). Akrasia (=weakness of the will) could be caused by threat/fear, ignorance and need, and it should not be exploited to your own advantage. It was, to take an example, seen as taking such advantage of the other’s need if you charged interest when granting a loan for an essential acquisition. Ursury is still a sin in some religions. But now we refer to “the market” as an impersonal, self-regulating mechanism that produces “fair prices” every day.

Today actors within the finance sector take advantage of the other’s weakness by, e.g., shorting, - selling something for later delivery at a certain price while expecting the price to fall so that the delivery can be accomplished by buying for delivery at a later date when prices have gone down. Predatory finance earns lots of money by exploiting the weakness of others. That would have been a deadly sin some 1000 years ago, even if other kinds of “one-up-manship” certainly were

not unknown. How did we get from there to where we are now? In what sense can this be looked upon as progress?

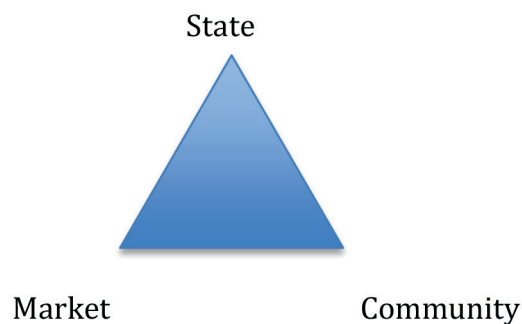
1. Preliminaries

1.1. Theoretical orientation

The justification for taking this long term view on the relation between banks and their contexts is the suspicion that banks, becoming an evermore important part of society, relate to society discursively. What is right and proper behaviour as the parties engage each other as lender and borrower must be regulated in a set of rules stemming from conceptions of what is required for a person (or organization) to uphold the status as member of society, and what it means to be a person of good character. Changes in these conceptions will occur as society adapts to events, new ideas, or overextension of resources. The need for change will be recorded in texts testifying to current concerns, and in this connection the current practices may be described and justified.

The assumption that banking is a dynamic activity adapting to its significant environment implies that there may be different ways of understanding the world and of legitimizing change. Before embarking on the planned historical journey through a very small part of what might be considered relevant texts we need a tool to help us select what might be relevant. Unavoidably the selection will be biased since it will tend to be based on references in the text under scrutiny, to help steer attention I have chosen to rely on traditional corporatist views as presented by, for example, Streeck & Schmitter (1985). What is of interest here is the values and arguments enshrined in the State, Market, Community conceptions (organized interests have been present all the time (guilds, unions, church) but are assumed to base their arguments in the dimensions of the triangular discursive space:

Figure 2:



State represents a view that society should be regulated on the basis of rules equally applied (via juris prudence) to all by an unbiased, transparent hierarchy manned by civil servants promoted on merit. State solves problems by the rule

of law. Stability stems from predictability.

Market represents a view where progress is driven by free competition among creative actors, where rewards go to the successful. Problems are solved by competition. Stability stems from self-regulated market equilibria.

Community represents a view where society is built on spontaneous solidarity (care for the other), respect for the individual, for science and professionalism. Problems are solved via free debate where the best arguments persuade. Stability is won through best practices.

In any world-view there are ingredients of all three aspects. For example, adherents to the Market view recognize the need for state intervention to reallocate resources to those who are unable to compete (children, the old, sick etc.) and to a minimal state organization (police, army, courts etc). What the triangle can help us with is to provide a map of the weight of the three dimensions, for a given society at a certain time, in the form of a location in that space. It is also possible to visualise how that location can be pushed in different directions by events and ideological debate. A war will generate a need for more regulation and stricter hierarchical discipline. Scientific progress will help promote a more liberal view of individual action.

The impact of arguments based in these dimensions of worldviews will depend on their persuasive power to capture the attention of others (we are thinking of collective sense making here – you persuade others) and change their configuration of values. Given the current configuration, and the situation, this impact may be enhanced if the logic of the argument is appropriate. In scientific discourse we like to embed our arguments in one and only one logic (analytic deduction) and dismiss other logics as irrational. In social situations, on the other hand, where people view events and ideas from different perspectives, we should expect several logics to be at play. The success of an argument depends on its ability to persuade the receivers of the statement (normally the sender will already be persuaded). Here are a few kinds of logic:

Logic of discovery – we “see” something new (things) against a background of what we already know. It is the contrast that makes us notice. A *measure* that deviates from what is normal, or an alien object that is moved into the foreground, will make/help us see a need for change. Here it is the *new fact* that has persuasive power.

Logic of justification – we argue our case, when it comes to showing that a solution is “good”, by referring to *values* that are legitimate in the context where the discourse takes place. Here it is *value alignment* that makes the argument persuasive.

Logic of ideology – we argue for change in priorities or configuration of value

structures by using *rhetorical devices* (Burke, 1950/1969) like metaphors (Lakoff & Johnson, 1980) to “show” (rather than “prove”) the benefits of change. Merton (1949/1968, “strain theory”) argued that the demand for ideology production increases in crisis (complexity and contradiction).

The working hypothesis is that we can see shifts, or, over longer time periods, or rather “drift” in conceptions of current context that will initiate change in the manner banking is conducted. Here the particular context that is constituted by dominating world-views is in focus. Obviously, reading old texts or texts about old texts will not deliver enough detail to pinpoint direct causes of the then current change, but ex post it is possible to discern that a change has taken place. By the same token it is not possible to prove cause-effect relations. My purpose is to show that there are indications that world-views should be reckoned with when we discuss banking practices (and the effect of theories on such practices).

Before immersing ourselves in the historical records of banks and their contexts it is necessary to say something about banks and their changing nature and also what it is that will drive banks to enter new areas of activity. I believe that it is an extended conception of arbitrage that will help in sensitising us to banks’ adaptive measures to changing contexts.

1.2. What is a bank anyway?

The distinguishing character of banks is the fact that money is the input, the output as well as the measure of success. In “normal” firms something is produced (e.g., horse shoes, or consulting services) and offered to clients, who pay money in return. Then the difference between inflow and outflow of money is a good measure of how well they are doing. For banks things are different. The assets are promises by others to pay sometimes in the future. You give money to somebody else and you have an asset. The flows of money are more complex. After many years of interviewing in big and small banks we have yet to come across any bank manager who believes that the Cash Flow Statement of a bank according to international standards contains any useful information at all. There are even strong indications (Torfason, 2014) that banks create money out of thin air. Part of the explanation for this is that banks have different kinds of relations and dependencies on their contexts.

Primitive forms of banking, long before Christ, have been discovered by archaeologists. One example is the Code of Hammurabi from about 1700 BC, which refers to regulation of banking.

The obvious prerequisites for banking are stable economic relations, monetary economy, record-keeping, and structure. The stability of *economic relations* is manifested in the lender having access, e.g., by court, to the borrower to demand his money back, otherwise trade on credit could not take place. It is also a matter

of *money taking a significant part* of the payment of goods and services. It is easy to imagine how the emergence of coins (copper or silver and gold) would speed up the rate of transactions since storage of goods from barter activity would be quite cumbersome. *Record-keeping* is necessary to keep track of a large number of transactions, which are required for a bank to be “professional”. The structures that allow the *formation of institutions* can be of many kinds, but they have the function in common that they will provide a forum for settling contested claims. This latter function also provides a basis for regulation. (I will try to add the predominant worldview as a determining factor as to what banking becomes.)

In the old age, like Babylonia around Hammurabi’s time (2000 BC), it was customary to deposit wealth at temples, being the centre around which society organized, for safe keeping. Families engaging in banking activity are recorded from Mesopotamia several hundred years BC. Xenophon is on record (in his “On Revenue” from the 350s BC) to have suggested banking in something like a joint-stock form.

It seems like banking flourishes when there are many of them around, creating financial centres, like Athens, Corinth and Patras a hundred years BC. Banking in the Roman Empire, however, did not develop much due to the Romans’ preference for cash. Furthermore the dominant religions disliked banking. Jews were not allowed to charge interest for loans to other Jews. Christian churches forbade the charging of interest on loans (ursury), and the same goes for Islam, even trade in promissory notes is forbidden. The key was that you are not allowed to increase your capital with no services provided. Lending your surplus money to someone in need is charitable. Giving it all away will save your soul (Brown, 2015).

1.3. The changing nature of arbitrage

Arbitrage has driven trade (together with greed) since the beginning of time. The discovery of a discrepancy between the price of something here and the price there entices tradesmen to move the goods from here to there with profit. Wikipedia knows what arbitrage is:

“In economics and finance, **arbitrage** (US /'arbitrɑ:ʒ/, UK /'arbitrɪdʒ/, UK /,arbitr'ɑ:ʒ/) is the practice of taking advantage of a price difference between two or more markets: striking a combination of matching deals that capitalize upon the imbalance, the profit being the difference between the market prices. When used by academics, an arbitrage is a transaction that involves no negative cash flow at any probabilistic or temporal state and a positive cash flow in at least one state; in simple terms, it is the possibility of a risk-free profit after transaction costs. For instance, an arbitrage is present when there is the opportunity to instantaneously buy low and sell high.” (capiche?)

Michael Lewis (2015) thinks this “instantaneously” has to do with technology. His first mention of it in “Flash Boys” (p. 65) is when he introduces one of the heroes in his tale of High Frequency Trading, Ronan, who helped banks and others to build faster systems:

“He was struck, over and over again, by how little the traders he helped understood of the technology they were using.” They’d say. ‘Aha! I saw it – it’s so fast! And I’d say ‘Look I am happy you like our product. But there’s no fucking way you saw anything.’ And they’re like ‘I saw it!’ And I’m like ‘It’s three milliseconds – it’s fifty times faster than the blink of an eye’
He was also keenly aware that he had only the faintest idea of the reason for this incredible new lust for speed. He heard a lot of loose talk about “arbitrage,” but what, exactly, was being arbitrated, and why did it need to be done so fast. ‘I felt like a getaway driver’ he said, “Each time it was like ‘Drive faster! Drive faster!’.....The two biggest high-frequency trading firms, Citadel and Getco, were easily the smartest. Some of the prop shops were smart. The big banks, at least for now, were all slow.”
(This was 2007)

The meaning of “arbitrage” has changed from the ingenious invention of transporting gold by way of written promissory notes like the Medicis and other banks did 500 years ago, to the current “lust” for speed. First it was the realization that you could buy cheap in one place and sell dear in another. All you had to do was to find a way to transport the goods safely between A and B. This is the spatial aspect of arbitrage that drives trade. The temporal aspect, which Lewis (2015) illustrates so well, has to do with the ability to do it faster than the others. This is achieved by, e.g., algorithm trading, and builds on fast cables and fast computers. The easiest phenomenon to understand here is “front running”. This trick presupposes the presence of several stock exchanges (or equivalents), some of them in the form of “dark pools” - facilities set up by, e.g., investment banks to allow clients to post financial instruments for sale (or buy) without the transaction being registered, and therefore without effects on prices). “Front running” means to snap up a posted order, find a matching one, and do a transaction before any of the two parties (buyer and seller) has noticed anything. This can only be done if you have equipment with superior speed (and brilliant programmers). This front running, one should note, is completely risk free. We just have to wait for the counter measures to appear. The Lewis (2015) story is about a group of people who set up their own exchange where transactions are slowed down to make front running impossible and thereby ensure fair trading.

The 500 years covered by the history of banks (even if it is uncertain where to place the beginning) seems to be the history of evolving arbitrage, from the spatial aspect driving banking’s related trade, to today’s “lust for speed” stressing

the temporal aspects of arbitrage. I will try to illustrate this journey into a spatio-temporal conception of arbitrage by contrasting the dominating world-views of the time with the fate of prominent banks.

1.4. A quick tour of the world views that set the stage for banking

Before I go into the literature on worldviews and biographies of banks with all their details and complexity I feel there is a need for a quick overview indicating what the reader can expect.

It seems like the driving force behind the flourishing of banks in several Italian cities was increased volume of trade over longer distance. In the opposite direction of the flow of goods there is a flow of payment. This payment flow generates a risk, even when buyer and seller trust each other, since it is attractive for robbers and pirates. The invention of “bill of sales” (a piece of paper saying that, e.g., on the presentation of this bill at the Medici office in Florence I will pay X florins) makes payments less accessible to outsiders. Furthermore, if the Medici office should happen to be out of the required cash at the moment a clerk could be sent across the piazza to cash the bill with another house on the good name of Medici. In this way several banks in the proximity could generate a money market. This would typically happen at trading centres where merchants had varying cash balances as ships come and go. The first banks of any substance would be related to trade – merchant banks – built on personal relations and the banker’s good name. The world view supporting this kind of banking was explicated over a very long period by the scholastics (Langholm, 1998).

As long as the early banks kept to financing trade they prospered on the basis of their “good name”.

As capital accumulated bankers became interesting partners to princes – all wars were (and still are?) conducted on credit. This adds a new kind of risk illustrated by the old saying in Ecclesiasticus² (Quoted from Ehrenberg 1928): ”Noli foenerari fortiori te, quod si foeneravis, quasi perditum habe” (Lend not to him who is mightier than thou; or if thou lendest, look upon thy loan as lost). The borrowing prince was a bad credit risk; if he won his war he would come back for more for the next campaign, if he lost there would be little left for the creditor. This problem bankers usually solved by acquiring the right to certain future money flows, like the income from the copper mines of Tirol for 5 years. In this way the Fugger family, stemming from textile trade, also became miners with interests as far away as Central America (16th century).

² The Book of Ecclesiasticus, also known as the Wisdom of Sirach is a second century BC writing by a Jewish scribe named Shimon ben Yeshua ben Eliezer ben Sira who was from the City of Jerusalem.

But princes die and successors might not honour debts. This started to change from the 30 years' war, a very complex war as to its origins as well as allegiances. Historians nowadays tend to agree that what supported the ghastly war for so long³ was the efforts of many princes to form a proper (pre-modern) State that was efficient enough to collect taxes and customs payment, provide stability, and administrative competence to regulate business in its territory. Here the catastrophic decline in British wool business due to the success of the new cotton based cloth (Calico) produced a very deep recession played a role. It needed to be explained. Money was flowing out of the country, not least, it was thought, by the machinations of a merchant conspiracy, and this had to be countered by state regulation (like the Navigation Act) to manage the Balance of Trade. The ideas were developed in a very intensive debate in pamphlets and brochures easily produced in large numbers now that Gutenberg's printing press came into general use. The first task – if you wanted to apply the general solution of importing raw materials and exporting manufactured goods - the British thought, was to break the Dutch dominance of the seas. This was accomplished in a series of wars over the 17th century as the Dutch were exhausted by their war of liberation with Spain.

The ideas about how important it was to manage the Balance of Trade have been summed under the label “Mercantilism” (Magnusson, 1999). Now the merchant banks had strong incentives to move office to London as “Britannia ruled the waves” and imperial trade was the order of the day, bringing raw material for emerging industries flowed in from the colonies and exporting manufactured goods at better prices. Banks needed not only to have their trading partners in place, but also the partnership and protection of the state. London was the right place to be.

With dominance of the sea free trade was again an attractive conception. Economists coming before Adam Smith (1776) developed parts of the doctrine, but Smith integrated it most elegantly. Praising the blessings of free trade, free competition and market solutions without the state meddling in the business of merchants and industrialists. The individual's striving to “improve his lot” by use of his abilities to “truck and barter” would generate a better life for all. Liberalism created a background for the “golden age” of merchant banks (Banks, 1999) that lasted up to the First World War. Baring Bank moved to London. The advantage of location in London improved with the advent of the telegraph (across the Atlantic). Now it was no longer a central part of the strategy to warehouse goods in Liverpool. Baring Bank could focus on merchant banking, and the odd loan to governments in a more selective business strategy. There was an overflow of opportunities and less than 100 employees in all. The bank had to be selective and develop its strength.

³ In 1962 citizens of Hessen responded to a survey concerning the most devastating events for Germany ranking the 30 Years' War as the worst, before the two World Wars (Ericson Wolke(Wolke et al, 2006, p.9)

Europe was devastated after the First World War, not least the losing side. For them it was necessary to invent a new state, after the imperial regime had lost credibility, Prussen as well as Austria. Socialism had gained adherents as laissez-faire liberalism was seen as failing in providing for all citizens. Proletarianization was a consequence of un-checked capitalism in the eyes of many. It also set the stage for socialism arguing for a state to serve the people (rather than trade) regulating life in according to the dictum “from everybody according to his ability, to everybody according to his need”.⁴

The struggle between versions of Liberalism (individual freedom) and versions of socialism (distributive justice by state regulation) characterised the first half of the 20th century with a centre of gravitation in Austria trying to build an (German) Austria on the ruins of the lost First World War. Here the modernist view of science grew strong (logical empiricism) and inspired rational constitutionalism (the rule of law). The debate of the proper organization of society was brutally interrupted by different versions of radical nationalist socialist (bolsheviks, national socialists, fascists). Many scholars and intellectuals fled Vienna for England and the USA (like Hayek, Popper, Schumpeter, Drucker, Wittgenstein...) persuading followers like Friedman to continue the struggle for individual freedom in the form of neoliberalism. Banks adapted, supported lobby organisations, and we ended up with de-regulation, drastic reorganization and growth of banks, and a devastating financial crisis (driven by Greed?). This was not what anyone wanted. How could things go so wrong for banks, again and again? How can we understand this? What is the relation between theory/ideology and practices that effect our life? Big question that could not be answered in a mere essay!

Liberals argued that it was the interventionist state (look what had happened before and during the war!) that was to blame. Street demonstrations were common with confrontation between believers. At the same time academic research had spectacular success. Modernism was breaking through. Scientific methods should be used in designing work processes and investment in new industries with new opportunities now that railways were established. America was the land of opportunity, even if the centre of finance was in London. In Vienna the design of a new Austrian state for the German part of the population was on the agenda. Unified Science with a strict mix of logic (analysis) and facts (empiricism) won adherents (logical empiricism) as religion and superstition were to be kept out of the state. All hopes for the future good society were quashed by emerging nationalism with different orientation in Italy, Russia, and Germany, fired on by the global recession and the Second World War

⁴ The phrase has been attributed to Etienne-Gabriel Morelly (Code of Nature, 1755), but was popularised by Marx (Critique of the Gotha Program, 1851). (Again we see a reference to “Natural Law” (rules that can be deduced from the Bible’s “Golden Rule”) in economic-political debate).

experience. Between the wars arguably the most noticed event (for economists) was the debate between Keynes and Friedman on the role of the state and the priority of unemployment as a target for economic policy. Welfare states would lean towards Keynes, and free marketers toward Friedman.

The centre of the ideological struggle for the primacy of free markets was the Mont Pelerin Society (MPS), a grouping gathered by the Austrian Friedrich von Hayek (1944) in a small Swiss village in 1948 to discuss policy issues for economies in the post war period. Milton Friedman (1962) was a founding member. Membership in MPS is by invitation only and it holds its meetings annually to this day. Hayek and later Friedman came to be the most prominent activists for the freedom of markets. The neoliberal economists never said much about the role of the state (except that it must intervene against those who cheat in defiance of the rules of fair competition), but it is a distinguishing mark of neoliberalism that the state is supposed to serve the interests of the free market for the good of everybody (Mirowski, 2013). This last argument for free markets – that everybody benefits by wealth “seeping down” – has been questioned by Piketty (2014). According to him wealth seems to be “seeping up”. His conclusions have been challenged due to methodological issues. The same fate has happened to Friedman’s seminal work (with Anna Schwartz, 1963) on the relation between inflation/business cycle and money supply, but, in the case of Friedman, the money supply policies he recommended were quietly abandoned by US authorities as the 2008 crisis approached, much depending on the fact that it was increasingly difficult to know what the money supply was. Banks seemed to create money out of thin air (Minsky 1992). Banks certainly have changed their role in society very rapidly after de-regulation in the 1980s and the crisis that followed in 2008, with new demands for regulation as a consequence.

This chapter introduced the idea of ideological influence on banking practices by way of “corporativism” where the centre of gravity of what constitutes good arguments for problem solutions is pushed in the direction of “State”, “Market” and “Community” by events, and discourse on values. The goodness of arguments and solutions will be influenced by how well they are aligned with the current worldview. I will try to interpret how the period of a particular world view tended to push “the centre of gravity”.

It was argued that banks are different from most other organizations in that money is the input, output as well as the measure of success. This is assumed to mean that they will be quite dependent on their external relations, and, thus, eager to observe and interpret their contexts. They will change with their changing contexts.

It was further assumed that arbitrage, the driver of deal making and trade, has changed over time. From a situation when arbitrage offered itself in space (moving things from a low-price location to a high-price one) it has also come to include time (doing things faster), which brings technology to centre stage.

Finally, a short account of the historical developments under study in this essay was given in order to provide a foretaste of what will come next.

2. Greed, arbitrage, and decency in action

Now the review of history through the looking glass provided by writers on historical events, worldviews, practices, and conceptions of citizenship begins. The ambition can only be to hint at patterns that may help us to understand the background to our current bewilderment concerning the finance sector of society. I assume that there will be fractions of earlier practices embedded in our current ones. Like sediments they provide the foundation for our building of better structures to serve human endeavours.

2.1. Greed – the original sin!

For economists greed is equal to our striving to improve our lot and therefore Adam Smith (1776) was right to base his argument for free trade on the effect it has on our activities (truck and barter) towards doing what we are good at and satisfy the rest of our needs in the market. Thereby we all benefit, we find our place in life, and investment is allocated to the most productive projects. Good for us! And the banks serve as intermediaries balancing the deposits of those who have more than they need at the moment, with loans to those who have the best ideas, but lack the funds to realize them. Good for us! So long as the bureaucrats of the State do not regulate by putting their own priorities before our greed it will work too. The State, controlled as it is by vested interests like lobbies, unions, politicians and other do-gooders, cannot take in all the necessary information and do all the calculations to find solutions. Better leave it to the Market, Hayek and Friedman said, because then greed is at its best.

But from the beginning greed was part of Original Sin, and it was assumed to be bad for your afterlife. Jesus told the rich man that the only way to get to heaven was to give all his riches to the poor. That rich man must have been greedy in the first place to amass his wealth. So our conception of greed must have changed for the better? First it was a deadly sin that would bring you to Hell on short notice as we learned from the Scholastics. Purgatory was just a way station that sorted some of the worst sinners out. The rest had a troublesome road ahead with daemons lurking in the bushes. Saints could help, and the prayers of others, if you had given generously to the church (earlier it was a matter of giving directly to the poor, later you could give to the church and the rest would be taken care of). Lending money against interest (ursury) was very bad. In this respect the vast cash flow into the Vatican was a problem for the Pope. He had to engage that money in other business than finance. Mining and trade could be done in partnership with tradesmen. Financing war against the heathens (e.g., crusades) was also a worthy cause. The end of Scholasticism came toward the end of the 16th century as the Salamanca school argued that interest

is in fact a measure of how much the lender had to forego by lending the money to a particular person. In that way the “market” came in to “depersonalize” the fair price, which was previously a negotiated price between individuals. With this “depersonalization” the sinfulness of finance started to wash off, so much the more as large scale war was conducted on credit. The fortunes of banks shifted and their strategies had to be adapted accordingly.

In trying to understand I will start from the age old conception of greed as a deadly sin, which we will pay for in the afterlife, just as a background for the scholastics, who were in the business of teaching people how to conduct their life in order to secure a safe journey to heaven. They were preoccupied with the moral conduct of the individual, and their influence started to fade (at least as far as business goes) as the scholastics managed to “depersonalize” fair prices and interest on loans and make them “market” phenomena.

It seems like greed was looked upon as an “original sin” from the beginning of commentary about proper conduct. It was after you got rich that you needed direction. It was how you can get to Heaven that became the problem then. You have to give all your riches to the poor if you accomplish something that is as difficult as getting a camel through the needle’s eye. The after life was the problem and family could help the soul along by prayer and alms. Gifts to the growing Christian church could mobilize the saints to help it along. It is different today!

Today, post crisis, a new sense of greed as sin has emerged. We have just to contemplate our conversations with the “financial advisors” inhabiting our banks or other intermediaries. Those advisors claim to be able to guide us through the jungle of financial products provided that we answer – honestly – a few questions that will give a measure of our “risk appetite”, and based on that the advisors will give us the right advice (and collect their bonus for good salesmanship). In the process we have signed a piece of paper with a number of paragraphs protecting the adviser from any complaint. The system rewards risk-taking by employees who manage other people’s money, but protects them from sharing the loss when gambles turn bad has come a long way. With each crisis regulators, driven on by public uproar, initiate stronger rules (like the Frank-Dodd act of the USA). But at the same time the financial industry mobilizes lobby forces to slow down implementation. It is a good sign, perhaps, that Goldman Sachs closed down its “high frequency stock market trading” when the practice was exposed (e.g., by Michael Lewis 2014). But it was only after the exposure that Goldman acted, even if it had its governance system.

One of the responses to the critique against big banks that caused the crisis by their reckless risk-taking prior to the crisis, was to produce ethical codes. Brummer (2015, p. 285) points out that *writing* such texts is the easiest thing – they tend to look much like the one constructed by Enron prior to its world famous demise – *living up to it* is the difficult part:

“In 2009 the Goldman Sachs code of business conduct and ethics lauded ‘integrity and honesty’ as being ‘at the heart of our business’. The shrewdest business on Wall Street added the caveat that ‘from time to time the firm may waive certain provisions of this code.’ A year later, in 2010, Goldman Sachs was fined \$ 550 million by the Securities and Exchange Commission for misleading clients.”

Does it all start with Smith’s (1776) premise of people wanting to “improve their lot” through “truck and barter” – probably not – or does it have ancient origins? Was it the neoliberal economists like Hayek and Friedman that made religion out of greed as part of their argument for how a proper society should be designed? Or has it to do with “the ransom of the soul” (Brown, 2015)? It seems the value of greed has changed considerably over time. The current idea of the value of greed – famously promoted (in May 1986) by (later) convicted criminal Ivan Boesky in a speech given at University of California Berkeley Business School: “Greed is all right, by the way, I want you to know that I think greed is healthy. You can be greedy and still feel good about yourself.” (This speech inspired the 1987 film “Wall Street”) – has had a short and disastrous life. Mankind (as we understand it) has always looked differently upon the phenomenon: Thomas ab Aquinas (1225-1274) wrote “Greed is a sin against God, just as all mortal sins, in as much as man condemns things eternal for the sake of temporal things.” Those who repent their sins (their greed) and seek forgiveness will not get away with it easily, however. Dante (in Purgatory) claims that they were bound and laid face down on the ground. It is obvious that the consequences of greed has occupied people’s mind for many centuries. Greed is, according to the Webster’s College Dictionary (2010) “excessive or rapacious desire esp. for wealth and possessions”. We have to start from the beginning.

2.2. An overview of wealth and the afterlife during the first centuries AD (Brown 2015)

It seems like the early Christians saw a distinct link between money/wealth and the afterlife. First there was the dominant idea that martyrs will come instantly into the presence of God. Death and afterlife for the ordinary Christian was of little concern in the 250s AD – and there was not very many of them (Cyprian, the bishop of Carthage, a small congregation wrote early texts at about 250). Tertullian wrote even earlier that after death the souls of the dead live in limbo in wait for Resurrection and the Last Judgment. This view of souls in waiting soon lost currency in Western Christianity. Now the words of Jesus to the Rich Young Man “If you would be perfect, go, sell what you possess and give to the poor, and you will have treasure in heaven” came into focus. But that big,

heroic gesture was not always required, small gifts, alms, would do. The hope was that the Creator would reward mercy with mercy. The living can prepare the way to Heaven by alms. By intercessory prayer the living could also smooth the way for their dead loved ones. Almsgiving became a standard part of funerals. Furthermore, as the catacombs of San Sebastian (south of Rome) show, there were facilities close by the tombs for having a meal – refrigerium – with the dead.

From the third century Christianity gained in importance with the conversion of Constantine (in 312). This meant that, with him, there were rich Christians in the community and the poor came more into focus (while the martyrdom was more or less forgotten as a portal to heaven). With this there was also a sense of difference between souls. Some were on a fast track to Heaven. Augustine (422) introduced doubt again in *Enchiridon*, written like a handbook for Christian laymen. When faced with the questions about to which extent different rituals “worked” his answer was “God only knows”, but in trying to sort things out he would distinguish between the *valde boni* (altogether good), who could be assumed to reach heaven with no difficulty, and the *valde mali* (altogether bad), who were destined for hell). This left the middle group (*non valdes*), which Augustine said could be helped by prayers and offerings provided that they had qualified by living a reasonably good life. Now the church was taking a dominant role in Roman society, a church of *non valdes*. This middle group needed guidance from the scholastics.

3. Scholasticism – guiding individuals to proper use of their free will

Langholm (1998) has sifted through the Middle Ages literature where scholars debate the free will of economic actors participating in exchange of goods and services, including loans, and its limitations. He shows how the scholars taught the official doctrine of the Catholic Church by drawing heavily on the heritage of classical antiquity (Aristotle). The topic in focus was the free will. Sin is voluntary, and scholastic advice aimed to fend off the weakening of that will (“akrasia”). Langholm (1998) introduces his topic by referring to Weber’s (1968/1925) treatment of power in the general sense (“Macht”) and in its particular sense (“Herrschaft”), domination. Domination comes in many forms. Langholm points to two limiting cases in Weber’s development of this topic: *Domination* by virtue of a constellation of interests (particularly monopoly), and *domination* by virtue of authority (power to command, duty to obey).

He argues that Weber is such a good introducer to the topic because of his insistence on putting the concepts “free” and “will” in quotation marks. Those concepts are always relative. It is easy to accept the claim that economic actors in effective markets should be “free” and act “voluntarily”, but what does that mean in practical terms? When is the deviation from the norm large enough to render an exchange or a contract invalid?

The free will can be weakened in several aspects. When it is weakened in one of the parties of a transaction the deal is not fair and thus not valid. Weakness of the will (Greek: akrasia) is at the very centre since Aristotle. It can be caused by *threat/fear*, *ignorance*, or *need*. It is inappropriate to exploit somebody’s *need* for one’s own advantage. This is the reasoning behind the claim that usury (charging interest when lending money) is not permissible. One should not take advantage of a needy person’s lack of money for essentials of life. When it comes to *threat/fear* it is necessary to establish how much intimidation a person should withstand. The Greek and Roman law set the norm by referring to “a man of character” (“vir constans”). If it is reasonable that a “man of character” would not succumb to the actual threat the complaining party has no case. One should also remember that in those days one was pretty tolerant toward power and threat. There was a principle that is present again and again in the literature on business transactions from ancient times up to, possibly, Hobbes, namely that also “forced will is free will”. This principle stems from Aristotle and his example of the captain of a ship in storm who throws cargo over board to save the ship. Was that act voluntary? Yes it was! The example of the captain and the jettisoned cargo, so much used in the literature, is an illustration of the enormous influence of Aristotle over a very long period. The purpose with this illustration, it should be noted, is to show how a compelling force (the storm) combines with a free will (the captain’s decision to jettison cargo) to form “mixed acts” (where

“forced will is will”). This argument was also used by the early liberal economists to promote the ideology of “laissez faire”.

We should note that only citizens could take their case to court in Rome. The slaves and other un-free men had no rights – not to speak of women. Furthermore if the deviation from the just price (on which well informed men of free will could agree as sellers and buyers) is less than 50 percent (plus or minus) there is also no case.

Ignorance also needs to be judged whether it is reasonable as an argument. The Romans recognized that the parties in a deal may have different negotiating skills (accounted for by the margin of error around the “just price” mentioned above).

We can see in accounts, like Langholm’s (1998), for the ideas of a fair deal that greed was taken more or less for granted. Focus was on the fairness of a deal between two persons and its regulation. The fairness had to do with ethical deliberations of the involved parties, as individuals. Things started to change with the Scholastics, but the discourse on business still was a matter of the sinfulness of unfair deals. The general problem was rather what the greedy person should do when he became rich (give direct to the poor, later via the church, to expiate his sins).

For St. Augustine the free will was the cause of sin, there is simply no way to sin except voluntarily. Again, then, what sins may be forgiven because they are involuntary? Only those caused by ignorance? Forced will is will.

Against the background of Aristototele, Roman law, and St Augustine, the scholastics with their centre in Paris prepared the way for modern economics via mercantilism in their preoccupation with moral instruction of Christians. The argument against usury followed several lines:

- The usurer sells time (time belongs to God)
- The ownership of the money passes to the borrower and any gain from the loan thus belongs to him (taking usury is therefore robbery).
- Money is consumed in use and therefore has no value separate from its use
- Money is sterile, i.e., it is a fungible, and therefore has no value beyond its substance.

The argument that the borrower pays interest voluntarily is dismissed on the basis that the borrower is under compulsion via his need. The question whether it was also a sin to *pay* usury came up also in relation to commercial capital. It seems like most authors argued that if the borrower had no other financing of trade and had no other source of income it was permissible to borrow trade capital against interest.

The scholastic doctrine concerning usury started to brake down in the 16th century with the argument of the Salamancan scholars, first Molina and later de

Lugo, who argued that what the lender sacrifices by lending the money is what he could have earned by investing it otherwise – i.e., interest is a (opportunity) cost. The latter (de Lugo) stressed that the most important aspect was that contracts must be kept whatever the terms. Thereby he foreshadowed Thomas Hobbes, the staunch anti-Aristotelian. Dealing with the justice of contracts required an authority that could hear the arguments – a Sovereign arbiter – the state.

Concerning the idea of a just price the scholastics had to fight a drawn-out war against a new approach of the opposition from the late 13th century (Langholm, 1998, Chapter 5 and 6). This new approach stressed ownership (“Anyone is the moderator and arbiter of his own thing” (quoted from Emperor Constantine’s ordinance) combined with the maxim “A thing is worth as much as it can be sold for”. Together these maxims eliminate “morality” from the discussion (and thereby the idea of “just price”) and, at the same time, they legitimize the use of economic power. Henry of Ghent led the way by arguing that the solution here was to rewrite the maxim’s substituting “can” (be sold for) in stead of “ought to” and others added various general conditions characterizing a fair price like, “maintained equality between buyer and seller”, “just and reasonable”, “without fraud” etc. But it was still unjust to exploit the “need” of an individual. Gradually the market was introduced as “the common need” (*indigentia communis*) of those who can exchange with each other. Langholm (1998, p. 86ff) discusses this gradual establishment of the market as the reference point by giving accounts of current controversies concerning the “common estimate” of the market and how it should be understood. The market price in a market that functions normally is uncontroversial, but what about the often overlooked situation when conditions are not normal? Speculation, price discrimination, collusion and monopoly are conditions that are taken up here.

Speculation in foodstuff is generally rejected (albeit the prudent man who gather reserves for emergencies, may sell surplus at the market price), but otherwise various forms of lawful exchange were condoned. The catchword for illegal exchange came to be “inducing dearth”, which was not acceptable. Price discrimination, for instance in the form of charging visitors more than villagers was prohibited in a capitulary by Carloman, King of the West Franks, in 884, and this was subject to scholastic comment. In time there was a distinction between necessities and luxuries. The latter kind was seen to be worth whatever the seller could extort from the buyer (short of fraud and force).

The scholastic literature on monopoly rested on two pillars; the story (in Politics by Aristotle) about the philosopher Thales, who was expelled from Syracuse for renting all olive presses from Miletus and Chois to let them out at a large profit when the season arrived. This was for a while interpreted as the philosopher wanting to show that philosophers could also become businessmen if they wanted to, but Albert the Great argued that what Thales did was harmful to society. That is why monopolies were prohibited by law (Emperor Zeno’s decree from 483). In time the school of Salamanca modified the ruling on just

price, in the words of Soto, to “A thing is worth as much as it can be sold for in the absence of monopoly, fraud and deceit.”

The consequence of these developments was the reestablishment of the principle that the owner can dispose of his property at will and the primacy of the principle that justice is based on contracts being kept (whatever their content). This meant that the scholastic paradigm was in effect undermined. Taking the “common estimate” as the measure of a just price meant that the just price had been “depersonalized”. Now the abstract phenomena of supply and demand were in focus rather than the subjective responsibility of persons (as sellers or buyers).

There was, we must remind us, an undercurrent of viewing exchange as something of mutual benefit through the scholastic literature, Scotus goes as far as emphasising that there is an element of mutual gift between the parties. Prices may vary on the basis of what the parties agree to. Still there was the problem of compulsion, exploitation of need, and deceit on both sides that may limit the justice of an exchange. The discussion on the just price and the weakening of the will went on until arguments - similar to the ones Lugo presented later - on usury emerged with Cajetan’s commentary on Aquinas. Cajetan argued that the dilemma of compulsion can only be resolved by distinguishing between “causa”, i.e., the motivation that prompts a person to agreement, and “modus”, i.e., the circumstances under which the exchange comes about (auction, through middlemen). A person who offers to sell something must expect to get a lower price than the person who is approached by somebody with an offer. The just price should be based in “modus” rather than in “causa”. This allows for a wider range of variation in prices (It seemingly brings “arbitrage” into play.) Cajetan’s reasoning won support, not least in the Salamanca school. This represents a further step toward “de-personalization” of economic ethics (Langholm, 1998, p.116).

After devoting a chapter to the price of labour (wages), which is generally accepted to be different than the price of goods, because the person seeking employment is at a disadvantage, Langholm arrives at the antithesis of scholasticism in the form of Hobbes’ argument.

Hobbes antithesis

Thomas Hobbes (1588 – 1679) provided the argument for “possessive individualism” even if he did not intend to. There are many interpretations of the Hobbes oeuvre, among them the Taylor- Warrender thesis (cf Murray, 1997). The debate on the proper interpretation is still on. Langholm (1998) brings out a reading that ties in with the development of classical economics:

In the pre-societal condition of Nature – everybody’s war against everybody - the individual is guided by one feeling, fear. In such a situation reason compels the individual to seek peace. The key then is to keep, always, covenant (contract) - to build peace by being trustworthy. Justice becomes the keeping of contract

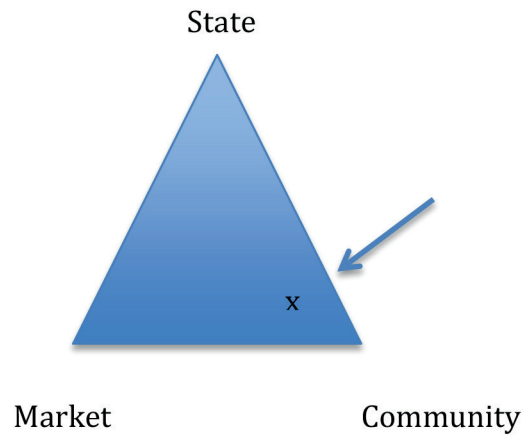
(The individual is bound by contract, only the Sovereign can release him from it). As the “social contract” is established the Sovereign authority (the state) may enact any law it pleases and decide on any quarrel between members. The problem, then, is what is the relation between Natural Law (derived by the individual from The Golden Rule, and reason) and the regulation by Sovereign Law? It is after all the duty of all members to obey the Sovereign Law. When the individual is free to pursue gain by contract, that pursuit will sometimes conflict with Natural Law. Hobbes solves this by distinguishing between Justice (according to Law) and Charity (according to conscience). Charity is the duty to participate in distribution of gain/profit to the poor. But charity cannot, by definition, be regulated by Sovereign Law. It is associated with a function or activity, like almsgiving. It is the virtue by which we share our surpluses. If the Law compels us to give it is no longer charity.

Hobbes thus “stripped justice of all relationship with economic contracts” (Langholm, 1998, p. 156) and thereby cleared the way for classic economics. When the market is closed there is only charity.

Summary of Scholasticism and what it means for banking

Scholasticism was preoccupied, as far as economic thought goes, with the regulation of self-interested exercise of bargaining power. Their theoretical basis was Natural Law defined by, e.g., Gratian “that which is contained in the Scriptures and the Gospels, by which anyone is commanded to do to others what he would have done to himself...” (Langholm, 1998, p. 162). The Natural Law gives rise to certain rights, which were articulated rather late especially by members of the Salamanca school, like Francisco Suárez, to mean two different things: the right to claim (or moral power), e.g., wage for labour, and the right to property. The idea of property rights points forward to John Locke (1632 – 1704), who, in his *Two Treatises of Government* (1689) argues that the purpose of government is to preserve property. Langholm points out that Locke’s argument is not so much a matter of protecting the weak against the strong but rather protecting the latter against interference from the government. But this was in response to Mercantilism, which will be dealt with later on. First consider what banking would be under the regime of scholasticism:

Figure 3:



Banking under scholasticism is relational. The primary asset is the banker's good name. Banking consisted of a set of individual deals. Transactions are always between individuals, who are under the Divine obligation not to exploit akrasia by using Threat, Ignorance and Need. The morality of individuals, governed by their Free Will, was upheld for a very long time as Christianity grew stronger, and the Church came to take a dominating part (but it also did some lucrative deals with banks). Risks stemmed from robbery and piracy, but also increasingly from princes. Medici and Fugger are examples.

4. The most prominent banks – watched by the scholastics

Banks, recognizable to us as such, really came after scholasticism. That is from the 17th century, when Bank of England 1694, Bank of Scotland 1695, and in 1656 “Palmstruchska Banken”, the Bank of Sweden to be, were founded. Those “central banks” were set up, mainly, to serve the state. Earlier banks were sidelines for merchant families mainly involved in trade. The word “banks” referred to the so-called public benches of charitable institutions, which arose in Naples in the 16th century and onwards. Notable here, in Naples, is a pawn shop “Tour of Mercy” founded in 1539, which claimed to lend without interest and which opened a case of deposits in 1584, recognized by the viceroy of Naples that same year. The ban on usury was strong and relatively strictly enforced. You had to be clever, and engaged in trade to earn money from banking.

4.1. Medici

“The rise and decline of the Medici Bank”, by de Roover (1963), is a classic in business history and is focused on and based in archival work. The institutional background (e.g. usury, the money-changers guild, catasto (income return for taxation)), the antecedents to the starting of the bank, the glorious days of Medici under Cosimo’s directorship, and the organization of the bank are described. This first section is followed by a description of the money market of the times (bills of exchange), the Medici as Merchants (alum and iron), and as industrialists (wool and silk), and as bankers to the Pope. Three chapters are devoted to the different branches throughout Italy and Europe. A final chapter tells the story of the decline of the Medici bank.

Institutional background

From the Crusades to the Great Discoveries Italy was the dominant economic power in the western world. Merchants were the middlemen of spices from the Levant, silk, cloth, wool. Banking prospered with trade since the transfer of payment for goods best was accomplished through bills of exchange (transporting money over land or sea was risky). In bank-dense Florence and some other centres there even was a market for those financial instruments. The Italians were good at organizing business in partnerships (the Medici bank was organized as a holding company), they had double entry book-keeping, and introduced what could be seen as insurance for marine transports. They developed a body of mercantile law. The Florentine were global businesses with as many as 90 employees in branches across Europe. The Medici bank is remarkable because of its good archive; up to 1450 there is an unbroken series of

account books (confidential ledgers). After 1450 the material is largely business correspondence. The Medicis are known for their role in art and politics as well. As a matter of fact it seems like their politics was the cause of the decline of the bank.

The institutional background to consider is the problem that the Church forbade the taking of interest (usury). The banks solved this by focusing the business on Bills of Exchange (sometimes “dry”, i.e., without any goods transaction behind it). Fees were included and profit from differences in exchange prices of currencies (The Florin was higher valued in relation to the pound in Florence than it was in London). A permanent problem throughout was the unbalanced trade (from Italy to Northern Europe, plus the flow of payments to the Vatican).

As bankers The Medici had to be members of the Money-changers’ Guild, but de Roover notes that the regulatory power of the Guild was rather limited and it did not interfere much in daily business.

There was a direct tax in Florence based on individual tax returns (catasto), which incentivized against overvaluation of assets.

The global firm of the 15th century

The Medici bank, like many of its competitors, had branches in many centres of commerce across Europa. From a modest beginning in Italy (branches in Florence, Rome, Naples, Venice) in the early 1400s it expanded to 13 businesses in 1450 (branches in Ancona, Avignon, Basel, Bruges, London (subordinated to Bruges), Florence, Geneva, Pisa, Rome, Venice, and in addition wool shops 1 and 2, and a silk shop in Florence). The executive managers of the different branches were usually co-owners, and their duties were regulated in detail in management contracts for up to 5 years (which could be terminated by the principals (maggiori) at any time). It was quite common that the branch managers had a share in profits (and losses) that was substantially larger than their ownership share. A “factor” was a manager who was authorized to enter binding deals for the firm. It was not the signature alone, but the whole text of a Bill of Exchange, that had to be written in the factor’s hand to make it valid. A factor could be promoted to partner (invest his own money in the branch) and employees were groomed by being sent to different branches to learn the business. Employment was closely monitored by the principals and was largely based on family and trust. The legendary Cosimo was not sentimental about dismissing non-performing managers, but his successors seem to have been too tolerant for the good of the firm, which contributed to the fall of the bank. In cities where Medici had no branch of their own they did business through representatives or silent partnerships.

The Rome branch was somewhat different from the other branches in that it was run without capital. This was a result of the flow of funds in this century, inward toward the pope, and of the fact that members of the Vatican court

deposited money with the bank (against other remuneration than interest, of course).

As mentioned the instrument on which most of the banking business was built was the bill of exchange. The basic value of this financial instrument was that it was a much safer way of transporting payments across Europe (land or sea). For this to function smoothly there had to be a money market that could liquidate such instruments (and provide for some trade credit). The power of the Italian banks in Europe came from this money market effect – there were several dozens of banks in Florence at the time. The Hansa League had, according to de Roover (1963), a much clumsier and slower way of dealing with payments and could not compete in Western Europe (except, perhaps, in London).

Trade was the very reason for doing banking business. As mentioned, Medici had two wool shops and one silk shop during most of its lifetime. One could see that good management made a difference by comparing the two wool shops in Florence. The best wool was imported from Britain, which was difficult business since the King of England would control the trade and collect custom fees (or borrow money on the promise for the lender to collect fees during a certain period). The Medicis also had trade in materials like alum, which was used to clean wool. However, contracts with the pope to secure monopoly in providing alum (sometimes threatened by the Turks) did not work out so well. Political games were frequent around trade. The most dramatic, and one reason for the decline of the bank, was the ill-conceived strategies of its representative in Brügge, Portinari (who had intrigued his way to the top there). The issue of appointing Portinari to manager in Brügge came up in 1464, the year Cosimo died. The contract with him was written by Piero (Cosimo's elder son) in 1465. Both of them hesitated because they considered Pontinari too reckless in business. Once installed he ventured into projects like buying the rights to the toll on wool at Gravelines (bordering on the English enclave of Calais) hoping to collect on all import to the Low Countries now that the Duke of Burgundy had banned all English cloth from his dominions. Unfortunately he did not include English counter measures in his calculations. Volumes were much too small to justify the deal. Furthermore he persuaded the Medici to buy two Burgundian galleys, which constituted surplus material from the Burgundian fleet now that the crusade against the Turks did not materialise due to the death of the pope (Pius II). Those galleys were costly and difficult to fill with cargo both ways as required for profitability. Brügge and its relation to London became a constant problem to the maggiori, even if its money market worked due to the presence of other Italian banks.

The decline

During Cosimo's reign the Medici policy was to avoid lending money to princes⁵, or to the court (the state as it were) because princes often had no intention of repaying. Still Cosimo was not foreign to use his financial resources politically. He even avoided a death sentence by bribes, but was expelled from Florence in 1433, when his enemy Rinaldo degli Albizzi had him arrested and argued for execution – only to be called back a year later. Florence was involved in complex and shifting alliances and wars at the time (Machiavelli, 2010).

When Cosimo died in 1464 the Medici bank was already past its prime. His older son Piero had been trained in politics rather than banking. Machiavelli (2010) claims that Piero caused discontent and many business failures by calling many outstanding loans. De Roover (1963) points out that the truth of the matter was that Piero, when assuming the role of principal, initiated an audit to see what state the business was in, and that this audit revealed that the bank was in poor condition. He therefore took steps to close down the Venice branch that was unprofitable, and he sent Tani to try to solve the London problem by negotiating a deal with Edward IV. He also ordered the Milan branch to reduce its loans to the Sforza court. Still de Roover maintains that it is doubtful whether the retrenchment of the Medici bank was the cause of “the epidemic of bankruptcies which broke out in Florence shortly after Cosimo's death” (p. 359). It was rather that many of the firms that went bankrupt had business commitments in the Levant, which were cut off with the war between Venice and the Sultan between 1463 and 1479.

There was more to come. Piero died already in 1469, and was succeeded by his sons Lorenzo and Giuliano, 21 and 18 years of age, who necessarily became dependent of their father's advisors. Lorenzo soon developed into a gifted politician, but was not interested in banking. He relied completely on Francesco Sassetti, a long term employee, who became the real manager at the headquarters. Due to Sassetti's policy of allowing branch managers too much room for extravagant manoeuvres the “maggiori” lost control of the Medici group and mismanagement in some branches was allowed to go on for too long. The Brügge branch and Portinari has been mentioned above (his brother Pigello was not much better as manager in Milan as he got entangled in ever increasing loans to the Sforza court). The other cause of decline was the Lyon debacle of Lionetto de' Rossi.

Up to 1463 the leading trade fair for merchants had been Geneva, but that year the French king Louis XI issued a decree that exempted all merchants that came to Lyon from toll. This turned out to be an effective incentive. Medici's Geneva branch moved to Lyon in 1466 to be where the business was. The name

⁵ Possibly under the influence of the saying from Ecclesiasticus (Quoted from Ehrenberg 1928): “Noli foenerari fortiori te, quod si foeneravis, quasi perditum habe” (Lend not to him who is mightier than thou; or if thou lendest, look upon thy loan as lost).

of the branch became Francesco Sasseti & Co (although the Medici provided 66 percent of the capital). At first the Lyons branch was successful, but soon the first branch manager was expelled from France (for supporting enemies of the King). The second managers died within a year, and the third manager, appointed in 1470, was the infamous Lionetto de' Rossi, who had been a factor with the branch (first in Geneva and then in Lyon) since 1453. The first sign of problem appeared in 1476 when headquarters complained that the balance sheet submitted by Rossi was "too full of slow debtors and stocks of merchandise". An intervention from Leonardo made Lionetto promise to mend his ways, but soon, by 1480, the balance sheet showed a loss and Medici's agent in Montpellier (Lorenzo Spinelli) was sent to investigate. Rossi did not like Spinelli's spying on him. In 1482 Rossi sent two balance sheets, one to Sasseti and one to Lorenzo (this one with lots of explaining text). Rossi claimed that business had picked up and the future looked bright. He had managed to collect a lot of bad debts and build reserves. The letter to Lorenzo contained a number of accusations against Sasseti. The real problem was that Rossi had come into the habit of drawing on the Rome branch for payments but fail to remit promptly. Rome complained but matters soured when that branch refused to honour a draft by a French merchant on the Lyon branch. Another set of accounts sent in 1484 claimed that the Lyon branch was now free of bad debts and generated a profit. Spinelli was sent to investigate again and found Rossi "out of his senses". Lorenzo, trying to mediate, called Rossi to Florence for a conference. Rossi took his time to set out on the trip. When he arrived, months after being called, he was put in the debtors' jail. An audit of the books showed manipulation and a frightening loss. Spinelli was persuaded to take over and clear things up, which was a formidable task since "the maggiori" were slow to provide fresh capital at the same time as they insisted on reducing debt. Turnaround by entrenchment is not an easy task. Sasseti, who had a(-n arrogant) son at the Lyon branch, promised to stay on as manager at headquarters until the mess was cleared up. He visited the branch from May 1488 and found improvement and helped restore confidence. His departure back to Florence was delayed for different reasons. A new management contract was set up in February 1489, but Sasseti died soon after his return, in March 1490. Soon Lorenzo de Medici also died and the entire Lyon branch was expelled from France as a result of new hostilities between the French king and Florence. After the failure of war efforts by the king, Spinelli and staff returned to Lyon, but were unable to run a profitable business without capital.

The fate of the Lyon branch illustrates how accounting fraud undermines trust and how difficult it is to re-establish trust by the new regime when there is insufficient capital infusion.

Lorenzo Medici devoted his energy to try to save the bank from 1478 until 1494 when the Medici rule of the City of Florence was overthrown and all the Medici property seized. Giovanni Tornabuoni and his son were charged with continuing to run the bank but without capital it soon perished.

It should be mentioned, to illustrate business conditions of the time, that the Pazzi bank, probably the second largest bank in Florence, saw what trouble the Medici bank was in. Was it heading toward bankruptcy or did it need a push? The Pazzi conspiracy was based in the idea that by toppling the bank one could also remove the Medicis from political power. There was an attempt to assassinate the two Medici brothers (Lorenzo and Giuliano) in a church in April 1478. Giuliano was murdered but Lorenzo escaped with his life... It might be claimed that politics as well as lack of internal loyalty killed the Medici bank. It simply was unable to uphold all its relations to keep its good name.

Learning from Medici

The Medici bank was run on trust and good book-keeping with trusted branches given much leeway during the growth period under Cosimo. Growth was incentivized by the agents' participation in the capital of the branch, and profit sharing contracts. Cosimo was a strong-willed and watchful "maggiore". He had a co-manager (Benci) who matched him in diligence. Lorenzo de Medici had a co-manager too (Sasseti), but did not pay much attention to banking during the first decade of his reign. When the centre was weakened (and local contexts got more dynamic) local risk-taking by branches brought the bank down (cheating in accounting delayed corrections).

A key to success for Cosimo seems to have been his careful selection of trusted branch managers and a watchful central eye on branch performance. The decline was driven by local agents immersion in local political opportunism. The control system (with its incentives for local growth) could not work "control at a distance" under the emerging circumstances as agents betrayed trust.

The lack of loyalty of some branch managers (Portinari and de' Rossi committed accounting fraud) combined with their increasing delight in granting favours to princes, made the bank vulnerable to declines in business that followed from the war between Venice and the Sultan.

4.2. Fugger

The successor to Medici as, arguably, the most prominent bank in Europe, seems to have been Fugger of Augsburg. This family had a different business model from the very start in that it quite early focused on lending to kings and governments, extracting in return interests in mining and farming, primarily from the Habsburg family of kings and princes. The Fugger banking business was dismantled after a drawn out decline at the end of the Thirty Years War (ending with the peace treaty of Westphalia in 1648).

Ehrenberg (1928) finds it necessary to give an account of the different kinds of credits that existed in order to give a proper view of the fortunes of the Fugger family and its problems, chiefly stemming from their strong commitment to support the Habsburgs and their wars. It is necessary to gain some insight into

the intricacies of public debt (nowadays known as "sovereign" debt) to see how Fugger got entangled. A special creditworthiness attached to the free cities at the time, since citizens could be called upon to pay if the city failed. At the other end of the scale were princes, who, with their longing for glory and war, usually never intended to pay back. Instead they had a tendency to threaten that if the creditor did not extend further credit the existing credit would be lost, or in other ways ("forced loans"). A contract was set up with the creditor to receive payment via the income from estates, mines, tax collection over a certain period. The problem with this "farming out" of income streams was that the creditor often did not know to what extent they had already been mortgaged. One had to try to maintain the goodwill of the prince so that one's contract could receive preferential treatment ("senior debt", as it were) if cash happens to be scarce at the time of maturity. And one had to be well informed about developments at the court.

It was the wars - particularly the payment of soldiers, who would ransack the place where they happened to be when contracted pay failed or go over to the other side – that drained the princes' coffers. No prince could afford to keep permanent forces of any size, so mercenary soldiers were hired periodically. This made princes rather desperate for cash at times. Cities and their guilds were common targets for extracting cash for war. Merchants were known to have streams of cash flowing in and out of their business. They also knew how to use financial instruments to lay their hands on cash in places like Antwerp or Brügge. Guilds were stable organizations to deal with. Merchants primarily had their good name as a primary sign of creditworthiness. The Church with its steady cash flow, and its preaching against usury, was a frequent business partner to merchants, making deals that contained great many synonyms for interest.

The Fugger house was brought down by committing too much of its resources to sovereign debt. Ehrenberg (1928) gives a short version of all the complexities of the greatest bank of the 16th century:

The first Fugger, Hans, came to Augsburg in 1367. He was a weaver, but also did some trading. Soon after his arrival the Guilds of Augsburg obtained a share of the management of the city. The two most prominent guilds, the weavers and the merchants, prospered from this. Hans also did well and left his two sons, Jakob and Andreas, in a good position. Jakob was already Master of the Weavers' Guild when Hans died, although he had given up weaving. Fugger trade was, like that of other Augsburg merchants, oriented toward Venice (spices, silk and woollen materials). Andreas did even better, marrying into an old family to start his own branch of the family, Fugger vom Reh, which prospered and expanded into links with the Netherlands and Leipzig. The Fugger vom Reh soon lost heavily on bad debts, sunk further in respect, and had, in time, to seek employment with their cousins, the Fugger of the Lilies. The more modest son, Jakob, married the daughter of the Master of the Augsburg Mint. He managed to fend off the imminent bankruptcy of his father-in-law by guaranteeing the debt.

The father-in-law then went on to become Master of Mint again, now in Hall. Thereby Jakob found connections with the Tyrol mining industry. Jakob's son, Jakob II, was sent for training to merchant in Venice, already at the age of 14 (even though he had first been intended for the church). He conducted business together with his two surviving uncles, and reached an agreement that their male heirs and descendants should leave property in common in the business in order to keep the business intact, but that daughters should be given money in dowries. This principle was adhered to as long as the Fugger house prospered. It was given up after the house had suffered losses on bad debts in connection with the war of Schmalkalden (1546-47). Even if Ulrich Fugger had a successful business deal with the Emperor (Fredrick III) to provide silk and clothing for his son Maximilian as he went to Trier to negotiate a marriage in 1473, it was Jakob II who set the Fugger house on course to success in 1487. He lent money to the Archduke of Tyrol against security in Tyrol silver mines. A still larger loan the next year established Fugger in the mining business. Copper was added in a similar manner, and syndicates were formed to control the copper market in Venice, and shipping organized via Danzig to Antwerp. As the Archduke of Tyrol handed over the government of Tyrol to Maximilian I in 1490, the stage was set for intensified financial relations between the Hapsburgs and the Fugger house. This relation developed over the years and consisted chiefly in Fugger giving loans to the Habsburg princes and Emperors against security in farmland, mines, and cash flows. This, of course, provided opportunities for trade, which was the main occupation of the house.

The relation between the King Maximilian I and the merchants in Augsburg were quite strained at times, and the King considered resorting to "forced loans" but negotiations lead to a large (voluntary) loan, most of it carried by Fugger. The situation grew evermore complicated as the merchants (and some cities) were targeted for credits again and again. They often had to borrow themselves to muster the cash required. Fugger also served as an intermediary for English subsidies to Maximilian.

Fugger had complex business with the Vatican, as well. The branch in Rome served several "princes of the church" with contracts carefully avoiding the word "interest". For instance they helped the new Archbishop of Brandenburg, Albrecht, with a loan to pay the Vatican for his appointment.

The most complex business at this time (1517), no doubt, was supporting the election of Charles V as Holy Roman Emperor. Charles was heir to three dynasties, Habsburg (Austria), Valois-Burgundy (Burgundian Netherlands and Franche-Comté), and Trastámara (Castile and Aragon). To win the election a large number of electors needed to be persuaded by money transfers, which drained the cash from Fugger, who had built a strong relation with Charles, via transfers from Antwerp to Madrid. With Charles V, as King of Spain the strain on the finances of Fugger continued as Charles had difficulties to extract money taxing the Spanish people to repay loans. Furthermore, the counter-reformation

(to combat the proliferation of Protestantism; Luther had nailed his theses in 1517) was managed from Spain as Loyola launched his Jesuit mission to reconquer the souls of Europe. Possibly, the worst consequence of the election, however, was that Charles gained a strong enemy in his, then, competitor for the post, King Francis of France. The complexity of the Fugger business is already overwhelming.

Jacob Fugger died in 1526 after having run the company since 1511, and nominated Anton as his successor in his will. Anton adopted a cautious policy the first few years. But as the threats from the Turks as well as the war with France ebbed and flowed the Fugger house found itself drawn into financing the Emperor's wars again. In the 1530s the capital of the Fugger house stagnated. The period of the war of Schmalkalden (1546-47) turned out to become the turning point for Fugger. In 1546 the Emperor decided to make war on the Protestants and mobilized money for the purpose. The Protestants were defeated but the continued resistance from them could not be suppressed by force and in 1555 the Peace of Augsburg officially recognize Protestantism as a legitimate religion. In the meantime Fugger had, faithful to the Emperor, provided finance to the Catholic side. This upset other merchants in Augsburg, who were on the side of the Schmalkaldian League (the protestants). At this time (1547) letters show that Anton seriously considered giving up the Fugger business. Anton Fugger, in low spirits and poor health, had found that none of his nephews was willing to take over, so it was agreed to liquidate it all. This was not easy however; Anton says in his will (Ehrenberg, 1928, p. 104): "On account of long wars, matters have gone right heavily, so that not only are we unable to bring our own business to an end and collect the monies owing to us, but we have been constrained, in order to serve the Emperor and the King, to make fresh loans, ourselves borrowing money and getting into debt."

Charles V, was in financial trouble again, and had turned to Fugger in his desperate need. Fugger used the Antwerp money market to raise money to save Charles, further increasing already impaired debt. In October 1555, Charles handed over the Netherlands to his son Philip including untenable finances. Again Fugger house had to advance further loans through its agent Matthew Oertel, and took over guarantees. In 1557 the Antwerp office went into crisis as King Philip ordered payments on government debt to be stopped. Oertel pleaded with the King pointing to all the years of faithful service. This came to nothing. Fugger's decline started to accelerate. In 1560 Anton Fugger died leaving the business to Hans Jakob and his three sons. Quarrel between the heirs, and mismanagement, did not help. The Spanish debt refused to come down. All that could be accomplished through three state bankruptcies for Spain was a moratorium and promises of future payments (in view of the great services to the King). Still other business continued up to the middle of the 17th century. What remained then was large areas of farmland that had been devastated during the 30 years' war.

Learning from Fugger

It is difficult to understand how the Fugger house became so entrapped in (financially) unhappy relations with princes, especially the Hapsburgs. How did it all begin? Why did they not stop? The decline of Fugger happened during the period building up to the 30 years' war. Researchers still disagree about the causes of that war (Steensgaard 1969/70, Braudel 1978). At the time when it is generally said to have started, in 1618 with the “defenetering” (throwing them out of the window of the Hradschin castle – miraculously they survived landing in a dung heap) of diplomats in Prague, there had already been dispersed wars and conflicts for several decades, as princes and dukes tried to position themselves to gain from the conflict. The Fugger house lived through the prelude to this most devastating of wars⁶ and they must have seen what was coming, devoted as they were to serve the Emperor. Steensgaard (1969/70) proposes that this war was driven by a process of building a State on many hands in parallel. Harrison (2014) discusses the formation of the “pre-modern state”. The old feudal system, with allegiance to the Prince in return for protection, was giving way, over a century, to an administrative state with a bureaucracy effective enough to collect revenues from taxes and tolls, to support a much more costly state (including standing armies). As creditor in this complex context you needed to bet on the right horse. It was the merchants who could provide credit against contracted concessions, like the right to collect revenues from the silver mines in Tyrol, for a number of years. Credit for trade concessions from the state was under development as a strategy for merchant houses. But giving credit to Princes still had the attached risk of credit loss. There was little in terms of safety nets except good relations. (Like Hobbes described; in the State of Nature - everybody's fight against everybody - the right strategy is to seek peace in terms of good relations).

We can also see that beside the already existing money market in Florence, where Bills of Exchange could be liquidated, a new market had emerged in Antwerp during Fugger time, and in Brügge. Again this was generated by the presence of Italian bank agents. But the good name of the Fugger house also was its curse as it was driven into deeper trouble by its good name. Instead of serving as intermediary to the money market Fugger had to take loans on its own books and then lend to the Hapsburgs. The Fugger had the good name that princes did not. One is reminded of the words in the Book of Ecclesiasticus mentioned above on p 3 about not lending money to someone “mightier than thou”. Now the (pre-modern) state was emerging as a significant actor and Fugger did not have the creative power to invent a less risky role as intermediary to the money markets. With the State beginning to be seen as the “manager” of the nation the flow of money and precious metals in and out of the country would become an urgent topic.

⁶ In 1962 citizens of Hessen responded to a survey concerning the most devastating events for Germany ranking the 30 Years' War as the worst, before the two World Wars (Wolke et al, 2006, p.9)

5. Mercantilism – the origins of political economy and, consequently, of economic policy

Magnusson (1999) is focused on how mercantilism and its ideas were coloured by historical events and how explanations to the then current economic plights gradually paved the way for understanding the economy as a system that could be subjected to interventions by governments to enhance performance.

Magnusson (1999) points out that what we call “mercantilism” really is a series of somewhat related policy debates contained in a very large number of pamphlets and brochures - Schumpeter (1973) called the writers collectively as “government consultants” - that started with the severe economic crisis of England in 1620.

The problem then was that “the old drapery” (broadcloth, made from wool) produced and exported by England, was overtaken and virtually wiped out by a lighter cloth “the new drapery” (calico, made from cotton) provided by Holland. It was a devastating blow to the economy. Unemployment in this dominating industry grew very rapidly. Investigative commissions were established and a vast literature on the causes and remedies emerged.

First it was a lack of money that was seen as the cause – the East India Company exported a lot of money and precious metals, didn't they. Later a balance of trade discourse emerged. There was also a debate on the employment effects of trade.

Magnusson (1999, see also 1994) argues that these debates produced a common language (“langue”), even if the different authors presented different arguments (“parole”), rather than a conceptually homogeneous worldview. The label “mercantilism” marks the “langue” of economic policy in Europe during the period from the dissolution of the medieval guild and trade organization to the time of the laissez-faire doctrine. Later writers, like Adam Smith (1776), are keen to portrait the “mercantilists” as irrational believers in regulation and sovereign power, but it seems more rational to look upon them as pragmatists trying to device solutions to the problems of the day. Most of the arguments used by Adam Smith had already been presented by other authors. It was the combination of arguments that rendered Smith's text on trade forceful – Magnusson even points out that it is doubtful whether Smith was a free-trader at all. He supported the Navigation Act (the 1651 Parliamentary Act that ruled that all imported goods (including fish) had to be brought by English ships). It was the Dutch that were in focus of the debate, they were capturing all the fish in the North Sea, and they had built a trading empire. Holland was described by one of the writers (Mun, 1655) as the warehouse of “many places of Christianity” with some envy. How could they build such riches without manufacturing anything? One should remember that from 1652 (the year after the Navigation Act, and a few years after the peace treaty of Westphalia) until 1713 England was more

or less constantly at war (three times with Holland, twice with France, twice with Spain), which may explain the intensity and diversity of arguments. Still Mercantilism is an important steppingstone for the development of classical economics and banking. Some of the arguments were recycled in the debates in the 1930s around Keynes' proposals.

Heckscher (1931), in his magnum opus, described mercantilism as just another phase in the development of economic policy. It had little to do with the economic realities of the time. As before it was a matter of strengthening the power of the state to interfere with economic development. What was new was the means used to further this goal. He made the will to control visible (in opposition to the self-regulation argued by liberals). Viner (1937) tried to understand mercantilism from the perspective of modern theories in the trade area. He comes out in support of Adam Smith's presentation of mercantilism as regulation being the result of lobby from *special interests*. Schumpeter (1954) argues along the same lines. Mercantilism can only be understood as rational if seen as promotion of special interests. Keynes (1936) pointed out that early economists -those active in the time of mercantilism - have been mistreated by the classical school. What we should learn from mercantilism is that an upsurge under *laissez-faire* will be broken by *inadequate new investment* (that is why the state has to interfere to uphold employment).

Magnusson (1999) brings out some of the strands in this colourful tapestry: An early actor was Gerard de Malynes, a "monetarist", who argued that the cause of the troubles was the unfair exchange rate, caused by a conspiracy of foreign bankers and currency traders. By forcing the rate down they made it necessary for British merchants to sell their wares prematurely at low prices in foreign markets since they had to pay their bills of trade. The solution was strong regulation to uphold a *par pro pari* exchange rate (exchange only in accordance with our money's real, inherent value). Thomas Mun was another contributor, and director of the East India Company from 1615. His company had been accused of exporting money from the country and that this was the cause of the depression. Besides defending the East India Company (it generated many jobs in Britain) Mun argued that a nation must export more than it imports. This, in turn, will generate money flows, which, if we use it for further trade, will increase the capital assets of society. The state needs to promote the export of manufactured goods and the import of raw material. He is especially aggressive toward the Dutch dominance of the fish trade.

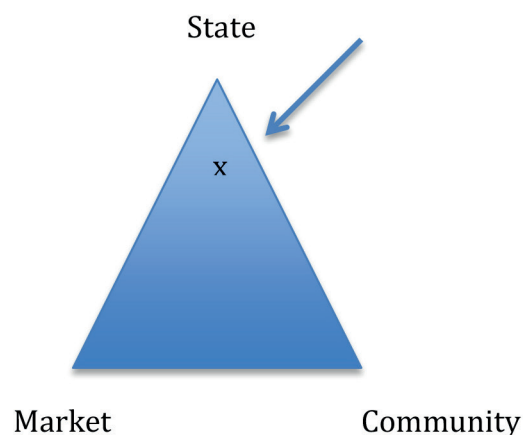
This articulated the "balance of trade"-aspect of mercantilism. Similar debates appeared in other countries with slight variations. Germany (many small states) established a inward-looking view (*Reichs-kameralismus*), which focused on order, administration and proper book-keeping. France, finally at peace after a long period of domestic warfare, was in a re-building phase with a stronger "dirigist" state, with Colbert as a leading figure, first oriented toward self-sufficiency, and later toward expansion of trade. Spain with its large inflow

of precious metals from Latin America had already under the period of the Salamanca school (scholastics) pondered the effects of this inflow of money on economic development (de Azpluceta). Focus came to be on the design of the tax system and how to promote the establishment of manufacturing, which, obviously, required investment in fixed assets with longer planning horizons. In sum the mercantilist discourse delivered (Magnusson, 1999, p. 115f):

- the belief that the monetary flow between countries was determined by real economic forces, i.e., the balance of payment
- the belief that the market mechanism was the dominating factor in this process
- the belief that the Christian moral order (scholasticism), or ethics, had little to do with this
- the view that the economy is a system of forces
- and the view that the economic world should be subject of systematic study

One might add that it also comes through that the participants in the debate were in favour of certain economic policies to promote the welfare of their nation. The state had now been established as a legitimate player and the beliefs listed above provided a basis for economic policy formation. Merchant banks gained importance in the mercantilist era, but they were under scrutiny, and they now had a complex of relations and investment opportunities to attend to beside trade. They needed strategies for trade and state. The problem was that banks were rather small in terms of personnel to implement strategies and vulnerable to withdrawals of capital in connection with death duties etc. It was merchant houses that had the head start in the modern era.

Figure 4.



5.1. The glory and decline of merchant banks

Banks (1999) treats the rise of the modern British Financial era from medieval times to the demise of the merchant banks as a distinct category at the turn of the 20th century. For each period Banks (199) gives an overview of the economic development and how this engendered new features in the merchant bank industry and for each of the major banks. I have chosen Baring as the representative one.

The chapters deal with different periods of Britain's modern financial era; the emergence of the banks from 1800 – 1874, the Glory years before the wars, the disruptions of the two wars, the changes after the Second World War and the consolidation of the City in the 1980s, and finally the end of merchant banks during the 1990s.

Dawn

Banking in England started in the wake of William the Conqueror's occupation. Jews established business in Cheapside (City). Since they were not allowed to engage in trade or manufacture and had no legal status, they took up money changing, and provided Norman kings with funds for wars. Defaults on such loans were rather common so high interest charges were required. This led to conflict, ending in expulsion of Jews in 1290. The void was soon filled by the Lombards (Italians, merchants and bankers, from Florence and other cities). The Lombards introduced their experience of bills of exchange. By the 16th century the Italian banking houses declined and their financial activities were taken up by merchants, brokers, scriveners and goldsmiths; merchants trading and providing credit by bills of exchange, brokers lent money against valuables placed in safekeeping, scriveners were clerical intermediaries who set up contracts and provided advice, discounted payment orders, and traded in gold, goldsmiths established in jewellery and became important financiers taking deposits and re-lending deposits. Goldsmiths' deposit notes developed into a kind of bank notes. The goldsmiths' business was greatly promoted by the raid on the Royal Mint (a safe deposit, people thought) by king Charles I in 1640 where he removed 200.000 pounds in bullion.

From the middle of the 16th century joint stock companies appeared. They issued shares to merchants and gentry against promises of participation in capital gains and dividends. Such shares changed hands informally via brokers (who "transact business for merchants"), and jobbers (who quote two-way prices for their own accounts of stocks). The first recorded 'stock jobbers' appear in 1688. One place where these middlemen met to conduct business was the Royal Exchange, but there were other locales, not least Jonathon's coffee house. Another coffee house was Lloyds, which became a centre for exchange of shipping information and later (from 1771) developed into an insurance business with members/underwriters retaining unlimited personal responsibility for losses.

Despite some progress London was still, at the beginning of the 18th century, a second rate financial centre after places like Amsterdam and Southern Germany. But trade expanded, supported by a growing colonial empire and protected by mercantilist policies (like The Navigation Act) These policies were, however, the seed of decline for the empire starting with the War of Independence in North America and the revolutionary ideas from France.

However, Britain came out winner of the Napoleonic wars and as ruler of the seas. In this period the role of the Bank of England expanded largely in connection with the management of the national debt that increased rapidly as a consequence of wars. Amsterdam, on the other side, suffered numerous bankruptcies in the crisis of 1763 (end of the Seven Years War). Then problems got worse for Holland through the Anglo-Dutch war 1780-83, and finally the French invasion in 1795. With that the financial, mercantile and naval power of Amsterdam was broken. London stepped in – Paris had other business to attend to.

Economic developments I

Industry was growing steadily at the beginning of the 19th century, even if Britain was involved in war. At the centre of this growth was cotton. Imports and exports dominated the economy after the end of the Napoleonic wars. Soon the railway era began. The first railway project in Britain started in 1825, by 1835 there were 21 listed joint stock companies trying to raise funds for railway networks. Britain and Europe at large were plagued by large national war debts and there were financial crises - 1825 brought runs on country banks throughout the system with payment stoppages at many banks – over 12 months 145 banks failed. In this situation Bank of England was successful in calming the financial markets by discounting government bills and bills of exchange to provide liquidity. Legislation strengthened the Bank of England in its role as central bank. A further crisis in 1839, emanating from the USA, marked the turbulence of the times.

It was in these tumultuous years at the beginning of the 19th century that merchant banking took off. Merchant families, emigrated to England from Prussia, France, Ireland, Russia, Italy and America, formed the core of this development. They started out from expertise in trade and commerce, were small family-owned, and managed houses with limited capital. They provided an essential link between commercial centres of the world. International trade was their business (remember Adam Smith 1776). Their reputation and connections with agents made them suitable as intermediaries. Since they knew both parties in a transaction they could accept bills of exchange. Merchant banks like Baring, Hambro, Brown, Kleinworth, and Schroder ran very large acceptance books, while others like Rothschild and Peabody and Benson were active at trading bills at a discount in the market. Bills for payment in London and the USA generated a market of currency exchange, and trusted clients could be provided with letters

of credit. Merchant banks, knowing their clients well, had an advantage in judging creditworthiness. During this century foreigners also started to issue loans in London (railways, sovereign debt), which needed underwriters to arrange things. From now on we focus on Baring, with occasional comments on the others.

Baring I

The Baring bank stems from Groningen, where Peter Baring established a wool importing house in the 15th century. A descendant immigrated to Exeter – a trans-shipment point for linen from Germany to the West Indies and Mediterranean countries – from Bremen to start his own business in 1717. By the end of the Seven Years War (1763) two sons had established business in London as agents for the Exeter branch. Gradually, and after several reconstitutions of partnerships between members of the family, banking took on a more prominent place in the business. Baring's strength was its ability to develop and maintain relationships with banking and merchant houses at key locations around the world. One such link was the one with Hope & Co in Holland. By 1803 Baring was appointed general agents for the US Government, arranging payment of interest, purchasing armaments etc. By the turn of the century the firm had gained considerably in stature. It took on a policy early on to only act as the sole provider of credit to a given client. In 1803 Baring participated, together with its partner Hope & Co in financing the Louisiana Purchase, its biggest transaction up till then. The firm was also involved in arranging Spain's payment of the annual subsidy to Napoleon under the Treaty of Spain (1803). It was Francis Baring, who, during his 40 years' rein, had transformed Baring from a merchant house to a first-tier bank.

As the bank increased its operations in the next few decades often in competition with its rival N.M. Rothschild. Even if Baring was larger than most houses in London it remained well behind Rothschild by the mid 1820s. In order to implement its expansion plans for the US operations the firm hired Thomas Ward to be its resident agent, in 1830. He extended long term credits to American merchants with business in the Far East and West Indies. A family member (John) had moved to Boston in 1826 to set up a partnership with Joshua Bates with focus on the cotton trade. This partnership was soon absorbed into Baring and a new office was set up in Liverpool to engage further into the cotton trade.

The Hambroe family, with roots in Hamburg and Copenhagen, established themselves in London during this time, in similar business but specializing in the Scandinavian countries. Kleinwort came from Hamburg like Schroder. Warburg did not set up business in London until in the 1930s, but was already an agent for Rothschild in Germany at this time.

Economic developments II

From 1840 onwards free trade made great progress as trade restrictions (like the Navigation Act and the Corn Laws) were dismantled. By 1880 Britain accounted

for 50 percent of the world's shipping tonnage and British credit supported the growth in trade. The empire generated revenue, e.g., in the form of "home charges" and interest payments from India. Industry grew – by the middle of the century Britain produced 66 percent of the world's coal, 50 percent of its iron, 70 percent of its steel and 50 percent of its textile. Investment in railways was a driver of the financial sector, as was sovereign debt. London was the undisputed centre. There were crises of course, many of them stemming from speculative adventures (cotton, land speculation, railway securities bubble, states overspending) in the USA. In May 1866 (Black Friday) the leading discount house (discounting bills of exchange) in London, called Overend Gurney, collapsed. Bank of England analysed the system effects and let it fall, but provided credit to carry the financial sector over.

A major technological development in the form of the telegraph – the Atlantic cable in operation from 1865 – changed the condition of international commerce drastically. The American Civil War shifted business to the North. The merchant banks had to adapt. While they hitherto had been used to rely on their personal knowledge of clients' creditworthiness, the growing volume now made this virtually impossible. Larger capital to carry risk was required. There were mergers and acquisitions and joint stock banks kept growing.

Baring II

Still a traditional merchant bank Baring shifted more of its business toward the USA in the period 1830–1860, among other business it became a major participant in Federal, State and railway loans, but it also helped issue loans for Russia, France and Brazil. It further increased its portfolio of acceptances. Especially the financing of trade on the Far East was lucrative. However the death or retirement of leaders of the bank exposed it to considerable reductions of its capital as a consequence of withdrawal of funds. Approaching the 1870s the bank reorganized, the number of partners doubled and a merger with a Scottish bank was undertaken.

Economic developments III - The Glory Years

The period between 1875 and 1913 is generally considered the glory years of Britain. The entire world economy was built around Britain with the City as its centre. Bagehot (1873, p.2) wrote: "Everyone is aware that England is the greatest moneyed country in the world; everyone admits that it has much more immediately disposable and ready cash than any other country." London dwarfed New York and other centres in terms of the volume of bank deposits. That very volume also generated a need for joint stock companies in banking. The "Big 5" banks emerged as the clearing banks by the First World War. Merchant banks saw this development with suspicion. Foreign banks in London granting trade credits to companies in their 'home country' expanded during the late 1800s. It was now that the term "merchant bank" became widely used. And the

category got new members; while there were 39 such banks in the City by 1890 the number had grown to 66 by 1897, even if they remained small. Baring had 71 employees by 1903. Politics was important. Many partners of merchant banks were members of Parliament.

Baring III

During the latter half of the 19th century Baring concentrated its business on the Americas and the Far East, but unlike other merchant banks it also made efforts to finance domestic industry. Two issues brought the bank down; a syndicated loan to Manchester Ship Canal was only subscribed to 18 percent leaving the banks to take up the balance and tie up capital for a long period. An ill-advised investment in shares and debentures of the Buenos Aires Water Supply and Drainage generated a liquidity shortfall in 1890. Under the leadership of the governor of Bank of England a successful rescue package was negotiated. In the aftermath Edward Baring, leader of the bank up to the crisis, was forced to resign, the bank was reconstructed as a limited liability company with only two family members holding stock in the company (20 percent). The reconstruction allowed the Baring family to repurchase voting share from new shareholders – mostly banks that had contributed to the rescue package – and within 5 years they held all voting shares and were again in control. The first priority now was to get rid of the illiquid Argentinian assets and soon it was back to its traditional business; acceptances, investments and new issues.

In the early 1900s Baring discussed a merger with JP Morgan, but in the end Baring decided to develop its own subsidiary in New York run by Hugo Baring. He started out disastrously and was soon replaced. In 1908 Baring decided to close down its New York office and work with Kidder Peabody instead. Baring had come through the 1890 crisis with lessons learned. As the War approached the bank was again in business, although more conservative than before. NM Rothschild had consolidated its position as the top merchant bank with Barings setback.

Economic developments IV – two World Wars

As tensions escalated in Europe financial markets suffered. Interest rates and volatility increased, gold reserves flowed out of London. With the War financial markets came to a halt in London and Europe. The problem for the government was the large amount of outstanding acceptances to foreign clients who were unable to remit payment. The Bank of England declared a moratorium on payment of bills and covered large amounts of acceptances, thereby maintaining liquidity. The gold standard was suspended in London and Europe, but this led to liquidation of securities in New York and conversion of the proceeds to gold. This threatened the US reserves and the New York Stock Exchange closed. However, trading continued off-exchange, and as the exchange re-opened several months later investors had started to look upon American securities as a

safe haven. In this way America became the recipient of large inflows of capital and its gold reserves were no longer threatened. When the USA entered the war in 1917 it could lend money to its allies.

At the end of the war England faced the problems of re-building its economy, stabilizing its currency and holding the empire together, which required a mobilization of a large amount of public and private capital. War reparation was a debated issue. The economy contracted considerably, exports reached only 80 percent of its pre-war levels. By 1918 2/3 of the British economy was under direct or indirect control of the government. 90 percent of all imports were authorized under government directives. By the late 1920s imbalances had grown out of control, culminating in the crash of the New York Stock Exchange in 1929. Total capitalization of securities decreased by some 30 percent in ten days. Banks' loans to brokers for securities purchase could not be repaid. At the time of the crash 4 major economies in Europe were in recession, which deepened and prolonged its effects. Soon Austria reported difficulties to meet war reparation payments and was granted a small international loan on condition that Austria leave the customs union with Germany. Shortly thereafter Germany announced that it had insufficient funds to meet obligations. There was a bank run in Austria that spread to neighbouring countries. Germany paid only interest on outstanding trade credits in 1937 and 1938, while refusing service on loans.

Merchant banking suffered during this period. Strict controls and state agencies building their own capacity to purchase material reduced opportunities. Banks were managed for survival with reduced staff. Even if trade rebound somewhat between the wars providing some acceptance business it did not reach pre-war levels. Furthermore, the number of clearing banks with deposits and large retail organization had solidified at the "Big 5", which set a completely new stage for banking business after 1945.

Baring IV

At the start of World War I "Baring's operations had effectively come to a halt" (Banks, p. 250). Core operations were limited to arranging payments and maintaining relationships. A new manager (Peabody, a Canadian) from the outside was recruited at the end of World War I and served to the end of World War II. The acceptance business was gradually rebuilt (tripled in 3 years), but Baring also focused on building a domestic issue capability (which requires a reach out over the whole country). Corporate finance and advisory work became new sources of revenue. International loans were much reduced between the wars.

Economic developments V (1945–1979) – Focus shift

The Second World War caused devastation for Britain as far as the basis for merchant banking goes. Britain had lost half of its international trade, 2/3 of its overseas markets, and 1/3 of its merchant fleet during the war. The position

of the USA had grown proportionally stronger. Coping with the large post-war debt burden was an important task for the government. Industry needed restructuring. The traditional industries (textile, coal, shipbuilding) were in decline, other industries were fragmented, e.g., there were 11 car manufacturers in Britain while there were 3 in the USA. The Labour Government in power from the war until 1951, and again in the 1960s and 1970s, created a framework for solving these restructuring problems by state ownership (National Coal Board, British Steel, British Gas etc.). The policy was successful in the sense that unemployment was low (1-2 percent) as well as inflation. In 1957 Britain declined to join the new EEC and banded together with other outsiders to form EFTA. However the struggle to defend the sterling by raising the interest rate and adding an import surcharge (in 1964) had to be abandoned 18 months later as violating the EFTA agreement. The trade deficit and currency turmoil remained a problem exasperated by the 1973 oil crisis. Britain had for a long time been the world's largest overseas investors, but the wars had forced investors to liquidate investments and the revenue from such activities was smaller. Industrial production grew, though, and the management of pension funds had been deregulated. This set a new strategic field for merchant banks. And there was the US Regulation Q and Interest Equalization Tax (IET). Regulation Q prohibited payment of interest on short term and set an upper limit for interest on long term deposits. IET taxed US domestic investors holding obligations of foreign issuers. This set the stage for the Euromarkets.

The Eurodollar deposit was an off-shore short term deposit paying a rate based on the LIBOR. It originated in the Soviet Government worrying about the risk that its holdings with American banks might be frozen or restricted (late 1940s). It re-deposited dollar funds with the Soviet-controlled Banque Commercial pour l'Europe du Nord in Paris. From this further dollar transactions could be undertaken outside the control of US authorities. The Eurodollar was born and London was the entrepot at hand.

Baring V

Merchant banks had to respond to this changed circumstances after the Second World War. There were about 40 of them in London. The strategic options ranged from growth by acquisition to specialization to narrow niches. Baring's choice was to expand its domestic presence and seek a more diversified base of revenue. It made progress in line with this (asset management, bond trading, M&A), but was considered a bit conservative. Managers were recruited from the outside. Foreign new issues declined during the 1950s but Baring took a leading role in bond issues for British corporations. Baring also set up an asset venture management team (Henderson Baring Asset Management) that was very successful. In 1975 it won the mandate to assist in managing a part of the vast petrodollar investments of Saudi Arabia. The other area was M&A, which offered opportunities to participate in the de-nationalization of industries

like British Steel. In 1960 the bank earned a reputation through its defence of Courtaulds against a hostile bid from ICI. Its list of clients grew after this

(Rotschild saw its capital decline after the war due to poor business conditions, but also due to death duties as family members died. Measures were taken to protect the company by setting up a holding company (Rotschild Continuation Holdings) and convert it from a partnership to a private company. A similar development happened to Kleinwort, burdened by a large portfolio of non-performing credits. Hambro became a limited company too. All merchant banks started to hire professional managers from the outside).

Economic developments VI (1980–1989) – City consolidates its position

Global financial markets were under pressure in 1980 due to the American difficulties. Chairman Volcker of the Federal Reserve had initiated monetary tightening to counteract inflation (16 percent), which in turn was due to the OPEC oil shock of 1979 (a previous oil crisis in 1973 in relatively fresh memory). An unforeseen effect of this high interest rate policy was the difficulties for less developed countries to service their much increased debt. By 1984 35 such countries were unable to pay. Global banking institutions faced large losses and began to reduce costs and rebuild reserves. The British government had increased borrowing to fund its restructuring of industry. In this situation deregulation as the solution won adherents. The conservative government started the stepwise process in 1980, but let it be accompanied by a strengthened regulation (FSA, ISB) structure - from its previous “self-regulation” approach - to protect investors, issuers, and intermediators from the excesses of the free market.

On Monday 16 October 1987 the New York Stock Exchange crashed as a bubble burst. Merchant banks made big losses mostly due to new equity issue underwriting commitments. During the 1980s British privatization of state-owned industries gradually gained tempo, and was successful (accept during the 12 months following the Crash). The most spectacular deregulation act, however, was “the Big Bang” – deregulation of the Stock exchange – in 1986. The strategic field changed again.

Under the previous regulations functions on the stock market were kept separate; ‘brokers’ (who matched sellers and buyers without owning any shares in between) could not work as ‘jobbers’ (who bought and sold shares on their own book). These two kinds of houses now became attractive acquisitions for merchant banks. Clearing banks saw the Big Bang as an opportunity to enter the securities markets in a more forceful way, and in effect became a new kind of merchant bank in the process.

For merchant banks the Big Bang announced the need for a more serious strategic planning approach rather than the previous ad hoc/grab opportunities policy. After formulating their strategy these banks had to carry out their plans either by acquisitions of firms or by hiring specialized staff to man new

departments. “This contributed to the creation of very high cost bases throughout the City, which became difficult to justify when profit margins contracted or volatility generated losses.” (Banks, 1999. p. 416).

Baring VI

Baring entered the 1980s as a top-tier bank but with a somewhat conservative reputation. Pioneering new activities was not in its taste. It was business as usual for the first part of the decade, but by 1984 it bought a 30 percent stake in a jobber (Wilson & Watford), and later the same year it was eager to acquire the City’s top broker (Cazenove), but negotiations failed and Baring chose to hire a 15-man team from another broker. This team, headed by Heath, was specialized in the Asian equity markets. Since Baring itself had started trading in Japanese Eurobonds that same year it seemed logical to try to find more business there. Japanese Eurobonds with attached equity warrants had become increasingly popular, generating handsome profit. From a balance sheet of 276 million GBP in 1977 it had grown to 2,7 billion GBP at the end of the 1980s. Baring Securities contributed 50 percent of the profit and employed 1000 staff. But as the Japanese market became more difficult in the early 1990s – decline in the Nikkei – a greater amount of Baring’s warrant business became proprietary, rather than client, in nature.

(All merchant banks faced challenges. Hambro entered the 1980s a full service merchant bank. However it failed to reach a top position in corporate finance. It purchased 30 percent of a broker and acquired a small American investment bank, but as a consequence of the 1987 crash it narrowed its focus to commercial banking, retail investment service, M&A, exiting the equity market and government bonds. Rotschild retained a conservative business approach focusing on its traditional strength; corporate finance, bullion dealing, export finance and new issues, avoiding areas where they lacked expertise. Rotschild had difficulties with access to capital since partners did not want to dilute their ownership interests. Still it grew into dominance in international and domestic mergers and was successful in building the asset management business. It purchased parts of a jobber and a broker to build a securities service and set up office in financial centres around the world. At the end of the decade it stood securely as a significant niche player. Kleinwort gained prominence over the 1980s by demonstrating its capability to manage complex deals in important privatizations and M&As. In October 1987 Kleinwort Benson issued new stock – bad timing in relation to the Crash – but managed to secure 148 million GBP in equity. The company still suffered from great variations in profit. Morgan Greenfell started the decade by severing relations with its previous shareholder and partner JP Morgan. In 1984 Deutsche Bank acquired a 5 percent stake in Morgan Greenfell. Management hesitated (due to limited capital) as to its approach to building a securities department and by the time they made up their mind most top tier brokers and jobbers were already spoken for. It bought

minority shares in a broker and a jobber and took full control of them after the Big Bang. Over the decade Morgan Greenfell won a top position in M&A, but also a reputation for not abiding fully to the code of conduct in M&A. Its involvement in the Guinness/Destillers takeover 1986/87, which turned into a scandal as various senior managers of Guinness were arrested for improprieties, was a cause for several clients to leave the bank.)

Economic developments VII (1990–1999)

Britain entered the 1990s with a curious mixture of prosperity and crisis. Several disturbances of markets happened in the early part of the decade (Iraq's invasion of Kuwait 1990, the ERM currency crisis, sharp rise in interest rates in 1994 followed by the crisis for the Mexican peso, and finally the failure of Baring in 1995). London City had prospered in its off-shore investment business. Financial assets had grown dramatically, not least by the new solutions in pension assets. Clearing banks continued to dominate most aspects of borrowing and lending in the financial sector even if they did not succeed fully in setting up merchant banking divisions, and they had to set aside reserves for the risks in loans to less developed economies. The number of foreign banks operating in London increased during the 1990s reaching 550 by the mid of the decade. London City continued to dominate the international cross-border bank loans sector (18 percent of the market compared to 14 percent for Japan and 8 percent for New York). Two major banks collapsed in the 1990s; BCCI was closed down by the authorities because of reporting irregularities and internal and external fraud, Baring will be discussed below.

An interesting aspect of the development was that the British clearing banks exited the merchant banking sector during the 1990s. After trying to establish a viable presence in the global market of merchant banking for 10 -20 years Barclays, National Westminster, Lloyds TSB and Royal Bank of Scotland withdraw partly or entirely. Banks (1999, p 464ff) claims that it was the demands by shareholders for a competitive return on investment that forced the decision. The Big banks could not justify the high expenses connected with global competition in this field. The irregularities discovered in several banks (Baring being the most spectacular) brought further demands for better internal control systems, which would increase costs still more. Retail banking was simply more profitable.

Merchant banks had to realize that aspirations to remain a top-tier global actor now required vast financial resources (personal connections could no longer compensate), world-wide distribution capability for securities, operating platforms, technology and robust control systems. The strategic options were to merge with another actor to become part of a financial conglomerate, to narrow business to a specialized field, or to be satisfied with being a mid-range actor.

Baring VII

Baring entered the 1990 with 3 business divisions; Baring Brothers (merchant banking/corporate finance), Baring Securities (securities sales and trading), Baring Asset Management (investment managing). It now started to expand into new areas (like asset swaps, asset repackaging, arbitrage, and derivatives trading) and new markets (like Latin America and Far East). Baring Securities, with its earlier success in Japanese warrants, began to decline in importance (losses in 1991 and -92). In 1993 Baring restructured, integrating Baring Brothers and Baring Securities into Baring Investment Bank. Heath, the 'creator' of Baring Securities, left the company. The challenge now was to manage the different cultures within the company. In an effort to improve the American presence Baring acquired 40 percent of the US investment bank Dillon Reed in 1990, which was increased to majority ownership in 1997, and finally full ownership. Baring joined with Abbey National – a building society that had been converted to bank – to set up a joint venture dedicated to derivatives trading. Abbey National brought a good credit rating to the venture, which had some success for a while.

Baring's Singapore office was the place where the notorious irregularities, which in the end led to the collapse of the entire bank, emerged. Leeson, who had been a trader there since 1992, used the weak control systems to establish very large positions in Nikkei index futures and options, Japanese Government Bonds futures and options, and Euroyen futures. Leeson's official job was to execute index arbitrage programmes (buying baskets of stocks that comprised the index and selling the equivalent index futures. A rather boring job dealing with negligible risk if done properly, one might think). The cheating was possible since Leeson could cover up trading losses by booking them to an error account – a so called 88888 account - that was not monitored by auditors. Leeson thus had effective control of back office functions, which was not in accordance with accepted practice. It was the Kobe earthquake of January 1995 that exposed Leeson. He had bet on the Nikkei remaining calm, but the earthquake caused the market to fall and remain volatile for some time. Losses mounted and Leeson fled the company. Baring had to call in Bank of England and other regulators to consider the consequences of the situation. Other banks negotiated a rescue package of 500 million GBP, but when news came that losses would be larger than 650 the plan failed. A final take over offer from the Sultan of Brunei also fell through. There were too many open-ended contracts to assess the value of the company properly. Baring started to unwind its positions and it turned out that the loss in the end was 860 million GBP. Now the different parts of Baring could be valued and after some turns the ING bank came out as the buyer of the whole operation for 1 GBP. The 'post-mortem' analysis of Baring was highly critical of merchant bank's control infrastructure, especially the control of posted margin calls – in January and February of 1995 Baring had paid 570 million GBP in margin calls; 25 percent of it one week prior to the collapse. ING integrated Baring with its own investment banking business, which was

of considerable size. By 1997 ING closed down large portions of its emerging markets activities (where Baring had been strong). Although the Baring name continued to appear in ING operations Britain's oldest top-tier merchant bank had ceased to exist.

(Hambro, experiencing profitability problems in the early 1990s it called in consultants (fellow merchant bank Schroder) to suggest solutions. The recommendation was to sell the bank. Although other merchant banks like Warburg, Kleinwort Benson, and Morgan Greenfell were sold as whole units – with business intact – Hambro was dismantled and sold in pieces (after 158 years)).

Rotschild was one of the few merchant banks that remained independent during the 1990s. Even if business was slow in the beginning Rotschild managed to maintain a revenue stream that was mainly fee-driven. By the middle of the decade about 20 percent came from privatizations, the bulk (50-70 percent) from M&A. The bank joined ABN-Amro in a joint venture (a replica of the very successful Smith New Court created after the Big Bang in which Rotschild held 25 percent, and which was sold to Merrill Lynch in 1995) of new equity issue that could benefit from both ABN-Amros distribution capacity and Rotschild's origination skills. After the Baring failure the bank reviewed its organization and control systems. The bank was restructured on a global basis. The principal component was still the family's Swiss holding company Rotschild Continuation Holding. Rotschild had chosen a successful niche strategy (corporate finance).)

Learning from the adventures of a merchant bank (Baring)

Baring negotiated successfully a great many changes of context over an extended period. This was no doubt due to the closely knit organization built on personal trust, and the small organization. In the end it was not possible to maintain the governance of intimacy while expanding globally. Most merchant banks had to bail out and seek protection in larger organizations. It should be noted that it was European universal banks that emerged as the major purchasers of the British merchant banks (UBS, Dresdner, Deutsche, ING). Banks (1999) claim that these banks had an understanding of the specific culture of merchant banks (personal connections, international deals, thinking in broader and more long term categories). These banks were better suited to operate in more regulated markets than were the de-regulated banks of London City.

Banks' (1999, 513ff.) recapitulation points to the fact that the premiere merchant banks emerged from a gradual conversion of their mercantile business to banking 1800 – 1839. Their roots were mostly in Liverpool, the most significant port for export and import. All major houses were managed by a small family-based staff, although the addition of external partners or agents in important overseas locations became increasingly common (p. 515). The pace in commerce increased with steamships, railways, and telegraph. Warehousing (in Liverpool and other places) declined in importance as buyer and seller could get

in more direct contact . Financing deals with reasonable risk still presupposed a good knowledge of the business plus capital and a good reputation. The period 1875 – 1913 was the pinnacle of British merchant banking under the banner of laissez-faire liberalism. A stable political environment, with a growing trade flow (not least to-and-fro the colonies), railway investments in many countries, and an investing public in Britain, made strategic planning feasible. The core business was still acceptances, advances, and loan issues (sovereign as well as railway companies). Mergers and amalgamation of a fragmented industry generated additional business. Family shareholdings and unlimited liability remained the norm. But this made capital variable because deaths or retirement of partners required payments of death duties as well as payment of partnership shares, which reduced equity.

The war period 1913 – 45 was very disruptive for these banks, which were so dependent on international trade. Most merchant banks emerged from this period as smaller and more conservative organizations.

The post-war period started with an inward focus on reconstruction. Remaining regulation of most aspects of international business forced merchant banks to relate to large industrial clients, nationalizations and privatizations provided opportunities to build expertise in corporate finance.

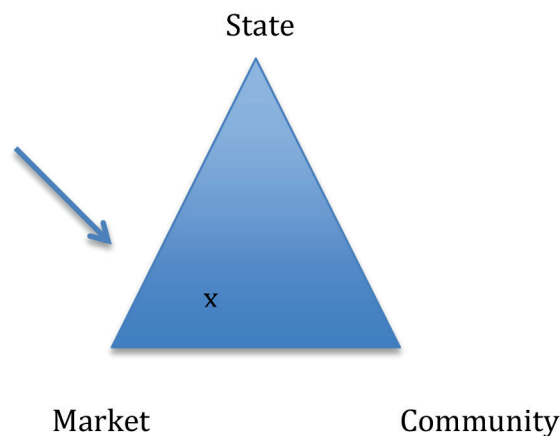
Now London had lost out to New York as the global financial centre. The Eurodollar market saved the day for a while, as did the large volume of privatization projects, but the de-regulation of London (the Big Bang) put merchant banks (and other banks as well) in situations where they faced difficult strategic problems; to go for full service investment banking, specialize to certain niches, or accept a less prominent profile. In all cases some acquisitions were required or new hiring of (teams of) expertise. This increased cost levels and made merchant banks more defenceless against variations in profitability. One explanation to the conspicuous deficiencies in management and control was that banks engaged in activities top management did not fully understand, another that acquisitions generated internal differences in culture that could not be handled in the rapid pace that was characteristic of the two decades prior to the 2008 crisis. As a consequence profits varied widely, which was not liked by shareholders, and that made it difficult to meet the capital requirements of a full service operation. The obvious thing to do was to merge with a larger, global organization and hope for some room of manoeuvring inside it. However the fragmentation of cultures, lacking control instruments and the rapid pace instead opened up organizations for power games and promotion of clever power gamers. The stage was set for the 2008 crisis with many global banks being too big to fail. After the effects of the Big Bang had subsided and the action moved to New York and its predatory capitalism under the auspices of neoliberalism that germinated in Vienna after the First World War.

Concerning Barings we may admire its ability to meet many changes in the economic and institutional context with adequate strategic reorientations. Its fall

as a consequence of Leeson's gambling behaviour illustrates how the "scientific" basis for the valuation of financial instruments was compromised by individuals cheating. He introduced the "operational risk" issue. Trust in gentlemanly behaviour in Baring had not yet been compensated by far-reaching internal control systems.

The case of Baring Bank covers the period of mercantilism as well as that of laissez-faire liberalism that dominated the 1800s. It should be noted, and the extensive case description aims to describe this, that the strategies of Baring, include a great many dealings with an interventionist state, not least in the USA. Over the whole period of Baring the Market aspect of "corporatism" got an extra emphasis, while the two other aspects remained more in the background. The State (and academic economists) developed their skill in economic policy, which included participation in rescue efforts as banks ran into trouble. This required a forceful central bank that could muster the necessary resources.

Figure 5.



The end of "the golden years" for merchant banking also marked the establishment of the State as a prominent actor setting the stage for many a deal (and rescue operations). The entry of Community again – now in the form Finance Theory for valuation of assets explicitly based on expectations about the future, and the curious presumption that individuals will always follow the rules of the game – is closely linked to the new political/scientific credo that emerged in Vienna at the end of the 19th century, which blossomed into a dominant worldview in parallel to the de-regulation of banking.

6. Neoliberalism started with the Austrian School

6.1. Modernism and crumbling empires

The action when it comes to neoliberalism and neo-classical economics started in Vienna, Austria. When Modernism found a new articulation in science, technology and industrial enterprising in the world towards the end of the 19th century Austria responded somewhat differently from many other major powers. While the western powers of France and Great Britain could embrace modernism and keep their (overseas) empires, landlocked and agricultural Austria saw real estate expansion to the south-east as its solution. Serbia represented only one of the nationalist movements that bothered the Emperor of this multi-national creation. Newly formed Germany/Prussia, also a strong state, but with more elaborated hierarchical/military control, embraced science and technology, but also made a plan of expansion. Russia with its vast tsarist empire did not bother too much with planning but with honour and with keeping the new socialists at bay. The world had prepared for the First World War for some time.

As that War approached Prussia, Austria's natural ally, did not trust Austria with much information after a tsarist spy had been exposed (by Prussia) at the military headquarters of Austria. Italy soon dropped out of the entente. So the Prussian plan, to strike quickly at Paris and then deal with the tsar, as well as the Austrian one; to take on Serbia (note that its soldiers had recent war experience) and then caring for its Polish territory, did not go so well together. The failure was most devastating for Austria since the empire was dissolved at the end of the war, and Austrians had to re-invent their nation. For Russia the Bolsheviks took over the on-going revolution, and to manage their new nation they had to redesign Marx's theory, establish the state on the basis of a new economic order for agriculture rather than industry and hope for industrial workers to join in as they grew in numbers. "Revolution in one nation" (also against Marxist thinking) could be managed with strong central coordination from the state. Spreading the revolution to other countries was not as easy as the original socialists had imagined, but it was the main option as soon as state coordination in the name of equality among all citizens had been established.

The alternative to this coordination through state planning was to let the economy and its emerging industries grow through Darwinian competition. Factories would pop up and generate lots of jobs and prosperity would come even if one could not say where or when. Inefficient ones will be eliminated and all will benefit. Market solutions competed with dreams of equality through socialism. Ideological struggle was the name of the game.

Modernism carried with it a new focus on science. The controversy as to the nature of proper science (was Freud a proper scientist?) as well as the one on how

to organize a good society preoccupied intellectuals in cafés, private seminars, and universities in Vienna (Janik & Toulmin, 1973). Two philosophers, notable from a present-day perspective, were young Viennese at the time of the First World War; Karl Popper and Ludwig Wittgenstein.

Karl Popper known for his work on the demarcation problem (what is scientific and what is not) and his thesis that science progresses by error elimination (falsificationism), was a young socialist who saw school friends killed by police in violent demonstrations in Vienna, and changed his mind about the proper basis for building a good society. He had difficulties in his education but managed to take a university degree and landed his first teaching job in New Zealand in 1937, where he started to write his book in defence of liberalism (“The Open Society and Its Enemies” published in London 1945). This book was a by-product, in a sense, of his work on “The poverty of historicism” a critique of the social sciences and the impossibility of making scientific predictions to be tested in this area. Given that historicism is untenable we should not place our hopes in the ability of a central authority to coordinate and plan the development of a good society. In gathering material for the book on historicism Popper also assembled the philosophical arguments (starting with Plato) for the idea of an elite that could plan for us from a centre of power. The ideas of those philosophers formed the structure of Popper’s “The Open Society and Its Enemies”. There simply is no basis for believing in central planning! From New Zealand Popper was recruited to London School of Economics.

Ludwig von Wittgenstein grew up in the most prominent family in Vienna. His grandfather was an authoritarian that refused to let his son Karl (Ludwig’s father) study engineering (not suitable for a person in his position). Karl rebelled, went to the USA and worked in menial jobs, and was later reconciled with his father and allowed to study. Karl became a leading industrialist through “industrial rationalization” and the leading art benefactor in town. His attitude toward his children was authoritarian, however, and Ludwig was taught at home until the age of 14. When he entered the technical school in Linz he got in contact with Hertz Principles of Mechanics. He showed an early talent for constructing things. Leaving school for university studies Wittgenstein had hopes to learn from Boltzmann, but was frustrated by Boltzmann’s suicide in 1906. Incidentally, Wittgenstein experienced suicides by three of his brothers, two of them while in opposition to their father, and one facing capture at the Italian front during the war. Family catastrophes added to the controversies in the academic world. When Wittgenstein finally published “Tractatus,” after having failed to persuade several publishers of its merits, it was a determined effort to reconcile the language problems between ethical and scientific discourse in Vienna circles. Janik & Toulmin (1973) argue that Tractatus is an exercise in ethics and draw our attention to the last part, which was intended to be the climax of that book, but was looked upon as an insignificant addendum by contemporaries like Bertrand Russell and E.G. Moore. Wittgenstein was also, in time, recruited to England – Cambridge.

6.2. The context in which the Austrian school developed

Already before the war Austrian intellectuals had been pushed into action by the obvious lack of tenability of the Austrian-Hungarian imperial life style. The “Vienna Circle”, a gathering of scientists, philosophers, humanists, artists and journalists (Janik & Toulmin, 1973), found reason to question most of the fundamental principles of social life and articulate new world views. Economists debated the foundations of the market economy in opposition to the failed state coordination of people’s life. Kaiser Franz Joseph had ruled according to the principles of “Ruhe und Ordnung.” He came to power in 1848 (note the Paris commune) at a very young age amidst the revolutionary movement, and allowed no change. A railroad system could not be built because it might promote revolution. To his death the royal palace was lit by kerosene lamps (electricity unreliable?). The military had to be controlled and was allocated its (meagre) resources, not to become too powerful, by royal decision (“Hausmacht”). Austrian administration had degenerated into formalism that was only a façade (Franz Joseph also did build a number of impressive buildings with impressive facades in Vienna) to cover up chaos and contradiction. Vienna, was known as the City of Dreams, and for its Strauss waltzes, chique cafes, and pastry. You could sit all day with a cup of coffee and read newspapers from all over the world – and discuss matters. Vienna was a very bourgeois town in a crumbling multinational empire. To escape dark thoughts about revolutionary developments the bourgeoisie attended to the upkeep of appearances.

“Sprachkritik” and a dream of unified science

Intellectuals found it necessary to get rid of a language use that tended to obscure realities and prevent a more realistic building of a good society. One line of reasoning in this “Sprachkritik” before the war had landed in the conclusion that “the meaning of life” is not a matter of rational argument, it cannot be given any “intellectual foundation” (as argued by such giants as Schopenhauer, Kirkegaard and Tolstoy). It is mystical in a sense and can only be *shown* as Leo Tolstoy did in his stories (“Twenty-three Tales”).

The alternative line of reasoning was that of Mach, further developed by Hertz and Boltzmann, where you base the analysis in general principles external to the subject at hand, i.e., keep the rigorous language of a particular science and depict a phenomenon in mathematical models (instead of metaphors), which, applied in the proper way, can yield true knowledge by analysis – this could be extended to all sciences.

The problem that remained, given these two positions, was “Is there any method of doing for language-in-general what Hertz and Boltzmann have already done for the language of theoretical physics?” (Janik & Toulmin, 1973, p. 166). This is where Wittgenstein’s “Tractatus Logico-Philosophicus” (1921) comes in. It uses a language of logical propositions (or rather aphorisms) to

argue that ethics cannot be dealt with in the same way as the sciences. There is no “rational” basis for ethical statements. They can only “show” their meaning. By separating reason from phantasy - the mathematical representations of the physicist from the metaphors of the poet, descriptive language from “indirect communication” - Wittgenstein thought that he had solved the problem of philosophy (Janik & Toulmin, 1973, p 198). He was recognized as a genius by Moore (Wittgenstein became the successor of Moore as professor at Cambridge) and Russell of Cambridge. They were on the same kind of crusade against the abuse of language of the Victorian age in Britain, using “analytical philosophy” (propositional logic) as their weapon.

Wittgenstein felt misunderstood by Russell but failed to articulate how and in what sense Russell had misunderstood. He also failed to participate in a discussion with the Vienna circle representatives on propositional philosophy (that they hoped would support their work on a “unified science”) – he actually insisted on reading poetry to them. It seems like he could not articulate the meaning of ethics “showing” itself via indirect communication, which the last aphorism of the *Tractatus* (6.54) seems to encapsulate:

“My propositions serve as elucidations in the following way: anyone who understands me eventually recognizes them as nonsensical, when he has used them – as steps – to climb up beyond them. (He must, so to speak, throw away the ladder after he has climbed it.) He must transcend these propositions and then he will see the world aright.”

Again, the ethical statements (goals and values) must “show” their meaning. They cannot be understood by deductive reasoning. (They cannot be “calculated” into utility measures à la Bentham, which already Moore and Russell had found inadequate and vulgar). But, Wittgenstein changed his mind, albeit late, and under persuasion from the Italian economist Sraffa (Andersson, 2012) and wrote “*Philosophical Investigations*” published after his death (Wittgenstein, 1953). Sraffa argued, obviously with some success, that different people view things differently (different ontologies?), so there can be no universal language to judge the truth of propositions. Instead Wittgenstein kept the notion of language making it possible to “show” things to those engaged in the same “forms of life” using “language games” and always applying some rule. This aspect of his philosophy - behaviour and communication as rule-following - is an interesting one and part of the “linguistic turn” in social sciences. Wittgenstein, influential but difficult to understand as he was, should perhaps be seen as a drop-out from the melting-pot of neoliberalism in the Vienna circles.

Karl Popper chose a different approach. He started out discussing the “demarcation problem”, the difference between scientific and non-scientific arguments, and produced his critique of authoritarian philosophers, which will be dealt with below, as a side product. His great influence on social sciences

has to do with his development of falsificationism, which states that science progresses by conjectures and refutations. Hypotheses can be generated however the scientist wants (conjectures) so long as they are rigorously tested. In this way the elimination of error is the key to scientific progress.

Milton Friedman (1953/1970) took this argument one step further in “Positive Economics” arguing that the criterion of good science is accurate prediction. He claimed that you can use what-ever assumptions/hypotheses you want as long as they generate correct predictions. The quality of the scientific approach to economics (and thereby to economic policy) lies in the accuracy of the predictions (not in the “realism” of its assumptions). This legitimizes, to take an example, the assumption that the price of a financial asset varies according to “random walk”, that is completely randomly (as physicists did about the movement of molecules in a gas). Then we can use statistical methods to calculate the “market price” of options even when there is no market! Arguably this is part of the causes of the financial crisis that caused the fall of so many banks. There are, thus, good reasons to have a closer look on the roots and development of neoliberal ideas about the economy.

6.3. The Vienna circle as the birthplace of neoliberalism

It was a tradition in Vienna to set up “private” seminars, out of some of those arose two groupings of significance for the development of a social science theory; the Vienna circle and the Austrian school in economics.

The ‘Vienna circle’ (Der Wiener Kreis) went public with a manifesto in 1929 where a group of academics with scientists Otto Neurath, Rudolf Carnap and Hans Hahn as the leading names. The scientific worldview promoted in the manifesto is mostly known as “Logical empiricism” (or positivism), and is the dominating view in social sciences (incl. Finance theory) today. Its name describes its main tenets; there is a world separate from us that we can obtain sense data from (by observation or experiment). Only propositions that can be analysed by the tools of logic into elementary propositions that are either tautological or are empirically verifiable can be said to be meaningful. Logical empiricism therefore rejects metaphysics, theology, and sometimes ethics, as meaningless. The boundary between scientific and non-scientific approaches was an area of contention also between members of the Vienna circle. It should be noted that a “left wing” in the Vienna circle, lead by Neurath, argued that society itself could also be improved by applying scientific methods to its problems. This, obviously, applies particularly to the social sciences, where Wittgenstein and Popper have made important imprints. Both of these philosophers had traumatic experiences in the turbulent times after the First World War. State (imperial) or Market as the principles of coordination of social and economic life was on the agenda already before the war.

As for the economists who came into contact with the Vienna circle the following ones are most notable:

Ludwig von Mises (1881–1973)

Mises was born in the city of Lemberg (now Lviv) in current Ukraine. Entering the University of Vienna at the turn of the century as a leftist interventionist Mises was converted to the Austrian school as he discovered "Principles of Economics" by Carl Menger. Menger emphasised individual action rather than unrealistic mechanistic equations as the unit of economics analysis, and the importance of a free-market economy. As post-doc at the university of Vienna Mises was also inspired by von Böhm-Bawerk who had disproven Marxian labour theory of value. During this period Mises was recognized for "The Theory of Money and Credit" (1912) where he integrated the theory of money into the general theory of marginal utility and price, i.e., micro and macro economics. This was not accepted in the Austrian school, so he chose to go "in opposition" arguing for a neo-Austrian approach. His theory claimed that an increase in money supply was not beneficial for society since that increase would generate bank credit expansion and therefore inflation and business cycles in the form of overinvestment in "higher-order capital goods" rather than consumer goods. The credit based, inflationary boom will require a painful recession while the market liquidates unsound investments to re-establish a connection with "real" consumer demands. (Would Keynes have anything to add here?)

Mises, and his follower Hayek, developed this cycle theory during the 1920s, on the basis of which Mises was able to warn an unheeding world that the widely trumpeted "New Era" of permanent prosperity of the 1920s was a sham, and that its inevitable result would be bank panic and depression. When Hayek was invited to teach at the London School of Economics in 1931 by an influential former student at Mises's private seminar, Lionel Robbins, Hayek was able to convert most of the younger English economists to this perspective. On a collision course with John Maynard Keynes and his disciples at Cambridge, Hayek demolished Keynes's "Treatise on Money", but lost the battle and most of his followers to the tidal wave of the Keynesian Revolution that swept the economic world after the publication of Keynes's "General Theory" in 1936. From now on Mises was strictly in opposition to the new global fashion in macroeconomic policy. Already in 1920 Mises had published an article "Economic Calculation in the Socialist Commonwealth", (1920) in which he demonstrated that it would be impossible for a socialist planning board to plan a modern economic system; furthermore, no attempt at artificial "markets" would work, since a genuine pricing and costing systems require an exchange of property titles, and therefore private property, in the means of production.

Friedrich von Hayek (1889–1992)

Friedrich Hayek received doctorates in law and political science in the early

1920s from the University of Vienna. He soon became a protégé of Ludwig von Mises and was hired by him to work as a specialist on legal details of the Treaty of Saint-Germain (containing the Covenants of the League of Nations). Again with encouragement from von Mises, Hayek founded and directed the Austrian Institute of Business Cycle Research from the late 1920s before he was recruited to the London School of Economics (LSE) in 1931. At LSE he was recognized as a leading scholar in the development of micro economics. Notable is his debate with Keynes on the benefits of private investment in the public markets as a better policy than Keynes' public sector deficit spending to improve employment. (On other matters they were in agreement). While in LSE he taught many economists that later reached influential status (like Coase, Gailbraith, Kaldor, Lange and many others). In 1950 he moved to the University of Chicago where he stayed until 1962, when he returned to Germany (University of Freiburg). He had a profound influence on Milton Friedman while in Chicago not least via the Mont Pelerin Society (MPS) (named after the place of first meeting in Switzerland) initiated in 1947 at the invitation of Hayek and still active today as a liberal defender against the arbitrary application of power to impose collectivist solutions to social problems. It could be noted that at the first meeting of this society Ludwig von Mises was present but he left early angered by the conservatism of the participants, slamming the door.

As mentioned, Hayek left LSE in 1950 for the University of Chicago. However, he was not employed by the Economics department but at the Committee on Social Thought and worked on political theory, not economics. He was critical to the positivist approach of the Economics department. Ideologically, however most of the economics faculty was in agreement with Hayek. Milton Friedman, a friend of Hayek's and co-founder of the Mont Pelerin Society, was often quite critical of Hayek's economics writings. Hayek focused on the constitution of liberal society and wrote the "Constitution of Liberty", which was published in 1960, but was disappointed that it did not receive the same attention as "Road to Serfdom" (1944). Milton Friedman had taken over as the most visible promoter of neoliberal economics.

Milton Friedman (1912-2006)

Milton Friedman is without doubt the most significant representative of activist, neoliberal design-oriented economics. From the early 1970s he was the driving force behind the advance of the Chicago school and its influence on policy and politics. Two aspects of his activities stick out; his relentless efforts to debunk Keynes, and his firebrand teaching of the blessings of freedom and individualism. He was a founding member of the MPS-movement (initiated by Hayek).

Friedman's parents emigrated from the Hungarian part of the Austrian empire in the 1890s. They met in New York and settled in Rahway, New Jersey, where Friedman grew up. An excellent student he intended to major in mathematics, but was persuaded to switch to economics by no other than Arthur Burns (who

later served as chairman of Eisenhower's Council of Economic Advisers), whom Friedman helped by reviewing the manuscript for his PhD thesis. Friedman was charmed by the elegance of Marshallian economics and the analysis of partial equilibria. He received his PhD at Columbia in 1945 on a thesis written with Simon Kuznets on professional practice and the negative effects of state limitations of the number of entrants to professions. He had then worked for the government during the early years of the Second World War. His first job as a PhD Friedman got at the University of Minnesota where he joined Stigler in writing an angry attack on rent control that was published by the Foundation for Economic Education, a lobby organization for "free enterprise". When Stigler got a job offer from the University of Chicago in 1947, and turned it down, the offer went to Friedman who accepted. His brother-in-law Aaron Director, had returned to the same university in 1946. He had studied in London and got to know Friedrich Hayek (at LSE), whose book, "Road to Serfdom", the British best seller, he persuaded Chicago University Press to publish. He was oriented toward Law and Economics and taught antitrust law.

The Volker Fund, having noticed the success of "Road to Serfdom", wanted to persuade Hayek to come to the USA. Hayek, in turn, persuaded the Volker Fund to support a new study program called Free Market Study lead by Director (who was at the Law department). When Hayek finally was offered a position at the university it was on the university's Committee for Social Thought (not the economics department). Madrick (2011, p. 36) thinks it was because of the fear his radicalism would be too influential.

As mentioned Friedman directed his energies in research towards showing that Keynes was wrong in recommending deficit spending by the state in recession times. His line of attack was to update a theory on the effect of the money supply that had been refined by Irving Fisher. The theory held that the amount of goods and services produced was dependent upon the size of the money supply and the velocity (rate of turnover) of money. Keynes was wrong because if government were to finance its increased spending by borrowing it would "crowd out" valuable private borrowing and growth would stay the same (or be reduced). To prove his point he embarked on a very large project, with Anna Schwartz, to reconstruct the money supply data since the Civil War and relate them to the ups and downs of the GDP. In 1963 the results were published in "A Monetary History of United States 1867 – 1960". There was a relation between money supply and GDP changes, but the relation was too broad based to justify any policy conclusions (critiques thought), for instance, one could not be sure about the direction of the relation between money supply and GDP growth. The concept "endogeneity of money" refers to the assumption that the quantity of money is a creation of the strength of the economy. Tobin, for one, also pointed out that it is suspicious to rely on data from the 1930s and 1940s as "normal" and the 1920s and the 1950s as "abnormal" as regards money velocity. The key factor in Keynes theory was the multiplier effect (that government spending, in turn, will generate more

spending by its recipients, etc.). Friedman also gathered data to show that people do not spend as much as Keynes assumed. They decide on the basis of expected future income rather than on the basis of the one-off effect of current government spending. He managed to show that the multiplier effect was smaller than Keynes assumed (but it was still there), but he also exaggerated the ability of people to foresee their future income. The project established a new interest in monetary policies, which became the main tool for combatting inflation. The instability of money velocity undid monetarism in the 1980s.

Arguably, Friedman's most important theoretical contribution was his claim that there is a normal (later called "natural") rate of unemployment, below which inflation will be stimulated. The argument is that as unemployment goes below the natural level wages will go up and firms will have to compensate by raising prices. As government will try to stimulate the economy (Keynesianism) to push the unemployment level down again prices will increase again eliminating the purchasing power of the wage increases and reducing unemployment again (to the natural level). Nowadays economists argue that the "natural" level shifts from time to time (one might wonder in what sense it is "normal" then).

Friedman was an activist and a gifted speaker and a clear writer. In 1962 he published "Capitalism and Freedom" without gaining much attention. In 1964 he joined Barry Goldwater's campaign for the presidency as economic advisor. In 1966 Newsweek offered him to write a column. He also made many TV appearances. He was successful in the sense that almost all his proposals in "Capitalism and Freedom" were taken up in policy debates by his political friends. The Fed adopted his monetary policy in 1979 but abandoned it a few years later (due to the volatility mentioned above). His 1980 book with Rose Friedman (his libertarian wife) will be briefly reviewed together with other activist texts below:

6.4. A brief review of some neoliberal activist texts

The success of the neoliberal doctrine does not only rest on academic research, but is, maybe primarily, due to successful socio-political propaganda – the kind of texts that the Vienna circle dismissed as meaningless. I will present the content of some of these pamphlets in remembrance of the time when economic policies were recommended by "government consultants" (Schumpeter's words) during the period called "mercantilism".

The three books chosen are Hayek (1944), Popper (1945) and Friedman & Friedman (1980). They are presented in the order of publication, but could be seen as a summary of the neoliberal agenda as far as it social values go.

Friedrich Hayek (1944), "The Road to Serfdom"

This book is written as an argument for a better post war social order. It is inspired by the Austrian school of economics and chiefly argues against centralized

planning rather than for market solutions. The problem that comes back again and again is that a powerful state organization can be an effective instrument for inflicting damage on friends and foes alike since the myth of coordination for the common good is, precisely, a myth. There simply is no way to consider all the different goals and desires of individuals at the same time. The cognitive/computational task is too large even if one were to have updated information on the wishes of all people (Hayek did not foresee computers). Since there will have to be prioritization between values and goals on an arbitrary basis the planning ideology will always have devastating moral effects (unless planning is done on the local level and among groups who are in agreement on desired outcomes).

Hayek wrote this text during the war as part of the debate on the post war organization of society. At that time admiration for the resilience of the Soviet Union was helpful in the promotion of a socialist alternative. Hayek provides an analysis of various aspects of the planning option in 16 relatively short chapters. One should remember that Hayek had a much-publicized debate with Keynes on the role of the state in promoting “full employment” in the 1930s where Hayek questioned the idea of the state using deficit spending to promote growth. This (business cycle) was Hayek’s area of research during his time in Vienna.

Hayek starts out by claiming that step-by-step we have allowed the ghost of totalitarianism to spread across Europe. Collectivism, the opposite of the individualism that is the hallmark of the liberty that bloomed with growth in the 19th century, is gaining ground. “Organization” and “planning” have replaced the ideas of making use of the spontaneous forces of solidarity in a free society. German intellectuals like Hegel, Marx, Schmolter, Sombart and Mannheim laid the foundation for this.

This great utopia is a “new freedom” that promises to rectify the inequalities and injustices that uncontrolled capitalism has generated. The progressive forces of society will create a more egalitarian distribution of wealth. Gaining political power is the first step since the tool for this “new freedom” is coordination from the centre and planning. Nazis and communists are varieties on the same root - collectivism - and they confronted each other in Italy and Germany already in the 1920s and 1930s.

Hayek points out that it was the old socialists, oriented by class analysis and based in trade unions – workers against capitalists – that set the game up by finding it relatively easy to reach agreement with employers on conditions for organized trained workers. This left the untrained out and that was the ground for Nazism and Italian fascism. One should remember that it was the socialists that were the main enemy for these new socialist movements (facists and Nazis) that took over the power to re-distribute privileges and wealth as a small elite saw fit. A return, after the Second World War to a democratic socialism built on planning is not possible, according to Hayek, because central planning can never accommodate all the various values and wishes of individuals. The number of factory workers – the representative citizen in a collectivist worldview –

has decreased drastically since the War and the number of self-employed, professionals, service workers has increased (my comment). The world has changed and planning is, if anything, less useful than before.

Hayek is quite ideological throughout the book, but also refers to the current debate and published facts now and then. He seeks trustworthiness in his early claim that he has seen the same tendencies develop twice, in his two lives, in Austria and in the Anglo-Saxon countries. Collectivist solutions cannot work because of the calculative problem and because the impossibility to set goals. The solution is freedom and free competition. For those that are unlucky there should, however, be a social insurance to ensure a minimum standard. The problem is how to deal with the variations of the business cycle – some economist believe that it could be managed by monetary measures, others that deficit spending in public works with the right timing will work. Hayek evokes the image that all interference with the market system, even if the purpose is to stabilize, will generate insecurity.

Three arguments are presented why collectivist societies tend to promote their worst members into leading positions:

- People with higher education and intelligence tend to have more differentiated opinions. Mobilization of political power has to turn to the “lower” sections of society. This majority also has lower moral scruples. A “strong” man with a simple recipe will promise to improve things. The totalitarian leader talks to them and converts non-believers to these simpler views.
- The dictator can appeal to people with vague and unfinished ideas.
- People find it easier to gather around negative slogans (Against capitalism, injustices, competitors). Division into “them” and “us” binds “us” together.

Once in control the central planners will kill the truth in the sense that any expression of doubt or hesitation in executing plans may jeopardize the improvement projects, and hence must be looked upon as treason. In time people adapt and avoid “sticking out”.

In some of the final chapters Hayek compares socialist and nationalist collectivists and traces the roots back to the same kind of reasoning, against liberalism, in both camps. Both camps also have the same attitude toward science claiming that their central planning approach is justified in the name of science. After all, this was a time of increasing respect for scientists and a time when scientists, not least in Germany, claimed to have knowledge that could be applied in the design of the good society. Hayek points to the roots of Nazism in socialism and to totalitarian streaks also in the British debate on society and how these tended to eliminate the difference between “society” and “state”. He also engages in the current debate with references to the debate of the day. In the final chapters it becomes clear that the fundamental problem Hayek is discussing

is how to cope with the problem of prioritising the multitude of desires, values and goals that people hold. His solution is the market, which will sort all this information out and arrive at solutions. It is not the means as much as the ends, that markets can coordinate. Freedom is the freedom for everyone to pursue happiness in ones own way. We do not know how a market works – it is his main point that planners and the state could never simulate it – but we should submit to its magic and accept our ignorance about it. Only late in the book does the concept of organization appear. Hayek claims that part of the dealing with a multitude of values and goals is to organize at the right level – the principle of subsidiarity applied by the European Union (my comment). Monopolies appear in his world of companies but not large multinational ones. A single goal for all in the form of “share holder value” is not present at all, even if he points to the capacity of money to translate between the different ends people might strive for.

Karl Popper (1945), "The Open Society and Its Enemies" – vol 1 & 2

Popper is most known to social science doctoral students for his theory of science doctrine called “falsificationism”, which states that a proposal is scientific if and only if it can be falsified. Science progresses via conjectures and refutations, i.e., by elimination of error. If claims are not falsifiable they are not within the lines of demarcation that separate scientific claims from beliefs, religion, and other superstitions.

Popper’s ideological work, written after he escaped from Austria in the late 1930s, first in New Zealand for a short period, and then at London School of Economics, was published at the end of the Second World War in London. He finds the enemies of the open society in some of our most prominent philosophers (Plato, Marx and Hegel) and shows how they went wrong. This is why the text could be classified as ideological. There were critics, of course. This is not intended to defend or accuse, just bring out a few arguments that Popper uses. Plato first. Popper points out that Plato reasons backwards from the current situation to earlier times to find his Utopia (the Golden Age); a society consisting of *guardians* (philosopher kings), *armed auxiliaries*, and the *working class*. *The guardians*, it should be noted, are communists. They are not driven by economic gain, but share all (including women and children), and are satisfied by enough wealth. They are also the prototype of latter days’ Principal (my comment). This class cannot be infiltrated by lower classes and is kept clean by breeding and education. *The auxiliaries* may keep arms, and *the workers* work. In a later chapter Plato defines justice as fulfilling one’s function in society and happiness follows from this functional view. Stabilizing society is the goal since change is decay. Popper points out, in several passages, that Plato wrote these texts as an ardent opponent to democratic Athens, and in defence of a return to (benevolent) tyranny.

An important prerequisite for Plato’s design of the good society is that

we distinguish between laws of nature and normative laws (a distinction not upheld by latter days' neoliberals – my comment). Natural laws describe a strict, unvarying regularity that holds in nature (when it is true) or not (in which case it is false). If we do not know which is the case the statement is a hypothesis about nature, which can be tested.

Normative laws are different. They can be enforced by men and are alterable. They can be described as good or bad, right or wrong, acceptable or not, but they cannot be said to be true or false, since they do not describe facts, but lay down directions for our behaviour. Popper argues that this distinction is necessary for understanding Plato's sociology (design of the good society). Popper's critique of Plato's theory will take him from "naïve monism" (a characteristic of the closed society) to the "critical dualism" of the open society.

In *naïve monism* the distinction between natural and normative law has not yet been made. Unpleasant experiences are means by which man learns to adjust to his environment, whether sanctions are imposed by other men or suffered in the natural environment.

In *critical dualism* we uphold the distinction between facts and decisions. But - one might claim - a decision is a fact, once it is taken. Here one must distinguish between the description made by the decision and the fact that the decision has been made. Popper illustrates by referring to the statement "Napoleon died in St Helena" as compared to "Mr A stated that Napoleon died in St Helena". We cannot deduce that Napoleon died in St Helena from the fact that Mr A said so. In sum, we cannot derive a norm, or a decision, or a policy proposal from a sentence stating a fact. As mentioned, the distinction between laws of nature and normative laws is crucial. An important point is that normative laws cannot be deduced from facts, they have to do with values and persuasion (rhetoric).

A critical moment in Popper's attack on Plato is his critique of Plato mixing up the meanings of individualism, which are two according to the Oxford Dictionary:

- Individualism as opposed to collectivism
- Egoism as opposed to altruism

There is no contradiction in an individualist being altruistic. But Plato uses the rhetorical trick of confusing individualism with egoism in support of his collectivist solution for the Good Society. This confusing allows him to use proverbs like "friends have in common all things they possess" to arrive at collectivist conclusions. It also allows him to define justice from the criterion of the interest of the state. That which serves the interest of the collective is just. Those with another opinion should be banished.

In a concluding discussion Popper makes an effort to understand Plato by pointing to the current debate at the time of Plato, which focused on the question "who should rule?". The obvious answer is "the best" or "the wisest", or "the

masters of the art of ruling”, “the general will”. But even the most powerful tyrant, once elected, will realize that there are other political forces. The ruler is dependent upon his secret police. We therefore cannot allow unchecked sovereignty. The ‘paradox of freedom’ was first used by Plato (What if the democratic majority wants to be ruled by a tyrant?); that we have to give up some of our freedom to be really free, is taken up by Popper to discuss *institutions* that may protect us against the mistakes of a bad or incompetent tyrant. To understand how Plato came down on the side of a “tyranny of the wise” Popper reminds us of that Plato is working backwards towards some original (utopian) stage of society – a tribal situation with organic order, intimacy, authority. The initiation of decay of the City State of Athens came from its opening up to trade, and its expansion across the seas. This brought new forces of change and thus decay, since it stimulated the democratic movement.

Popper argues that Plato, who hated the decadent democracy of Athens, wanted to design the good society by seeking origins and take inspiration from there. He ended up with collectivism and justified this stabilised society by using rhetorical tricks (like, confusing the meaning of individualism) to define virtues like justice in terms of what is good for the state. Popper’s account for Plato’s organizational ideas should be remembered when we look at the fate of RBS (Royal Bank of Scotland) ahead.

Milton and Rose Friedman (1980), ”Free to choose – A Personal Statement”

The book is based on ”Capitalism and Freedom” (1962) and a TV series and is decidedly “popular” in its presentation of arguments against an interventionist state and for increased freedom of choice for individuals as the solution to most social and economic problems. Having been alerted to Plato’s rhetorical methods by Popper we can see similar patterns in the Friedman approach.

There is frequent reference to “origins”, i.e., going back to old historical sources to “prove” a point about current problems. Adam Smith is used very often as an authority on free trade and competition, as well as “founding fathers” formulations. Nothing wrong with that, except that those authorities were dealing with current problems more than 200 years ago. The “facts” were different at that time even if their phrases were convincing (my comment). Further, the Friedmans often label things normal or “natural” when it is more like assumptions, on their side, that are required for their arguments to hold. This is a technique that is pre-modern in that social philosophers and scientists in that era usually referred to introspection as a source of knowledge in their reasoning (like Adam Smith did – even if he recommended the impartial spectator procedure in moral reasoning).⁷

They also refer to “movements” among the people to dismantle crippling

⁷ The impartial spectator procedure was discussed in Smith (1759) and tells the decision maker to consider how an impartial spectator would judge the contemplated act before acting.

state bureaucracy. The ascent of Margaret Thatcher is promising and the Swedish welfare state is doomed now (book published in 1980) that the social democrats have been defeated in the election. Single cases are typically used to “show” the meaning of more general statements – carefully selected cases – no doubt for pedagogical reasons.

The book starts out in praising the strength of the market where cooperation through voluntary exchange makes everybody better off, and how the price mechanism transfers information about the value of things to people who need it, i.e., to the insiders. This happens because those with the information have an interest to transfer the information to those who have use for it, and those who have use for the information want to gather that information. The information is useful because people have an incentive to act on it. Action, i.e., voluntary exchange, will have an effect on the income distribution, since both parties to an exchange consider themselves better off after the exchange since their sales income is greater than the production cost of the exchange object and vice versa. Since both will be better off, there will be economic growth. The “invisible hand” metaphor is also widened to other areas of life where sophisticated structures emerge as unintended consequences of a large number of people cooperating while seeking their own benefit.

Take language for example, or science, where spontaneous interaction leads to progress! Then “the state” is brought in. Adam Smith has defined the duties of the state (protect citizens, careful justice, promote voluntary exchange by introducing generally applicable rules). The third duty mentioned is the difficult one since there must be limits to the expansion of state intervention. The Friedmans present examples of such limitations in practice. Next a chapter deals with the tyranny of regulation and planning with arguments for free trade and private property rights.

A third chapter describes the emergence of the Federal reserve system, the crisis of 1929 and the failure of the Fed to combat the crisis by increasing the volume of money in the economy, and, finally (December 1930) the closure of Bank of United States (its name was thought to constitute unfair competition for immigrant deposits) as the plan to save it by setting up a guarantee fund failed because New York Clearing House backed out in the last moment. The consequences were dire. In the same month 352 banks went bankrupt. As other banks called repayment of loans the economy stalled and the depression was a fact. That crisis generated space for a discourse on safety and welfare; the “New Deal” was established.

The idea of the welfare state with extensive obligations for the state gained adherents, but the results are frightening. In Britain unemployment grew and Margaret Thatcher came in as a saviour, Sweden has fared better than Britain but the people were fed up and replaced the social democratic government in 1976 (still we have not seen any real change of direction, though, the Friedmans claim). The most dramatic example in the USA is the failure of New York City.

Federal money saved the city that had invested unwisely in a large hospital, a university, and tuition free education. The welfare state does not work because it transfers money to the middle class (notably the bureaucrats), at the expense of the rich and the poor (Director's Law – Director, as we have noted above, was Milton's brother-in-law). The chapter concludes with recipes as to what to do to put a stop to the waste. A final chapter on equality argues that by putting emphasis on freedom we will achieve greater equality as a welcome by-product. We are now ready to discuss more in detail the reform requirements in different sectors of society. First schools; the problem with their poor performance is that public schools have been bureaucratized, and the solution is free choice based on a voucher system. Same with higher education! Consumer protection should be achieved by information rather than regulation (Prohibition did not stop the consumption of alcohol, did it!). If the government has information about the benefits of using safety belts or avoiding cyclamates or DDT it should let us know. But we should decide for ourselves what risks we are willing to take with our own lives.

Who protects labour? Labour unions, one would assume. The Friedmans claim that unions, which do not have that many members anyway, only redistribute resources to those who have jobs from those who have not. The power of unions comes, not so much from threats to damage the employers' equipment as from their ability to elicit help from the state, for instance minimum wages, or limit the number of workers who are allowed in a profession, like in the medical profession where authorities set the criteria for legitimation to practice medicine. Look, say the Friedmans, the headquarters of the unions are gathered around Capitol Hill in Washington. Undue influence peddling is going on!

All these state interventions lead to waste, which contributes to inflation, the process whereby people are robbed of the purchasing power of their savings. Of course they like the value increase of their houses and the lower value of the debt they have to repay, but soon the bank will compensate by increasing the interest rate and inflation will accelerate and spread. The cure for inflation is management of the volume of money in the economy. The consequences will be painful for a while, but the diagrams show that inflation moves in step with the volume of money. The consequences in terms of higher unemployment and slower growth are not the cure, they are the unfortunate side effects of the cure. The argument in this final descriptive chapter is full of illustrative anecdotes from many countries. The important conclusion is that inflation is a monetary problem. It is the government/state that decides about the money supply nowadays.

The final chapter indicates that the tide is turning. Change is imminent. The collectivist solutions are giving way to individualism and freedom of choice. Margret Thatcher is one sign, Proposition 13 in California another. The intellectuals are the Friedmans' main target. When the opinion has started to change and reaches the general public there will be a quiet revolution. The

Friedmans cite an article in Wall Street Journal about “the Swedish tax revolt” in showing how far we have come. The tide is turning, but special interest groups still sway power in Washington by using lobby to influence the bureaucrats of all these program specific agencies. The smaller the state apparatus the more limited the opportunities for special interests to assert their power against the general public interest. The book ends with suggested changes of the constitution, which by the way, can be integrated into one package law stating the right of the people to buy and sell legal goods and services at mutually satisfactory terms must not be infringed upon by Congress or any of the states. The free market will solve all and any problem.

Three ideological/neoliberal books: The Friedman book is openly political as indicated by the subtitle “A Personal Statement”. So are Popper and Hayek. The rhetorical principles are the same as those pointed out as used by Plato in his frustration over the decay of Athens into a mire of democratic irresponsibility. Back to the origins and toward what is natural are the design principles the Friedmans apply. Lots of carefully chosen tales from the current debate as well as far away countries, like the Meiji restoration in Japan in the 1860s, give meaning to the arguments. All kinds of human activity can be reduced to economics, we all strive towards utility, which in essence equals the pursuit of happiness-clause of the Constitution because it is up to everybody to define what happiness is. Plato, who defined happiness as stemming from functional contribution to the state, was wrong. Hayek’s claim that we should embrace the market even if we do not understand how it works adds a magical touch to neoliberalism.

This was the normative/activist side of neoliberalism with many good arguments for freedom and individualism. Problems arise, though, when these ideas are put into practice via economic policy measures based on its assumptions about what people are like and how they seek happiness.

6.5. The practice of neoliberalism – deregulation

The Second World War and the Cold War got in the way of the liberal agenda. Socialism got a new hearing as people watched the heroic efforts of the people of the Soviet Union during the war. Only later did the general public get information on the abuse of power that manifested itself in the vast Gulag system exposed so vividly by Alexander Solzhenitsyn. In media and the public conscience the Soviet failures were overshadowed by the horrors of the Holocaust. Rebuilding Europe took a massive intervention by the state, already expanded to manage the war economy, but now using its regulatory power to promote growth and consolidation of damaged economies. American aid (the Marshall plan) and the international expansion of American industry (*Le Défi américain* (1968) by Servan-Schriber illustrates the discomfort Europeans begun to feel about the “help”) generated mixed feelings. Nationalist, and regulatory regimes survived for a long time.

The de-regulation episode started in the 1980s and Finance triumphed (Madrack, 2011). Again it was firebrand economists with an economic policy agenda that cleared the way. Milton Friedman and the Chicago school soon became an ideological centre and Thatcher/Reagan provided decision and implementation power. Madrick (2011) has chosen to describe the process in terms of portraits of important actors. The action had, no doubt, moved over the Atlantic Ocean, the academic excellence with it, but Thatcher and the British establishment longed to prop up London as a world centre of finance by means of a Big Bang.

Madrack (2011) starts out by pointing out how a slow moving revolt against regulation had started already in the 1960s, but it was the shrewd ideologue Milton Friedman (1962), who knew how to give the neoliberal movement a new momentum: “Only a crisis – actual or perceived – produces real change. When the crisis occurs the action taken depends on the ideas that are lying around.” (preface of the 1982 edition). He engaged in various political activities as mentioned above (Barry Goldwater, column, TV series) to hammer home the message of the MPS. The free choice of individuals must be promoted and regulation minimized. But action was delayed, the US government had Vietnam to think of, currencies and interest rates were volatile, the oil crisis of 1973 had great effects on all economies. Banks, lead by Citicorp, used their creativity to develop derivatives to hedge against fluctuations. The merger and acquisition bubble of the 1970 generated a need to fund the evermore daring takeovers. Banks’ equity was under pressure as liabilities increased.

At this time Ronald Reagan, a devoted democrat and union activist (actors’ guild) from the beginning, had a change of heart under the influence of the Hayek and Friedman books. The problems with the state’s finances were the result of an overgrown welfare system. Reagan took office as Governor of California in 1965. In his second term, 1972, he initiated a Tax Reduction Task Force, which was lead by Lewis Uhler, a devoted right wing constitutionalist, who later set up an organization (limittaxes.org) to promote constitutional limits to public spending and included Milton Friedman (Friedman was on the board of Uhler’s organization). Its report (December 1972) resulted in the famous Proposition 13 that proposed a binding decision to reduce the personal income tax of Californians from 8.3 percent to no more than 7 percent. Proposition 13 was defeated. (See O’Reilly & Dugard, (2015) and Weisberg, (2015) for further information on Reagan’s presidency).

The 1970s was, politically, dominated by the fight against inflation (oil prices). Milton Friedman’s idea that it had to do with the money supply had taken hold of the thinking (even if Blinder (2013) showed that it could not explain the level of inflation). Things started to change when president Carter appointed Paul Volcker to chair the Federal Reserve System (the Fed). Volcker was a dedicated inflation fighter. He used money supply and interest rate changes to push inflation down. When the measures took effect the GDP fell sharply and Volcker had to

set in stimuli, which made the economy rebound, not least because of president Reagan's deficit spending (and tax cuts). When Volcker handed over the Fed to Alan Greenspan in 1987 his defeat of inflation had provided a good cover for other activities to reduce government interference (by "starving the beast" as Friedman had argued), which caused imbalances that in turn, caused the stock market to crash in October 1987. Alan Greenspan, saved the financial sector by rapid monetary expansion, which worked, partly because Volcker had starved the economy. In this sense the 1980s had been geared to volatility by the use of strong state interventions.

Alan Greenspan, born 1926, is an interesting participant in the period leading up to the financial crisis. A New Yorker he started his studies at Julliard School of Music instead of attending a conventional college, with the aim of becoming a professional musician. He dropped out and joined a professional jazz band as a clarinetist (Madrack, 2011, chapter 14), but 1945 he entered New York University graduating in 1948. Then he attended Columbia University to study economics under Arthur Burns, but dropped out to join a consultancy firm oriented toward economics (Conference Board). His first wife, introduced him to Ayn Rand, who made a strong impression on him (she and her husband were the only persons Greenspan later invited to his swearing in as head of president Ford's Council of Economic Advisors (CEA)). Greenspan entered politics in 1967 by joining Nixon's campaign as economic advisor, but refused to join the White House staff after the election was won. In the wake of the Watergate chaos Arthur Burns, his former professor, now chairman of the Fed, persuaded him to enter CEA. In spite of the severe recession Greenspan advised Ford to fight inflation generating high unemployment. He commented this on a TV-show by showing little understanding for unemployment ('only a pause in the upswing'), which probably contributed to reduce Ford's re-election prospects. When Ford lost the election Greenspan returned to business. In 1977 he got his PhD from NYU on a thesis consisting of a set of "business analyses" mostly published in "business journals" or done for clients. In the 1980s Greenspan gave advise to the Reagan White House, and he was called in (1981) by Reagan to head (with senator Moynihan) a committee to find ways to combat the rising deficit in the social security system. His visibility and many good relations helped him to the post as Chairman of the Fed to replace retiring Volcker in August 1987. The first years he followed his predecessor's policy and gave priority to fighting inflation by raising the interest rate. There were arguments for paying more attention to unemployment, but he managed to keep the trust of presidents and consolidated his position. In late 1994, against a background of critique that he did not care enough about unemployment, Greenspan took action twice to fight inflation. This generated a crisis for Mexico, a country in deep debt, much held by US banks, but a rescue package (30 billion USD) saved the day and by 1995 inflation seemed to have been broken, staying steady at 3 percent.

Greenspan was well liked by the finance sector now. Share prices increased

rapidly. Shiller (1989) warned about a bubble. In 1996 Greenspan commented on this “bubble” using the term “irrational exuberance” and saw a strong effect on stock markets all over the world. He might have realised the power of words at this time and now he started to pronounce in an opaque Oracle-like manner.

Things were looking good toward the end of the century, inflation and unemployment were low, the budget deficit had turned into a strong surplus.

As LTCM (Long-Term Capital Management, a hedge fund started by academics and based on the Black-Scholes model) failed, partly due to the Russian default on interest payments at the time, Greenspan and his friends in government called in investment banks to bail it out, stopping panic to spread quickly. A disturbing aspect of the situation was that consumers had reduced their savings significantly, and invested instead in derivatives (borrowing money to fund it). Greenspan was convinced that the rapid growth of the economy had to do with new technology. In 1999 he was ready to start the fight against inflation again and raised interest rates in several steps to 6.5 percent in May 2000. The effects were strong; a serious recession met George Bush as he assumed the role as president of the USA. It was agreed that the best way to meet the recession was to reduce the budget surplus (Clinton had used the surplus to reduce government debt rather than investing in infrastructure etc.) by tax cuts. Nearly 90 percent of the tax cuts benefitted the top 5 percent income earners. The surplus shrunk rapidly.

As Manhattan was attacked on 11 September 2001 it was necessary to step up action to restart the economy. Interest rates changes did not seem to help much, the budget deficit grew even faster as the wars in Iraq and Afghanistan turned out to be more costly. But the low interest rates fuel the housing market, banks selling mortgages with ARM (adjustable-rate mortgages) to generate a very strong dynamic. The demand (from pension funds etc.) for the derivatives based on these mortgages seemed without bottom. But when Greenspan raised the interest rate again in 2004 the bomb started to tick as mortgage holders, their “adjustable-rate mortgages” being based on Greenspan’s rate, started to fail to pay on time. The rest is history. Greenspan came to personalize the marriage between free market ideology and state intervention to bail out the large actors that failed in the race toward economic growth. Greenspan preached that markets would regulate themselves (and the creditors) at the same time as he endorsed state intervention to save the failed banks (for the sake of the system stability).

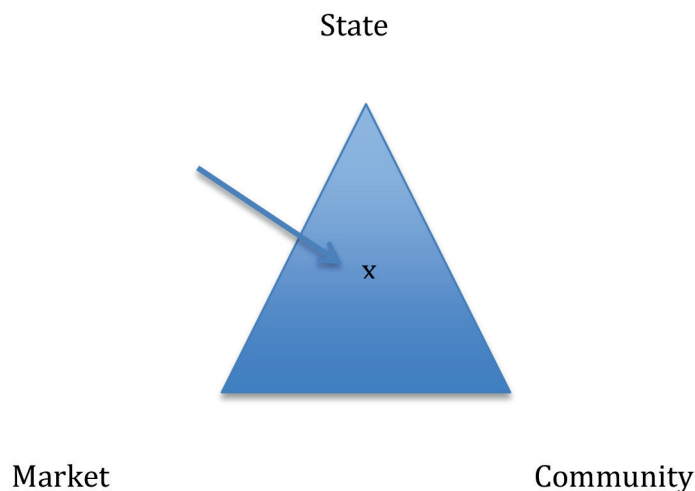
Prime minister Thatcher of Great Britain played a parallel role, with the “Big Bang” in London. It was based in an agreement in 1983 between the government and the London Stock Exchange to settle a wide-ranging anti-trust case initiated by the previous government. The complaint was that the London Stock Exchange had restrictive practices in place; like minimum commissions, ‘single capacity’ rules, which separated actors into separate functions (brokers, jobbers, etc), plus excluding foreigners from doing business on the LSE. The Thatcher government saw that London had fallen behind New York as a global

centre of finance and risked falling further behind. The cause of this was over-regulation and the reliance of “the old-boys-network” rather than free market competition and meritocracy. The “Big Bang” was an expression marking the idea that deregulation would increase the activity in London as a financial world centre. The lax oversight and regulation by the Financial Services Authority (FSA) that accompanied the Big Bang was strongly criticised later in the report on the HBOS failure. The report claimed that the FSA had focused on the competitiveness of Great Britain rather than the stability of banks. (FCA/PRA, 2015).

Discussion

Now, that is after the 2008 crisis, things get complicated! Complexity and contradiction are abundant as we have left “academic” debate and entered the world of economic policy making (at the same time as academic research in the form of Finance Theory has entered the banks in the form of risk management and –measurement). In such situations, Merton (1949) tells us, ideology production is stimulated. To depict the situation in the banking context as the financial crisis approached in terms of the “corporatist” triangle one would have to choose some middle ground with all three corners “in play”.

Figure 7:



This means that the “logics” of all three organizing logics appear at the same time without anyone of them clearly dominating. Market arguments, State arguments, and Community arguments compete for public attention. Dealing with complexity with a single-minded world-view stemming from a situation and practice a hundred years ago is not likely to work. At the same time there are sediments of all the foregoing world-views in current policy statements and actions. When facing complexity people tend to resort to power as a way to

simplify the road to action (as history shows us). The case of the Royal Bank of Scotland will illustrate how this works.

6.6. A bank under neoliberalism

I have chosen Fraser's book (2014) on the trouble of the Royal Bank of Scotland (RBS) to illustrate how the practice of banking can go from good to bad in a very short time if conditions are conducive to such a development. I could have chosen Grind's book (2012) on Washington Mutual or Perman's (2013) on HBOS – the patterns are quite similar – and I am fully aware of the fact that these three authors are business journalists specializing in banks, and not scientific researchers. But in this project only description of facts on the ground (which can in principle be checked) and common sense interpretation of them, or applying a new perspective that will “show” the obvious conclusion, is required. There are not very many academic studies of a descriptive nature yet of banks and their responses to a changing environment. One could wonder whether the world and worldviews have become more complex these days than they were in the days of Fugger and Medici. Probably they are not. It is only that academic research – in the case of Fugger and Medici done by historians – is good at reducing complexity and clarifying issues of this or that specific branch of research. Here I am writing from a standpoint of confusion over the fact that so many banks, policy makers, and researchers failed to see what was coming and take appropriate action. This historic overview of the fate of banks in particular circumstances and particular world views is aiming at finding clues that could help us re-set bank management studies to better understand what is going on when banks interact with their environments. Persuasive arguments in such an endeavour are not likely to come from strict adherence to the theory (implicitly) under attack. But we will probably find that the keys to understanding in crisis situations – as Friedman (1982) put it – “depends on the ideas that are lying around”.

Inside the Royal Bank of Scotland (RBS)

I have read Fraser's book carefully, noting arguments and facts that seem strange in the light of received wisdom in finance/banking theories, I have then pieced together the shortest possible account of the rise and fall of the RBS

Actually the title of that book (“Shredded - inside RBS the bank that broke Britain”) is rather clever (if somewhat overblown) since the leader of the bank during the most dramatic period was Fred Goodwin, nicknamed “Fred the Shred”. When Fraser reported on RBS (1999 - 2008) its most striking feature, he thought, was its market value, that at times seemed detached from reality. The value was greater than all other listed companies in Scotland put together. How could that happen?

RBS originated in the failed Company of Scotland that tried to establish a

colony in Panama several hundred years ago. As part of the agreement to form the Union with Scotland in 1707, the British government paid compensation to those who lost money in an effort to establish a trading colony in Panama, and these resources were pooled to start the Equivalent Company that, in turn, was instrumental in starting the RBS in 1727. The earliest goal of the new bank, Fraser claims, was to put the "Old Bank" (Bank of Scotland) out of business. After the First World War RBS found Scotland too small and embarked on expansion by acquisition of four British banks. The period after the Second World War was good to banks, with Keynesian spending to rebuild society and strict regulation of the financial sector, which prevented new players from getting a foothold. But as heavy industries declined, like shipyards, the bank attempted to solve the problem by acquisition again. The National Commercial Bank of Scotland, a larger bank than RBS, was acquired in 1969/70, resulting in a market share of some 40 percent, and 700 branches. But the leadership of RBS saw no merit in supporting the manufacturing sector - volume of the bank itself rather than promoting growth of the Scottish economy had priority. In 1981 the board accepted a take-over bid from the Standard Chartered bank, but there was opposition from the public and a competing offer from the Hongkong and Shanghai Banking Corporation (HSBC). The public was unaware of the fact that also Lloyds Bank had been pursuing a take-over of RBS for some time (and other banks, including Deutsche Bank, were thinking in similar terms). This situation with competing bids was the reason for the board's acceptance of the Standard Chartered's offer. The battle over who should take over RBS generated an intense political debate. The Thatcher government (despite its free market ideology) referred both offers (Standard Chartered's and HSBC's) to the Monopolies and Merger Commission, which concluded that neither of the bidders could be allowed to take over RBS. This experience was something that the RBS did not want to have again.

Thatcher had come to power in the election 1979 and embarked on reforming the economy and "bring harmony" into it by monetarism, lower taxes, and privatisation. However she had included high interest rates in her policy and this generated decline in industrial investment and increased unemployment. Demands for her resignation emerged, but popularity returned with the victory in the Falklands War, and Thatcher embarked on further free market reforms and "responsible capitalism". RBS acted upon these reforms by acquisitions and by starting an insurance business (Direct Line). At this stage RBS was underperforming due to an unwieldy structure and multiplicity of businesses without matching systems of management.

When Thatcher was re-elected for a third term, the shock therapy seemed to have worked, the economy was growing, share prices soared. In 1987 a fairly young (47 years) scientist (mathematics and physics, PhD in engineering), George Mathewson, was appointed director of RBS responsible for strategy and development. Even if he was not a banker, he had business experience from

venture capital and had worked very actively with SDA (Scottish Development Agency) since 1981, recruiting “sunrise industries” to Silicon Glen, Scotland’s technology corridor. He was also a close ally of the secretary of state for Scotland, George Younger.

After announcing his resignation from SDA in March 1987 he was offered many jobs, but chose RBS as a good opportunity. The current CEO, Winter, who had started his career in RBS at 16 and soon would retire, supported Mathewson, and saw him as a possible successor. But Mathewson had to prove himself. He started his new job on October 1, and on October 17, “Black Monday”, the stock markets in New York and London crashed. Mathewson hardly noticed since he was busy familiarising himself with the bank. “The Royal’s new strongman” (a headline at the time) saw his mission as “to shake things up”. The strategy for this was worked out in secret meetings with a small team. It stressed marketing (properly targeted), beside layoffs, and introduced a performance measure called “products per customer” (properly incentivized) – the branches must sell more. The changes amounted to a cultural revolution. The current CEO, Winter, who had accepted the plan (called Nova Reda) was disappointed and resigned “a broken man”. It seems like the new culture did not filter down through the ranks as Mathewson had expected. Communication with the “grass roots” was not in order.

Britain’s “Big Bang” ended in a spectacular bust as property values declined about 30 percent from 1990 to 1993 with attending bad debts. Mathewson initiated a further restructuring plan to improve management capacity and slim the structure further. This project, called Columbus, (‘he did not know where he was going’, internal comments went), included segmentation and specialization of staff, with the regional level dismantled. McKinsey had been brought in to assist. Banking had changed from service to sales and profit, Mathewson argued that RBS should be best in class. No more “sleepwalkers” in the management team. Six hundred secretaries were made redundant. Managers had to type their own letters. One manager, quoted by Fraser (2014, p 30), pointed out that “this meant that there was no longer any record of what we were doing”. Bad debts were transferred to a special unit “Specialized Lending Services”. Mathewson considered the Columbus project a success; the cost-to-income ratio came down from 65-70 to below 50.

What had given him the resources to carry it out was his marketing strategy built on the idea of multi-branding. This included winning customers from the lazy big four banks by making deals with, e.g., Tesco to offer bank services in supermarkets under the brand Tesco Personal Finance, or developing direct services in car insurance (Direct Line). This provided growth, profit and a comfortable cash flow that made Columbus and further ventures instrumental as base for the bank’s ability to leverage capital. It was a design for enhanced control from the centre. The stage was set for the next venture, which was financial engineering. RBS was now big, but was still considered a “plain vanilla

bank” by corporate customers, it could not deliver the financial services that more “sophisticated” customers needed. So Mathewson hired Iain Robertson (his own successor at the Scottish Development Agency) to lead a new corporate banking division, headquartered in London, which was assembled from existing business units. Still strategically oriented toward competitive advantage in special niches this new division soon sold its asset management and investor services and engaged in train and rolling-stock leasing and in helping Enron with 14 structured finance deals – very profitable initially but with a huge loss as Enron went bankrupt in 2001.

The globalization of RBS took two roads; into the USA via the acquisition of Citizens, in 1988, and a further 19 banks over the next 12 years all integrated with Citizens, where CEO Graboys later was succeeded by Fish. These CEOs on the American side were allowed to run their business as they saw fit with little interference from head quarters.

The European road, fired on by the prospects of a single European market from 1992, started with a strategic alliance with Spanish Santander (in 1988). Both moves (Citizens and Santander) were strongly criticised by bank analysts who did not like the declining profitability 1988 – 1992. The 1990s constituted a disappointing decade for ambitious Mathewson, with a number of failed acquisition attempts.

Deregulation had made it possible for building societies to de-mutualize and, thus became targets for mergers bids. RBS courted a number of them but failed to offer top prices. Mathewson did not want to enter into open price bidding for fear that a failed offer would make RBS itself a possible target for take-over bids. A deal with Birmingham Midshires building society went to the public stage however, but its members refused the offer and chose a higher bid instead. The plan had been to continue to run Birmingham Midshires as a separate brand (a policy that was to continue). Instead of growing in the building society sector the consequence of this “failure” was that RBS itself became an interesting target!

In late 1998 Martin Taylor, CEO of Barclays, suddenly resigned in a strategy dispute with his board. Barclays warned that profits for the year would be lower than expected. Now Barclays also was “in play”. The investment advisor Terry Eccles of JPMorgan encouraged - “and probably egged on by the new recruit Fred Goodwin” (p. 55) as well - Mathewson to offer a “reverse takeover” (i.e. the smaller partner takes over the larger one), but with a new CEO appointed at Barclays this deal was turned down as well. Now RBS really had caught attention! Its actions seemed somewhat desperate.

Mathewson had met Fred Goodwin in meetings of the CSCB (Committee of the Scottish Clearing Bankers) and was impressed by his “intellect, grasp of detail and no nonsense approach” (Fraser, p. 62). He asked Goodwin whether he would accept the job as finance director of RBS (indicating a further step to CEO). After some negotiation Goodwin had started at RBS in August 1998. After 15 months at his previous job as CEO of Clydesdale Bank he was deeply

disliked at that bank for his autocratic style. Several of the members of its management team had left. (A proper check on Goodwin's merits would have discovered this.)

Goodwin had studied law but was chartered as accountant at Touche Ross (later Deloitte) where his greatest achievement was 'leading the worldwide liquidation of Bank of Credit and Commerce International (BCCI)'. In fact he was a member of the liquidation team and charged with back office chores. A Touche Ross colleague from that time said to Fraser: "Either you were a solvency partner or you were not. Fred was not." Still in 2012 newspapers wrote that Goodwin had single-handedly lead that liquidation. Commenting on his "autocratic style" at Clydesdale Goodwin claimed that he wanted to be judged on his results. A control freak and micro manager Goodwin was obsessed with décor, appearance and tidiness (Fraser, 2014, p. 69). However, when Goodwin was touring RBS to get acquainted with the organization, people were surprised by his lack of interest in credit scoring or anything that had to do with his role as finance director. On his new job Goodwin soon developed a habit of "tearing people apart" at morning meetings. He was called "Fred the Shred" and some called the morning meetings (every day at 9:30 to 10:00) "morning beatings".

Bagging NatWest

The most significant event in the rise of RBS was the hostile take over of NatWest, a London bank formed in 1970 by a merger between Westminster Bank and National Provincial Bank. The affair was dramatic and drawn out. From 1999 NatWest was in trouble. It had opened itself to "be in play" by announcing plans to buy the fund management group Legal & General investors, but met resistance there. Rival Bank of Scotland (BoS) saw an opportunity and announced a hostile take over bid in September 1999. RBS prepared a counter offer, but preferred a friendly approach. Negotiations turned sour as NatWest wanted to be the dominating part. The RBS, offer was well prepared by analyses top-down as well as bottom-up. Bidding ensued and RBS came out as victor after many turns (Fraser, chapter 9). Due to the good preparations the merging process went smoothly and was declared a success (to be used as an argument by Goodwin in the coming years – a Harvard Business School case study was made under the title "Royal Bank of Scotland: Masters of Integration"). Two aspects of the integration of NatWest should be noted; due to internal conflicts and lack of organization RBS decided to get rid of many managers of NatWest in the London office but to let the American part continue relatively intact as Greenwich Capital, the other notable observation is that RBS decided to keep its "spreadsheet approach" to group financial reporting (NatWest had a more advanced system), which meant that there was no "audit trail" to the underlying financial and operational information. This made RBS accounting more susceptible to cheating with the numbers.

Soon after the NatWest deal was settled Mathewson moved up to chair the

board. Goodwin took over as CEO and was given a free hand. RBS showed very good results for 2000, but the auditors refused to sign off on an issue related to the NatWest acquisition and Goodwin dismissed the auditors, PwC, and hired Deloitte, Goodwin's former employer, without tender. Tensions soon developed between Mathewson and Goodwin resulting in Mathewson's withdrawal from active participation. Increasingly Mathewson participated in board meetings via the video conferencing facility installed in his home. Goodwin pursued growth, especially in the investment bank business, but also through continued acquisition of other banks in northeast USA for Citizen Financial. All the time using the RBS retail bank as a cash cow and increasing leverage. Goodwin wanted RBS to be one of the largest banks in the world, like Citigroup, often talking about rankings. He stressed the use of "metrics", not least return on equity (RoE), in managing the bank.

"Discipline and punish"

Fraser claims (2014, Chapter 12) that a culture of fear emerged as a result of people who wanted to be open and honest about a situation risked being "shredded" in Goodwin's Monday meetings. Goodwin adopted Welch's (former CEO of General Electric) method of ranking employees on performance. The problem with this was that moving a well performing subordinate up to the "top performance" category required another to be moved down since each unit had to comply with the "Bell curve". Very ambitious budget targets, often considered unrealistic by those who had to live up to them, set the stage for internal competition rather than co-operation. You had to allocate all your time to meet your own targets. Employees were disciplined under the yoke of PEF (Performance Evaluation Framework) and LEP (Leadership Excellence Profile), which were quite open to subjective abuse (Kerr & Robinson, 2012). To further extend control over information Goodwin and communications director Howard Moody initiated stronger control over contacts with external stakeholders, even consultants could not be used without Goodwin's authorisation. Goodwin also engaged in litigation concerning defamation as journalists criticized aspects of RBS. One particular event is the effort to "slap" an injunction on a building company erecting a department store building on St. Andrew Square. The reason: it left specks of dust on Goodwin's Mercedes parked nearby.

Expansion

Now, early 2000s, Goodwin turned his attention to Ireland. Its economy had grown rapidly over the last few years as a result of tax incentives and deregulation that went a bit further than other nations'. RBS had acquired Ulster Bank in 2000, a well-run bank ranking as number three in the country. The new owner centralised the credit process to free staff to devote more time to selling. But Goodwin wanted a still larger share of the growing economy (BoS had entered the race in 1999). He found the solution in Cormac McCarthy, the

young CEO of First Active (an Irish mortgage bank). The timing was right since First Active had been made a limited company (former mutual building society) 5 years earlier and the ban on concentration of ownership was about to be lifted. McCarthy was offered good terms (to become CEO of Ulster Bank after the merger), his finance officer would follow him to the same position in Ulster Bank and a number of non-executive board members would be given a place in the new entity. Analysts were concerned that the offered price was three times the book value of First Active's assets, but the deal went through.

Now Ulster Bank embarked on a journey to become the number one bank in Ireland (J21, "journey-two-first", for short). The pressure to sell increased. Soon Ulster Bank was the first to offer mortgages at 100 percent of the value. An illustration of the atmosphere at the time is the Dunne affair: Sensing the overheated market the owners of a large site including two premium hotels in Ballsbridge, an up-market suburb to Dublin, had set it up for auction. Dunne, a rich property developer, arranged funding with his usual banks, Bank of Ireland and Irish Nationwide (275 million EURO) to enter the bidding. Ulster Bank approached Dunne with a better offer to take over the financing; credit for the whole sum of purchase, and a further 130 million EURO to buy an adjacent office building. This was the most expansive commercial property site in the world for a while. Before Dunne could obtain planning permission the financial crisis struck and Dunne went bust. Before the crash the Ulster Bank had managed to syndicate some of the loans to Rabobank and Kaupthing (among others). The credit loss seems to have been absorbed; on the surface the figures of Ulster Bank looked good for 2007.

In 2002 Goodwin was named the Forbes "Global Businessman of the Year". His position was very strong. Fraser has a chapter named "Royal Bank of Fred" with tales about extravagant expenditure on activities only remotely related to the business of the bank, like involvement in Formula 1 racing (the Williams team) and in golf (Jackie Stewart and Arnold Palmer appointed "ambassadors of the RBS at a handsome salary), seven limousines on duty 24 hours a day all days of the week for Goodwin, the corporate jet. By now the new regulator (FSA) had found its proper role was that of a quite lax regulator.

The American build-up

Goodwin now considered growth in the USA the best option, the Labour government had stopped Lloyds attempt to take over Abbey National in 2001, acquisitions in Europe were unattractive because of the cost of laying off people there. In the USA take-overs as well as lay-offs were less regulated. The RBS American arm, Citizen Financial had a smooth operator in Larry Fish, who had acquired smaller banks, seemingly successfully, at a rate of two a year for some time. However those acquisitions were usually paid in cash using RBS cash, but when pushed towards larger deals Fish's tendency to overpay for acquisitions came under scrutiny. A triangular drama between Charter One (that was also

courted by KeyCorp) and RBS (intending to bid on KeyCorp) ended in RBS acquiring Charter One after only three days of due diligence at a quite high price (10,5 billion USD cash, the largest cash transaction in the history of US banking). The deal was considered a bad one by Mathewson and by analysts, RBS shares fell five percent on the day of announcement in May 2004. Charter One had pointed out how well they were doing in HELOC (granting consumer credit with homes as collateral – not subprime mortgages).

In this situation a non-executive board member of RBS, Sutherland, commissioned an opinion poll of how investors saw the bank, its strategy, management team etc. The report, ready by May 2005, was devastating to Goodwin (does not listen, arrogant, treats share holders like idiots, etc). Sutherland read out parts of the report at a board meeting. Hostilities with analysts came to the fore at an analysts' conference in August 2005 where there were questions about a "management discount" on the share due to Goodwin's deal-making. After the board meeting and the critique in August Goodwin seemed a different person stating that he saw no need for further acquisitions - but before long it was announced that RBS would form an alliance with Bank of China (11.307 branches in mainland China), which meant acquiring 10 percent of that bank. A solution had been found whereby two other (passive) partners would acquire about half of this. Goodwin tried to calm analysts by pointing out that that the deal would be funded chiefly by the sale of RBS's stake in Santander (at 900 million GBP). The summer of 2005 also included the sudden resignation of the RBS director of finance (with "be more with the family" reasons given), and the appointment of a successor recruited from Citibank, but without experience as director of finance. The new CFO had, however, participated in the installation of an IT-system for credit derivatives at Citibank, a system that was rumoured to focus on hiding toxic assets rather than accurate reporting (Fraser, 2014, p. 212). By now the production of toxic assets via very high leverage was at its height. These activities created a system of interlinked traders that did a lot of trading between themselves, keeping the market "liquid". These volumes of trading required a large balance sheet. The fastest way to increase the balance sheet was by acquisitions (including the goodwill that came with overpriced acquisitions).

ABN AMRO - Goodwin's biggest mistake

ABN AMRO had sought growth over the first part of the 2000s and was underperforming. Goodwin was interested in ABN because of its Chicago-based subsidiary LaSalle Bank that could be merged with Citizen Financial to hide the fiasco with Charter One. Contacts with Santander showed that they were primarily interested in the Brazilian subsidiary of ABN AMRO, Banco Real, and the Italian one, Banca Antonveneta. Another possible partner, Fortis, saw the taking over of ABN's Benelux operations as their target. While this consortium was forming Groenink (the boss of ABN AMRO), who judged the RBS interest as hostile, had initiated negotiations about a merger with Dutch rival ING. This

came to nothing since ING would not pay enough for the shares of ABN. The low performance of ABN had drawn the attention of several hedge funds that were pressuring Groenink to achieve a turn-around, or else. On March 1 2006 RBS reported pre-tax profit that was 17 percent above the previous year. A couple of weeks later it was announced that Barclays was about to bid on ABN AMRO. Goodwin seemed to have panicked – he thought Barclays was likely to be targeted for a take-over – now, should their bid succeed, they would become “bid proof”, and focus might be directed toward RBS instead.

Fortis, RBS and Santander met in early April (2006) to work out a deal between themselves as the basis for their offer. The agreement was that ABN AMRO would be divided between the three, with RBS getting LaSalle, the Asian operations, and investment banking in the USA, while Santander would get the Brazilian and Italian subsidiaries, and Fortis the BeNeLux-operations. The agreement was legally binding for the rest of the acquisition process. The problem was that in the next few days Groenink sold the LaSalle Bank to Bank of America (price: 21 billion USD). This was described in the press as a “poison pill” to avert RBS interest in ABN AMRO. Goodwin was furious and took this as a personal insult. Things were hurried up, due diligence was insufficient, the consortium justified the acquisition with a claim that they could achieve considerable cost savings – this in spite of a US court having confirmed that ABN AMRO had the right to sell LaSalle (the chief reason for the RBS interest) at the stage it did.

Now ABN AMRO had two competing bids and the board refused to recommend either of them to share holders. By now the risks in the sub-prime market had been noticed and Moody’s started to down grade mortgage-backed securities in July. Northern Rock issued a profit warning at the end of July. BNP Parisbas suspended three funds exposed to that market on August 9. The next day the European Central Bank pumped 94.8 billion EURO of liquidity into the market. The same day RBS held its shareholders’ meeting, which voted to affirm the offer to take over ABN AMRO. By September Barclays shares started to decline – their offer was based in shares – which improved RBS’ prospects to win the battle. When the Dutch authorities accepted that the RBS consortium could buy ABN AMRO they appended very strict conditions, including that RBS must take responsibility for the whole of ABN AMRO as the bank was dismantled and obtain regulatory clearance every step of the way. Investor discontent with the deal grew after Bloomberg had publicized it on October 8. When speaking to the Treasury select committee on February 10, 2009, Goodwin admitted that it was a “bad decision” to acquire ABN AMRO. RBS had to borrow the majority of the payment for the deal on short terms (payable within a year), several surprises were discovered at ABN AMRO - 725 million USD invested in Madoff’s Ponzi scheme, ABN had shouldered 840 million of USD risk in one of Goldman’s synthetic CDO’s, and it had lent tens of billions to Russian oligarchs. Furthermore, the integration process got stuck in cultural clashes. A “bad decision” indeed.

On the RBS side Killop (now chairman of RBS) and Goodwin (CEO) claimed 2005 to 2007 that RBS was not doing “subprime” in spite of the fact that RBS was the third largest underwriter and bundler of US housing debt. In February 2008 RBS announced record profits (10.3 billion GBP for 2007) and a raise of dividends, but were also pressured by authorities to undertake a 12 billion GBP rights issue due to its leverage. Suspicions about the quality of its assets and liabilities grew. Time was running out. By October 11, 2008, in a meeting at the Treasury, the RBS leaders were told that RBS had to sell 20 billion GBP of equity to the government as part of the bailout (almost double the current capitalization (10,9) of RBS at the time), and that it had to abstain from paying any dividends until the 5 billion GBP preference shares that were part of the equity issue had been redeemed). Goodwin and McKillop had to go.

Learning from RBS

As mentioned this case is similar to the Washington Mutual (Grind 2012) and several others (cf. Financial Crisis Inquiry Report, 2011), so even if it is a single case it may be considered representative of the managerial activities in many banks destroyed by too fast de-regulation, the predatory atmosphere, and the following financial crisis. By focusing on rapid growth of the balance sheet to gain financial power via ever-increasing leverage top managers saw acquisition as the best strategy. They got used to deal-making as a normal part of business. Once acquired the “integrated” new parts of the growing bank were pressured to increase sales and cut costs at the same time. Investment in systems to back up well formed corporate governance documents were not popular because they were costly and time consuming. Centralization of decision power to decisive leaders with the talent to spot opportunities, and exploit them before others, was necessary for such a strategy to be executable.

The rhetoric in vogue at the time was neoliberal. The State is clumsy, bureaucratic and inefficient, while the Market is innovative and finds the solution, and therefore also the right price, much quicker. The only requirement is to allow the creative market actors to get on with it without unnecessary obstacles. Part of the innovative character of the Market is that individual, well informed, and competent actors in the market may be allowed to outsmart other actors. This was the game Mathewson and Goodwin were in. But it seems like they were also driven by a fear of being taken over, be “in play” as it were.

In the upsurge toward the financial crisis the market liked what they saw – the deal making caught the attention of the financial press as well as the investors – but the price of a take over bid tended to drift upwards – it was often too high to be attractive. Cost reductions were required to save the deal. Goodwill as part of the asset side of the balance sheet - the difference between the paid price and the book value of the acquired company - tended to grow, which required annual depreciation. Clearly the financial reporting was misleading over the last few years of RBS as an independent bank. But it had also been demonstrated that

auditors with doubts about the valuations will be replaced by more friendly ones.

Mathewson, and especially Goodwin, upset the delicate control balance (celebrated by the revered Agency theory (a product of the Chicago School)) by reserving the role of principal for themselves with the investing public (the owners) as supportive audience. This is in line with what already Chandler (1977) had described for the USA as happening in the 1930s. (Agency theory cannot survive without the assumption of a Principal constituted by the owners). Goodwin achieved his self-governance mandate by taking strict control of the information flow to the environment. The transition was gradual but quite discernable.

Mathewson was recruited from the outside. He was different than the existing managers in the sense that he had analytic training, but he was keen on the development of Scotland and thought that the key to success was firmness in the pursuit of efficient banking. He disciplined the RBS to make it ready to welcome Goodwin. Mathewson embraced the multi-brand strategy that allowed control by metrics and fast expansion. Goodwin took command in that structure by using temper and abuse to get his way. This stimulated power games, which are not part of agency theory, as the standard way to sort out the candidates for promotion. Predatory behaviour seems to have been rewarded inside as well as outside the bank. Like Medici, Fugger, and Baring, but in a different manner RBS failed to see the danger ahead and continued in the direction of its tangent.

7. Instead of a conclusion

7.1. The relevance of worldviews

When trying to get an overview of the material presented above – and almost all of that material are summary reports on summary accounts of chains of events – the first impression is that Banking in context really is a matter of complexity and contradiction. This, according to Merton (1949/1968), will stimulate ideology production (to simplify judgement). Consequently, this observation in itself, is an argument for the relevance of providing maps of world-views as backgrounds for accounts of the history of prominent banks that failed. They seemed to have failed because they tended to be caught up in value and action patterns that prevented them from seeing fundamental changes coming upon them. One is reminded of the claim by Friedman (posted up front of this essay): “Only a crisis – actual or perceived – produces real change. When the crisis occurs the action taken depends on the ideas that are lying around.” (preface of the 1982 edition). The problem is that due to sedimentation it seems like the wrong ideas are lying around. Sediments are entrenched parts of worldviews that remain practice long after their use-before-date. The new situation does not match the standard situation imagined by the current worldview. Consequently action will be constructed to be out of step with what the new situation requires. Success will generate strong beliefs in current practices and worldviews will provide good arguments for those beliefs. It should come as no surprise that successful banks go under in times of change. At such times newly established practices will be subject to critique, like the one on the title page: “Fairness demands the end of a system that privatises gains but socialises losses” (Mark Carney, Bank of England, 2013).

One could see the help to failed banks Carney talks about as alms to the poor that would clear the way to heaven for state agencies in charge of rescue operations, but the scholastics would probably object to that kind of moral; as a matter of fact the state agencies as well as top managers of banks are managing other people’s money. For whom, one might ask? Certainly not for the shareholders, who are the first to lose, but probably for the creditors (usually other banks), and certainly for “the system”, which under neoliberalism is the market. The markets are infused with new liquidity in order to uphold the function of the markets (which have already failed to value assets properly). The “Market” corner of the corporatist triangle has been held in high regard lately, which means that arguments based in this “paradigm” have come to good use in understanding as well as solving problems.

Nobody saved the smaller banks that were prominent in the old days (well Barings was saved once more than a hundred years ago by fellow banks orchestrated by Bank of England). Part of the explanation for this is, of course,

that there was no State to mobilize the necessary resources, and saving banks was not a worthy cause. Also one could not blame “the market” (in the case of Baring it was miss-management of “operational risk”). In the cases of Medici and Fugger it was a matter of lack of adaption to the emerging proto-state in the form of princes making war on credit (plus miss-management). We see that up to the last century there was no State to save banks in the worldviews. The task of the emerging “pre-modern” state under Mercantilism was to cater for the nation and its balance of trade (through regulation). To the extent that banks had any role to play here it was as suspects for conspiracy and illicit export of money and precious metals.

From the 18th century international trade blossomed under the protection of the State in the form of the navy. Trade houses expanded business and developed merchant banks, which in turn were granted privileges in the colonies in return for helping the State to a more steady flow of credits. Deal making with the state as a partner became the core business of banks under the Liberal era. Mutual support was the winning formula.

As Liberalism was challenged by socialism in different forms at the turn of the century the need for ideological struggle came to the forefront as “strong leaders” cast their nations into war (twice). The idea of allocation of resources according to need and the dream of equality was a formidable challenge that seemed only to be averted by channelling/focusing value statements toward external enemies and the ultimate sacrifice for the nation. Banks assumed a mere service role as the State took over the coordination of resources for the joint effort. Under such conditions it is good advice for banks to identify their mission with the State’s (as the representative of the nation), and orient their rhetoric accordingly (Burke, 1950/1969). Baring bank prospered during Liberalism, hibernated during war-time, and was not quick enough to acquire fully equipped complementing firms with the needed competences. Adding a team of traders specialized in the Far East did not bring with it the adequate control mechanisms. The traditional “old boys” control does not work, at a distance, among young, frantic “day traders”.

Dismantling regulation after the War, first to restore civil society, and later to enhance investment in industry, took its time since mercantile conceptions remained in the form of Balance of Payment, currency values, and competition among nations. Supported by a growing common view among academic economists Neoliberalism provided arguments for step-by-step deregulation (the welfare states staying on for a little longer) up to the burst of the “Big Bang” that left everything in banking “up for grabs”. The financial sector gained in prominence. Now competition had gone global and ensued between “full-service” banks with a global reach even if it centred on trading rooms in New York with flickering screens showing instant price changes for all to forecast and react to. To build itself into a recognized member of “Big Five” (or whatever the national number was) a bank had to add the lacking services by acquisition in a hurry. Otherwise it would itself be “in play”, i.e., a target for possible take

over. Thus a new form of capitalism – a predatory one – emerged. A proper bank, a bank attractive enough for heroic leaders, would live in a constant fear of becoming the prey, while pursuing conquest. When this kind of approach to banking becomes the fashion financial systems grow inherently unstable. The story of the Royal Bank of Scotland illustrates how this comes about. Several other big banks could have been used to the same purpose.

It seems justified to draw the conclusion that the ideologies (world views) dominant at the time played a role in the definition of what a bank should be doing. But at the same time it seems obvious that such worldviews are quite stable (they have de facto served the prominent banks well!), which will have the side effect of delaying a bank's adaption to societal change. It seems like it was the failure of seeing the implications of change in relations to princes, proto-states, pre-modern states, globalization of markets that brought the banks in decline. The decline was quicker, the faster the technology used. (Expect future banks to fall super-quick as relations have digital form rather than intimate relation between "men of character" – it is not a very daring proposition to claim that the next financial crisis will stem from world wide fraud by network).

From this follows that it is of great interest to study how world views penetrate into the organizations of banks to have an effect on management decisions. This will have to be studied as close to "real time" as possible, by recording how bank managers argue in meetings to make sense (or give sense) to contradictory information reaching them, or with a somewhat less reliable method by analysing interviews with bank managers giving accounts of their decisions during, e.g., the recent crisis. This way one could assess the "collective worldview" of that bank, as a microcosm of societal worldviews, as well as the weight that should be given to Friedman's statement about "ideas laying around".

7.2. The issue of the nature of banks

There is no doubt that the nature of banking, and of banks, has changed dramatically over recent times. This development is dramatic and too recent to be properly assessed yet. In the old days, up to the 1970s, banks were rather small in number of employees. Control could be upheld by personal trust and face-to-face communication – then the old fashioned reliance on your "good name" could work well. Always honour contracts was the rule to live by, and the rational incentive was to do due diligence in pursuit of arbitrage. With the "de-personalisation" of the market (no longer business between individuals in the form of one buyer and one seller, but the business of abstract forces called supply and demand), and the recognition that actors in the market may have different negotiation skills, the market became a system. Its self-regulation would reward the smart ones and punish the dumb, but always uphold the equilibrium, indicating the fair value of assets. This liberated market actors from

any moral scruples, if there were any complaints the State would supply the proper jurisprudence to settle conflicts, which in turn would generate a market for good lawyers. Practical men, like bankers, did not realize the implications of this de-personalized world of economics but continued with trade as the basis of operations. But the new prominence of the State as a power centre to relate to and trust (now that bureaucratic rules made it more predictable) made it more desirable to move headquarters to a closer proximity to the regulatory power of the state. England having become the dominant international trade partner it was London that attracted the growing merchant banks seeking protection under the state umbrella for trade agreements of mutual benefit. Banks participated actively in the dissemination of large loans by the state for all kinds of infrastructure investment. War times when everybody must contribute to the national interest are not good for banks.

For the emerging big banks after the War the market was, initially, strictly regulated as the State took a firm grip of most processes in society, either to mobilise all resources for the post war effort or to achieve a welfare state (or both). Routine management under the rule of regulation assured a secure steady growth and central place for banks in society. Competition was limited by the rules and by a limited supply of deposits. Monetarism could work then as well as Keynesianism. Business cycle changes were the thing to observe if you wanted to be prepared.

With the right ideas “laying around” and the right politicians in office a neoliberal world-view could be promoted via deregulation of financial markets (and the fall of the Berlin Wall). Top managers were, if not taken by surprise, overwhelmed by all the strategic opportunities that offered themselves. Banks seem to have found it necessary to have a full assortment of financial activities, which could be accomplished quickly by acquisitions, and they needed to make use of the new possibilities to use leverage, which required new, scientific ways of managing risk. The number of definitions of risk (and the appended models for measuring them) multiplied. Regulations and, in some jurisdictions, supervision also multiplied (in the name of de-regulation). Compliance, new professions, deal-making, new technologies etc. complicated management and provided a hearing for “ideas laying around”. The investor (or share-holder) seemed to give up trying to understand, by themselves, what kind of financial instruments were offered by advisors (sales people, including traders with clients). It seemed to be enough to determine your “risk appetite” by answering a number of questions and then follow the advice of the advisor. “Screw the investor” is a term Michael Lewis (2015) used repeatedly in his recent book, “Flash Boys”, about the new ways of putting technology to use in algorithmic trading on stock markets. We have come a long way and it seems too early to say what banking is going to be tomorrow. But it has always been too early to tell – also for bank managers – and then we will have to fall back on the Darwinian attitude of looking upon banking through the eyes of survival of the fit. It is quite natural then that banks

fail and we should accept that we need to divide our financial resources between a portfolio of banks. Behave as risk managers rather than loyal customers! What role does rhetoric (understood in a negative sense) play in dealing with all the contradictory interests banks claim that they cater for?

7.3. Arbitrage in space and time

In the time of Medici, when scholasticism ruled and family (and its good name) was synonymous with the business, arbitrage was fairly simple. There were price differences between goods at different places to exploit via trade. There were also price differences between currencies at different places, which could be exploited while you were at it. The vehicle for transporting payment (and avoid robbery as well as loss at sea) was the promissory note (Bill of exchange), which worked on the family's good name, in Florence, as well as Venice, Antwerp, and London. Furthermore, when other banks/families were present in the proximity an interbank market could emerge where this family's Bill could be cashed in another family's house (at a price). Banking was "grafted" on trade via Bills of Exchange, taking advantage of two price differences at the same time, provided trade was international.

Both Medici and Fugger ran into trouble when lending to princes took an unreasonable part of the loan book. Princes base their creditworthiness in power. They command resources that can be posted as collateral, but they also command the right to postpone or even dismiss payment altogether. Arbitrage was present in a different form when Fugger used its good name to borrow in Antwerp and lend to the Habsburg king in Spain. At the end of the 16th century scholasticism lost its grip on the norms of people (bankers as well as princes) as the personal relations catered for by "Natural Law" were "de-personalized" and replaced by markets with their abstract "market prices" and interest understood as income foregone by tying up money in a particular loan. Arbitrage in the form of lending to the most powerful prince had turned out to be risky. The world of finance had been opened to economists discussing money flows and balance of trade.

In mercantilism the troublesome prince was (gradually) replaced by the state. The articulation of the problem came as a response to the failure of the wool trade as the basis for British prosperity. Money was flowing out of the nation at a faster rate than the inflow, pamphlets said. Stabilizing the nation meant replacing the prince with the permanent structure of the State. The mechanism was war (on credit) and the tool of establishing jurisdictions of states was peace treaties (contracts), like the ones of Westphalia in 1648, which, by the way, confirmed that religion was no longer a political issue. The Rule of Law was laid down in a bureaucracy predictable enough to be included in the plans of actors in the markets, banks among them. The concern of the state under mercantilism was to

see to it that a balance of trade was maintained, which legitimized interventions in trade practices (like the Navigation Act of 1620). The effects on banking were probably limited, but arbitrage became more complicated to manage. You needed to be present both in trade centres, like ports, but also in power centres – now in the form of administrative centres – like London. Baring centred on London as global trade with colonies required state support, not least protection by a growing navy, and negotiations on terms as the state focused its interest on promoting low priced imports and high priced exports. Arbitrage could be negotiated, and shielded by contract.

As the State was established liberalism came to concern itself with limiting the space of its intervention. There were many areas where free trade and competition could accomplish more than the clumsy state bureaucracy. The main argument was that the market is a self-regulating mechanism – Darwinism helped produce compelling ones – not to be interfered with. Economists appeared, most prominently Adam Smith, dealing with “political economy” and as a consequence how the good society should be organized. The search for arbitrage now included the discovery of system improvement opportunities through technology applications, like the railroads, telegraph, and large scale industrial production.

Banking now faced an overflow of opportunities of putting together large scale financing - via creative new forms of financial instruments - of infrastructure investment, which required strategies of specialization (structures following strategies, according to Chandler, 1962) to keep track of arbitrage. Provided the strategy was adequate banks, like Baring, prospered. Still, banks were relatively small. Baring had about 90 employees by 1903. As mentioned, banking came to a virtual halt as all European nations mobilized all their resources for the First World War. The experiment to return to the earlier laissez-faire economy failed in the depression, and in the emergence of nationalist and socialist ideologies. Economies were thrown into another period of strict regulation – of banking as well as most other areas. The Second World War brought a divided world, and the cold war. A sense of belligerence justified continued regulation at the same time as technological progress, and welfare state solutions stimulated a steady economic growth in the west, with the American economy as the engine. When the Berlin Wall fell in the late 1980s, the end of history was declared, capitalism had won, and a neoliberal world-view could take over. This set the stage for a complete reformation of banking and the domination of the finance sector that we experience today. Arbitrage can now be created by influencing policy makers as well as investors. Arbitrage has become a discursive phenomenon. Now the vocabulary of finance is full of “magic” descriptive terms, for what goes on “out there” in the world that finance is increasingly isolated from, like in “Black Swans”, “White Knights”, while words used to describe financial markets include “sentiments”, “mood”, and “exuberance”. “Risk” has become a word of many uses.

Traditionally risk is a measure of the variation in a variable. When we know nothing about the causes of the variation – it is completely stochastic and varies around a mean - we have a measure of risk. In this case of ignorance of causes we talk about “random walk”, and after specifying the expected shape of the curve describing the distribution (e.g., normal distribution) of outcomes, we can calculate values. Black & Scholes (1973) used an assumption about random walk in their development of a model for option prices in their seminal article that set the modern development of financial instruments in motion. Now we could price risk, if you take a higher risk you can earn more money (-and lose). Your personal banker will ask you about your “risk appetite” (is it a “5” or a “6”?) before advising you on buying shares or bonds. Risk is everywhere and we do pretend to know what it is.

Let us take the subprime case

The originator of a mortgage cooperates with a developer and helps the prospective buyers of a newly built house to the loan. It is a young couple, he graduated recently as an engineer and has his first job (not permanent but in a booming industry), she has a year to go in law school and they have a baby. They might be seen as a risk to the lender at the moment but prospects are good. They hesitate to take on large loans at this stage, but the originator sweetens the deal by offering 2 years without amortization and a lower interest rate. The couple expects to be up and running in 2 years and signs the deal. The originator has reduced the risk for them with this loan considerably. But he also has a way to reduce his own risk because he expects to pass the mortgage on to somebody else within 2 years. The couple still carries the risk and it is going to get much greater in two years when repayment as well as interest increases. Anyway both originator and creditors are quite safe because house prices are on their way up and the young couple could easily get out if they should run into problems.

The originator soon sells the mortgage (standard forms filled in to allow classification of the couple into risk classes) to an investment bank that will take a thousand mortgages to form a package with a nice risk profile (individual mortgages classified and described in a appended document). This package can now be given the rating AAA by a rating institute (at the going rate paid by the bank) using “scientific” methods. In the package good and bad risks even out and nobody can have any complaint. The decision to buy a “tranche” of the package fitting the portfolio of the buyer can be taken on purely scientific grounds.

When selling the package to investors the investment bank will cut it up in “tranches”, some with very low risk, others with higher risk (according to the risk classification forms), but with higher return. In this way a “product” can be adapted to the individual buyer’s risk appetite and portfolio composition. Most buyers at the time thought they were buying AAA rated papers. In the aftermath of the financial crisis (2008) it was found that failed banks had astonishingly

much high-risk tranches left in their own books. One might assume that they were more difficult to sell, but they could still be accounted for as AAA in their own balance sheets.

The investors, typically institutional investors, e.g., fund managers, included the subprime tranches in their portfolios, hopefully as part a separate risk strategy for that particular fund. Their concern was to persuade investors (individuals) to deposit their savings (for pension purposes) in their funds by indicating how much the capital of the fund has increased during the last few years. No risk as indicated by the continued successful management of the fund.

The investor – a person – in that fund will be asked by her personal banker “What is your risk appetite?” Indeed, what is the underlying risk to be taken by this investor as part of her savings for a secure pension? Can anyone explain? Still, the advisor will say “in today’s market you cannot get any decent earnings unless you take risks!” When asked to describe what risk is the advisor will start with a risk-free investment in State bonds and compare its interest rate with the rate at which you can buy a “junior” bank bond and call the difference “the spread”. Then we understand! The market has spoken. If it has a price it must exist. Risk has been reified!

This little story about how risks taken by different actors in “the market” are layered upon each other and “managed” on a scientific basis of a “random walk” assumption illustrates how far we have come. From Medici’s trading on his “good name” (meaning the family’s good character of always to honour contracts, earned over time) to today’s traders in abstract “tranches” at the click of their computers. Risk differences in time and space are now the turf for arbitrage seekers. A very large part of the financial instruments we meet, when we see our financial advisors, are constructions for arbitrage.

7.4. Can the corporatist view help?

When trying to locate the world-view and related bank management principles in the corporatist triangle map (Community-State-Market) I found it easy and natural to place banking in the scholastic era close to the “community” corner. This because it is so obvious from the texts that the primary asset here is your “good name” – the Medici bank was equal to the respect for Cosimo. Normally we would assume that there are courts to appeal to if one feels betrayed, but we can see that they did the Medicis little good at the time, infested as they were by political factions. There were markets but those were actively manipulated by different parties, including the guilds (and Medici). Better rely on personal relations! (Except princes where you were liable to be trapped in spiralling bad debts). Personal relations, and spontaneous solidarity, are at the core of attitude of “community”. This colours the business of banking as well.

Under mercantilism, from the middle of the 1600s, the formation of a State,

stable and efficient enough to provide a predictable basis for planning ahead, changes the game. Now good relations in markets have to be complemented with good positions to negotiate deals with the state, not least in colonial trade. *This moves the locus of arguments for managerial principles toward the “state” corner.* Moving headquarters to London, did not only provide proximity to the administration (and to Parliament – many bankers were members), but also access to the local money market. Baring Bank organized several international loans to states, often with syndicated banks, but also with investors other participating. An investing public was emerging even if they were comparatively few yet. The State was consolidated as the dominating “corner” by the wars and the necessary regulation, but also welfare state ideas justified strict regulation by the state. Some professions - notably the auditors - managed to negotiate a measure of self-regulation, but the state was at the centre. Good arguments were the ones that appealed to the state.

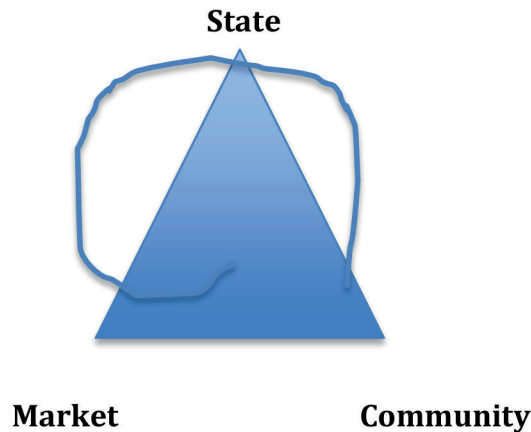
Liberalism won the day when the state (notably Britain) was established to “rule the waves”. The world was awash with investment and trade opportunities. The state could not do it all but was persuaded to transfer as much of the work of sorting out the best opportunities to private entrepreneurship. Some will be very rich but we will all be better off. This was proven true in the 19th century and also banks prospered closer to the Market corner.

When we had accepted the Fall of the Wall as proof of the superiority of the market economy de-regulation followed in a massive way. The market jargon related mostly to the sale of financial instruments produced en masse through “securitization”. But for bank management the acquisitions aiming at complementing lines of business (brokers, insurance etc.) were as much a protection against being taken over by a “bigger fish” as gaining a full assortment of services. The complexity of finding oneself at risk of coming “in play” in a predatory context, at the same time as you negotiated competition issues with the State, and accommodated new professions coming into your organization with the new technology, must have been overwhelming. It seems *like all three corners of the corporatist triangle are now in play* in the sense that arguments will have to be found to accommodate all three perspectives. This will make contradictions as well as complexity manifest.

Under such conditions bank managers as well as the public will demand ideologies (Merton 1949/1968, Geertz, 1973) that can help simplify things. This is manifested in the conspicuous increase in corporate communication professionals and lawyers in banking, which is matched by a shift toward opinion formation rather than fact-finding among journalists. The demand for ideology generates metaphors that exhibit values (“toxic assets” is one example). The worrying aspect of this is that too many actors may lose contact with economic reality and with its management. On the other hand the “sentiments” of the market are also real, in the sense that they manifest themselves in price movements of financial instruments (even if the real engine behind volatility

we observe is algorithmic trading by computers programmed to act on price movements only).

Figure 8:



The answer to the question in the heading of this section seems to be that it helps in the sense that it warns us against judging history on the basis of current world-views. We will be wiser if we look upon banking in context. We will also discover sediments of abandoned world-views in some current banking practices and vocabularies. It seems like the corporatist view could be used to classify the arguments in use at given times to better understand related managerial dispositions.

7.5. Recapitulation

I believe there is a benefit in looking long term at the relations between banks and their contexts, pragmatic and ideological ones alike, and that this essay has contributed to “show” the connections. First it should be noted the world in all probability did not appear less complex and contradictory to those who lived it 2000 years ago as compared to today. It is only that the source material, when looking back, is less extensive and less accessible. A reasonable attitude when interpreting the material presented is a belief that human creativity will generate evermore complexity and contradiction with time under any worldview. This complexity will make situations susceptible to shocks or crises as even relatively modest external changes require reorientations of strategies of actors in a given context. Such reorientations will in turn engender changes in worldviews through debate and ideological struggle (which replace or reconfigure values). Refusal to look at history from a different perspective is likely to be ideologically motivated. In transition periods people are likely to harbour contradictory views,

like when Adam Smith argues for the Navigation Act as well as for free trade. The question of whether world views change by people changing their mind about how the world is constituted (ontology), or whether new beliefs take over as the old believers die out, like Thomas Kuhn (1962) showed is the structure of scientific revolutions, remains unresolved for banks. But maybe bank managers, like scientists, are true believers who are not easily convinced that the world has changed, requiring banks to enter into severe crises before views are changed (often by replacing managers). Then Friedman's "ideas lying around" come into play.

I have chosen prominent banks to be put in their contexts and I find that they all failed because of management failure. Risks have always plagued banking, be it pirates robbing trade shipments, princes failing to honour their debts, rouge traders, or predatory capitalism. What is important when it comes to understanding the nature of banking is to see how risks were managed in context. The common factor of Medici, Fugger, Baring, and RBS was that they finally met with conditions they could not adapt to. Part of the failure to adapt may have been the world-views in vogue at the time, which helped (or not) managers make sense of the situation they faced. I have noticed, en passant, that all four banks were actively involved in politics in different ways; Medici in Florence leading to assassination, Fugger in intimate relations to the Habsburgs, Baring brothers being members of Parliament, and RBS cultivating special relations to the minister for Scotland. Politics being an interesting side show for banks, the main occupation for bank managers is always the issues of competence, attention, and organization/control, but even these factors are influenced by the current world-view (ontology = what the world consists of and how its parts interact). This will influence how banking is shaped by its practitioners in context, and how important events are understood and dealt with (managed). As events are made sense of (or rather "given sense" under a certain world-view) the pragmatics of banking drifts. A successful deal gives reason to try to design an even more successful one. Frontiers are tested, risks accumulate, and, in time, something breaks (e.g., depositors' trust in Northern Rock, (Liff & Wahlström, 2016)). The "world" has changed in the eyes of bankers, and new avenues for banking practice need to be developed. Take the meaning of arbitrage as an example!

7.6. With such increasing complexity and contradiction – what kind of banking do we need for the future?

Today we live in a credit society - in the world of banks! Equity is minimized while regulation sees to it that it does not go too low, and leverage is maximized. (One should note that the core of the capitalist idea is the striving to increase your equity!) National and super-national authorities pump out money in "easing"

operations to promote growth in economies that are already over-consuming. This should provide a wonderful market for banking and it seemingly does. But “securitization” (the construction of financial instruments to generate arbitrage) is increasingly pre-occupied with a kind of gambling where one party’s gain is another party’s loss – a zero-sum game. Furthermore computers do more of the trading than we generally are aware of.

When we look back at the arguments against usury provided by scholastics we should note that they point to the sterility of money. Money in itself does not provide any service to the borrower beside the lender’s exploitation of his need – a kind of bullying not condoned by the church. The need should be alleviated by charity. We might harbour the same feelings toward the “front running” described by Lewis (2015).

Contemplating the role of power and politics (capacity to manipulate) we might associate back to the Jewish scribe from 180 BC who advised against lending to anybody “mightier than thou”. We are then reminded of the devastating influence of princes on the fate of banks 500 years ago (with their wars on credit). The modern state was built out of the ruins of war and since then we have had a constant debate on the proper role of the State in relation to banking with mercantilists, liberals, socialists and neoliberals providing the inputs. We should remember that it was the States that carried out de-regulation. The relation between State and Bank is tighter than ever now in the era of globalization and super-national authorities. For some time the market solutions have been the first choice among state bureaucracies. What was previously core state operations in advanced welfare states are “outsourced” at a blinding pace. At the same time complexity and contradiction characterize markets – the smart operators, who know how to manipulate it to their advantage, are having a field day. It is time to stop and reflect – go back to the question what it is that justifies the prominent position of banks in our society.

Not so long ago I noticed a sign on the door of a branch office of a bank growing out of its insurance origins saying: “We have no money!” in order to avoid robberies. (The robbers are now located in distant places raiding (hacking) accounts by internet. Banks have dedicated departments constantly on the watch for “strange” transactions that might indicate foul play. These departments are growing rapidly. Their problem is that the risks they are dealing with can never be assumed to be generated by “random walk”, because they are the result of the creativity of intelligent actors “Phishing for Phools” (Akerlof & Shiller 2015)). Inside the bank branch with “no money” there were sales people calling themselves advisors. The money was elsewhere. Still, it is now common knowledge (Torfason, 2014) that banks are able to create money out of thin air. So monetarism is not what it used to be. We live in a world of below zero interest rates and vast sums of money flowing fro and to in the world.

Hardly any of the initially stated pre-conditions for then emergence of banking (stable economic relations, monetary economy, record-keeping, and structure)

are there any more. One might wonder if we need banks at all. There should be better reasons to have them than the more or less permanent service as “pumps” of wealth from the poor and middle class to rich friends (family, princes, states, cronies, bonus takers). There is the ultimate challenge for research! Why do we need banks in the future? Everybody his own banker?

References

- Akerlof, George A. & Shiller, Robert J., (2015). *Phishing for Phools – The economics of manipulation & deception*. Princeton: Princeton University Press.
- Andersson, Sören, (2012). *Filosofen som inte ville tala – ett personligt porträtt av Ludwig Wittgenstein*. Stockholm: Norstedts
- Banks, Erik (1999). *The Rise and Fall of the Merchant Banks*. London: Kogan Page
- Binder, A. (2013). *After the music stopped: the Financial crisis, the response, and the work ahead*. New York: The Penguin press.
- Black, Fischer; Scholes, Myron, (1973). *The Pricing of Options and Corporate Liabilities*. *Journal of Political Economy* 81 (3): 637–654.
- Bowersock, G.W. (2015). *Money and Your Soul*. *New York Review of Books*, vol. LXII, no 9, pp 28 – 30
- Braudel, Ferdinand, (1973). *The Mediterranean and the Mediterranean World in the Age of Philip II*. 2 vols., 2nd rev. ed., transl. 1972 and 1973 by Sian Reynolds. London & New York: University of California Press
- Brown, Peter, (2015). *The Ransom of the Soul – Afterlife and Wealth in Early Western Christianity*. Cambridge, Mass.: Harvard University Press.
- Burke, Kenneth, (1950/1969). *A Rhetoric of Motives*. Berkeley: University of California Press.
- Chandler, A.D. Jr. (1962). *Strategy and Structure: Chapters in the History of the American Industrial Enterprise*. Cambridge, MA: MIT Press
- Chandler, Alfred Jr. (1977). *The Visible Hand – The Managerial Revolution in American Business*. Cambridge, Mass.: Harvard University Press.
- Cockfield, G., Firth, A., and Laurent, J. (eds), (2007). *New perspectives on Adam Smith's The theory of moral sentiments*. Cheltenham: Edward Elgar
- Cooren, Francois, (2000). *The Organizing Property of Communication*. Amsterdam: Benjamins
- Cruver, Brian, (2002). *The Anatomy of Greed – the unshredded truth from an Enron insider*. Carroll & Graf: New York
- Ehrenberg, Richard, (1928). *Capital & Finance in the age of the Renaissance – A study of the Fuggers and their connections*. (transl. by Lucas). London: Cape
- Ericson Wolke, L., Larsson, G. & Villstrand, N.E., (2006). *Trettioåriga kriget – Europa I brand 1618 – 1648*. Stockholm: Historiska Media
- FCA/PRA, (2015). *The failure of HBOS plc (HBOS)*. A report by the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA).
- Fraser, Ian (2014). *Shredded – Inside RBS the bank that broke Britain*. Edinburgh: Birlinn

- Friedman, Milton, (1962). *Capitalism and Freedom*. Chicago: University of Chicago Press.
- Friedman, Milton & Anna Schwartz (1963). *Monetary history of the United States 1867 – 1960*. Princeton: Princeton University Press.
- Friedman, Milton, (1953/1970). *Essays in Positive Economics*. Chicago: University of Chicago Press
- Geertz, Clifford, (1973). *The Interpretation of Cultures: Selected Essays*. New York: Basic Books
- Harrison, Dick, (2014). *Ett stort lidande har kommit över oss – Historien om Terettioåriga kriget*. Stockholm: Ordfront.
- F.A von Hayek, (1937). *Economics and Knowledge*. *Economica* , vol 4, pp 33-54
- F.A. von Hayek, (1944). *The Road to Serfdom*. London: Routledge
- Heckscher, Eli, (1931). *Merkantilismen : ett led i den ekonomiska politikens historia. Del 1 - 2*. Stockholm: P A Norstedt & Söners förlag,
- Keynes, M., (1936/1973). *The General Theory of Employment, Interest and Money*. London: Macmillan.
- Kerr, R. And Robinson, S. (2012). From symbolic violence to economic violence: The globalization of the Scottish banking elite. *Journal of Organization Studies*, vol 33, no 2, pp 247 – 266
- Kuhn, Thomas, (1962). *The Structure of Scientific Revolutions*. Chicago: Chicago University Press.
- Janik, Allan, and Stephen. Toulmin, (1973). *Wittgenstein's Vienna*. New York: Simon & Schuster.
- Lakoff, George and Johnson, Mark, (1980). *Metaphors we live by*. Chicago: Chicago University Press.
- Langholm, Odd, (1998). *The Legacy of Scholasticism in Economic Thought – Antecedents of Choice and Power*. Cambridge: Cambridge University Press.
- Lewis, Michael, (2015). *Flash boys – A Wall Street Revolution*. New York: Norton
- Locke, John, (1963). *Two Treatises of Government* (edited by P. Laslett. Cambridge: Cambridge University Press
- Liff, Roy, and Gunnar Wahlström, (2016). Why did a solvent bank like Northern Rock fail? (forthcoming)
- Niccolo Machiavelli, (2010). *Florentinsk Historia* (övers. Paul Enoksson). Stockholm: Atlantis
- Madrick, Jeff, (2011). *Age of Greed – The triumph of Finance and the decline of America, 1970 to the present*.
- Magnusson, Lars, (1994). *Mercantilism: The Shaping of an Economic Language*. New York: Routledge.

- Magnusson, Lars, (1999). *Merkantilismen – Ett ekonomiskt tänkande formuleras*. Stockholm: SNS.
- March, James G., and Johan P. Olsen, (1984). *The New Institutionalism: Organizational Factors in Political Life*, *The American Political Science Review* Vol. 78, No. 3, pp. 734-749
- March, James G. And Johan P. Olsen (2009). *The logic of appropriateness*. University of Oslo ARENA Working Papers WP 04/09
- McCloskey, Diedre N., (2006). *The Bourgeois Virtues : Ethics for an Age of Commerce*. Chicago: University of Chicago Press.
- McCloskey, Diedre N., (2010). *Bourgeois Dignity; Why Economics Can't Explain the Modern World*. Chicago: University of Chicago Press.
- Merton, Robert K., (1949/1968) *Social Theory and Social Structure*. New York: Free Press
- Menger, C. (1981). *Principles of Economics*, (ed. by James Dingwall and Bert F. Hoselitz), New York: New York University Press.
- Minsky, Hyman, (1992). *Financial Instability Hypothesis*. Working Paper No. 74 , May, Levy Economics Institute, Bard College New York
- Mirowski, Philip, (2013). *Never let a serious crisis go to waste: How Neoliberalism survived the financial meltdown*. London:Verso
- Von Mises, L., (1920). "*Die Wirtschaftsrechnung im sozialistischen Gemeinwesen*" (*Economic Calculation in the Socialist Commonwealth*). Paper presented to the Nationalökonomische Gesellschaft, later published in the *Archiv für Sozialwissenschaft und Sozialpolitik*
- Von Mises, L., (1912). *Theorie des Geldes und der Umlaufsmittel (Theory of Money and Credit)*
- Morelly, Etienne-Gabriel, (1755). *Code de la nature, ou de veritable esprit de lois. Chez le vrai sage*.
- Mun, Thomas, (1655). *England's Treasure by Forraign Trade or the Balance of Forraign Trade is the Rule of Our Treasure*. Glasgow: Foulis (assumed to be written about 1630, published by his son in 1655).
- Murray, Alastair J.H., (1997). *Reconstructing Realism – between Power Politics and Cosmopolitan Ethics*. Edinburgh: Keele University Press.
- O'Reilly, Bill & Martin Dugard, (2015). *Killing Reagan: The Violent Assault that changed a Presidency*. New York: MacMillan
- Parks, Tim, (2005). *Medici Money. Banking, Metaphysics and Art in 15th Century Florence*. London: Profile Books
- Perman, Ray, (2013). *HUBRIS - How HBOS wrecked the best bank in Britain*. Edinburgh: Birlinn.

- Piketty, Thomas, (2014) *Capital in the 21st Century*. Cambridge, Mass.: Belknap Press
- Popper, Kael, R., (1945). *The open society and its enemies (vol 1 and 2)*. London: Routledge & Kegan Paul.
- de Roover, Raymond, (1963). *The Rise and Decline of The Medici Bank*. Cambridge, Mass.: Harvard University Press.
- Schumpeter, Joseph A. (1954). *History of economic analysis*. London: Allen & Unwin.
- Servan-Schreiber, Jean-Jacques (1968) *Le Défi américain*, Paris: Éditions Denoël
- Smith, Adam, (1776). *An Inquiry into the Nature and Causes of the Wealth of Nations*. London: Meuthen
- Shiller, Robert, (1989). *Market Volatility*. Cambridge, Mass.: MIT Press
- Steenstaad, Niels, (1990) The Seventeenth-Century Crisis and the Unity of Eurasian History, *Modern Asian Studies*, Vol. 24, No. 4, pp. 683-697
- Streeck, Wolfgang, and Philippe C. Schmitter, (1985). Community, market, state – and associations. The prospective contribution of interest governance to social order. *European Sociological Review*, vol 1, no 2, pp 119 – 138.
- Torfason, Ausgeir, (2014). *Cash flow accounting in banks – a study of practice*. PhD thesis. Gothenburg Research Institute, Gothenburg University
- Viner, J., (1937). *Studies in the Theory of International Trade*. New York: Harper
- Weber, Max, (1968/1925). *Economy and Society* (English translation by Roth and Wittich). New York: Bedminster Press
- Weisberg, Jacob, (2015). *Ronald Reagan*. New York: Times Books
- Wittgenstein, L. (1922). *Tractatus Logico-philosophicus*. (translated by C.K. Ogden) New York: Harcourt Brace.
- Wittgenstein, L. (1953). *Philosophical Investigations* (edited by G.H. von Wright and G.E.M Anscombe). Oxford: Basil Blackwell.