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## Mortgages to Real Bills

The Transformation of North European Public  
Banks in the 19th Century

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# Introduction

- Classical Model of Central Banking
  - Real Bills Doctrine
  - Gold Standard
- The Pre-Classical Public Banks
- Common Features
- The Transition

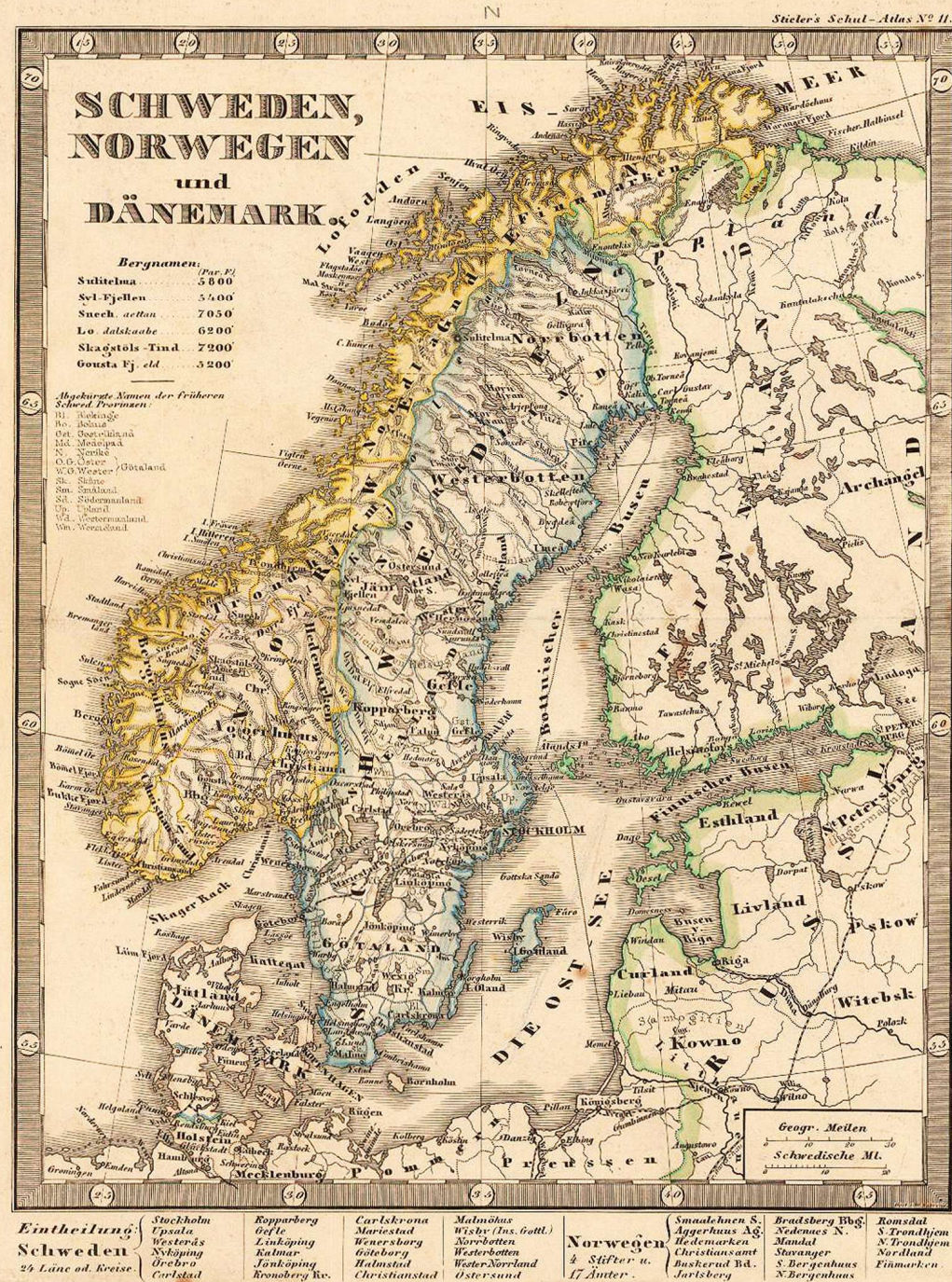


## The Baltic Sea Area

- Hamburg/Germany
- Sweden
- Denmark
- Norway
- Russia
- Finland (Russia)
- Prussia/Germany

The area included also:

- The Baltic provinces (Russia)
- Poland (Russia)
- Schleswig-Holstein (Denmark)
- Mecklenburg/Germany





## The Real Bills Doctrine

- The classical model of how note-issuing banks should be organized and managed
  - Bank of England (at least from the 1760's, after the Seven Years' War)
  - Banque de France (established in 1800)
- Coined by Adam Smith in the Wealth of Nations (1776)
  - Written as an attack against certain prevailing ideas (Law, Steuart...)
- The emphasis is on liquidity and flexibility
  - Short-term lending
  - Self-liquidating bills of exchange generated in real transactions
  - But distance from the "bank of exchange" idea of a 100% reserve
- Much confusion prevails on the content of the doctrine
  - In the bullionist controversy, and the literature about it, the doctrine was mixed up with the antibullionist position during the suspension of convertibility
  - In fact, a guideline for managing a bank of issue under metallic standard
- Spread globally during the 19th century
  - U.S. Federal Reserve founded on the real bills doctrine in 1913



## Adam Smith (1776)

“When a bank discounts to a merchant a *real bill of exchange*, drawn by a real creditor upon a real debtor, and which, as soon as it becomes due, is really paid by that debtor; it only advances to him a part of the value which he would otherwise be obliged to keep by him unemployed, and in ready money for answering occasional demands.

“The payment of the bill, when it becomes due, replaces to the bank the value of what it had advanced, together with the interest. The coffers of the bank, so far as its dealings are confined to such customers, resemble a water pond, from which, though a stream is continually running out, yet another is continually running in, fully equal to that which runs out; so that, without any further care or attention, the pond keeps always equally, or very near equally full. Little or no expense can ever be necessary for replenishing the coffers of such a bank.”

(The Wealth of Nations)



## Before the Real Bills Doctrine?

- The bank of exchange (giro bank) model
  - Amsterdamsche Wisselbank (1609)
  - Hamburger Bank (1619)
  - Account-based money with 100% metallic reserve
  - No banknotes, no lending (some exceptions)
  
- The land bank idea
  - Solving the liquidity problems of landowners
  - Stimulating the economy by increasing the money supply
  - Sir James Steuart (1765): Mortgage credit is the most secure backing for banknotes (better than "mercantile" or "public" credit)
  - Scottish experience in the first half of the 18<sup>th</sup> century
  - German official mortgage institutions (Landschaften; 1770 - )
  - Wide application in the Baltic Sea Area until mid-19<sup>th</sup> century



## James Steuart (1765)

”It is proper to establish a bank upon the principles of private credit. This bank must issue notes upon land and other securities...To them the improvement of [Scotland] is entirely owing; and until they are established in other countries of Europe, where trade and industry are little known, it will be very difficult to set these great engines to work.

”Although I have represented this species of banks, which I shall call *banks of circulation upon mortgage*, as peculiarly well adapted to countries where industry and trade are in their infancy, their usefulness to all nations, who have upon average a favourable balance of trade, will sufficiently appear upon an examination of the principles upon which they are established.”

(An Inquiry into the Principles of Political Oeconomy)



## Hamburg

- The principal trading centre for the Baltic Sea Area from the 1790's until the late 19th century
  - Hamburg not really part of the story, but a point of reference
- The stable hub of the North European silver zone
  - Reichsthaler banco (= 3 marc banco = 48 schillings banco)
  - Managed by the Hamburger Bank (1619)
- The two-part structure of the Hamburger Bank became a model for the other public banks in the region
  - A giro bank department
  - A lending department
- Activities severely restricted – a narrow bank
  - A deposit bank, no banknotes
  - The giro department maintained 100% reserves (in theory at least)
  - Loan department lent only against silver collateral





## Monetary Standards

- Silver was the legal standard in the area until the 1870s
  - Monetary systems based on varieties of the Reichsthaler
- Convertibility of notes was suspended during the Napoleonic wars
  - In some cases convertibility had ceased even before the war
- Silver convertibility was restored as follows:
  - Prussia 1818
  - Sweden 1834
  - Norway 1842
  - Finland 1840 -1854, convertibility restored again in 1865
  - Russia 1843 - 1856
  - Denmark 1845
- Gold Standard adopted after 1873
  - Prussia 1873, Sweden 1873, Denmark 1875, Norway 1875
  - Finland 1878, Russia 1897



## Sweden

- The Bank of Sweden established in 1668
  - Early experiments with banknotes which failed
- Two-part structure
  - Bank of exchange (växel-banco) for payments and notes
  - Loan bank (lån-banco) for deposits and loans
- Banknotes issued from about 1745
  - Competition with treasury notes in 1789-1803
- Most private loans originally in long-term mortgages
  - Importance declined gradually from 1804 on, but significant until the 1860's
- Bills of exchange avoided for a long time
  - Short-term lending through special subsidiaries (Discount offices)
  - Bills of exchange became significant in the 1830's, recognized in the statutes in 1845, surpassed the mortgage loans in 1865



## Russia

- The Assignat Bank and the Loan Bank established in 1768
  - "To operate as a single unit"
- The Assignat Bank issues banknotes
  - Inconvertible from 1786 until 1843
- The Loan Bank makes long mortgage loans to landowners
  - Land collateral valued on the basis of the number of serfs attached
- Plan for a real bills –based central bank cancelled in 1812
- State Commercial Bank established in 1817
  - Discounts Bills of Exchange in a small scale, depositor to the Loan Bank
  - Until 1860, most loans from state banks are on agricultural mortgages
- Bank and currency crisis in the 1850's, Loan Bank liquidated in 1860
- State Bank of the Russian Empire founded in 1860
  - On the basis of the State Commercial Bank, real bills ideals
  - Repeated wars delay the stabilization of the rouble until 1897
  - Bills of exchange dominate in State Bank lending only after late 1880's



## Finland

- The Bank of Finland established in 1811
  - A result of the Russian conquest of Finland from Sweden (1809)
  - Agricultural and industrial credit, rouble-denominated note issue
- Two-part structure
  - Original fund (long-term mortgage loans)
  - Exchange fund (banknotes, short loans against pledge of goods etc.)
- Long-term loans to landowners dominated at first
  - Agricultural mortgage loans accounted for 80% of lending in 1840
  - Discounting of bills of exchange allowed in 1840
  - A specialized agricultural mortgage bank established in 1860
- National currency unit in 1806, silver convertibility in 1865
- Bills of Exchange portfolio grew only gradually
  - Bills became significant form of credit from about 1858
  - Real Bills policy started with Gold Standard (1878)
  - Strong growth in the bill portfolio from the 1880's onwards



## Denmark

- "Kurantbank" established in 1736
  - Both a bank of exchange and a loan bank, with official name "Den Københavnske Assignations-, Veksel- og Laanebank"
  - Issued banknotes which became inconvertible in 1757
  - Bills of exchange insignificant, loans against mortgages common
  - Inflation started with the war in 1807, the bank failed in 1813
- Rigsbank established in 1813
  - An instrument of monetary reform, currency written down to 1/6
  - Obtained compulsory mortgage of all landed estates in Denmark
  - A true "land bank" issuing currency backed by real estate
- Danmarks Nationalbank established in 1818
  - The mortgage assets inherited from the Rigsbank were gradually run down up to 1835, as part of deflationary monetary policy
  - Bills of exchange became important in the 1840's
- Silver parity restored in 1835, convertibility 1845
  - Mortgage bonds excluded from the cover of banknotes in 1847
  - The bank followed the real bills doctrine closely after that



## Norway

- Norway separated from Denmark in 1814
  - Previously, Danish currency used
- Norges Bank established in 1816
  - Inherited the Danish banking problems
  - Danish banknotes exchanged for Norwegian mortgages
  - Intention was to have at least 25% in bills of exchange
  - Share of mortgages over 80% until the 1840's
  - Restrictive monetary policy in the first decades, as in Denmark
- Silver convertibility at par achieved in 1842
  - Bills of exchange portfolio started to grow strongly in 1850
  - Volume of bills surpassed mortgage loans in 1864
- Gold Standard in 1874 (Scandinavian Monetary Union)
  - Real Bills policy followed closely
  - Banking crisis in 1899 temporarily increased other asset holdings



## Prussia

- Royal Bank established in 1765
  - Two-part structure "Royal Giro and Loan Bank"
  - Giro services, deposits and loans; note issue not very large
  - Landschaften, the Prussian mortgage bank system from 1770 –
  - The Royal Bank invested in mortgages against its statutes, suffering almost fatal losses from the war in 1806
- Treasury notes dominated the circulation from 1806
  - Their value was stabilized by 1817, however
  - Bank recovered gradually, bills surpassed mortgage assets in 1833
  - Issued some notes in 1820-1836
  - The whole circulation in Prussia was unified as treasury notes in 1836
- Preussische Bank established in 1847
  - Organized according to the real bills ideals
  - Bills of exchange dominated the lending from the start
  - State paper money continued to circulate (56% of notes in 1865)
- Preussische Bank merged to Reichsbank in 1875
  - Organized in accordance to the real bills doctrine from the start



## Convergence to Real Bills

- The Real Bills Doctrine was generally recognized as an ideal already by the start of the 1800's
- War and other difficulties (economic backwardness?) made its realisation difficult in practice
- Convertibility reached late (exception of Prussia)
- Adoption of the Real Bills policy preceded the adoption of the gold standard
  - Some countries more active in the pursuit (Prussia, Denmark, Norway)
  - Sweden hesitant
  - Russia slowed down by crisis and repeated wars
  - Finland late because of slow economic development





## Some observations

- The proto-central banking phase in the countries of the Baltic Sea basin shows remarkable similarities
- Before the Real Bills Doctrine was implemented, the issuing banks were following a land bank type policy
- The transition to the Real Bills policy happened at different times in different countries
  - Denmark (by 1835) and Prussia (by 1846) were the first;
  - Sweden (1860s), Norway (1870s) and Finland (1880s) followed
  - Russia was the last (about 1897)
- What caused the change?
- What determined the timing?



## The Relationship to Economic Take-Off

- Rostow's concept is controversial, but may be useful
- Tentative take-off points (by Rostow and others)

Sweden	1868-1890 (1870, says Sandberg)
Russia	1890-1914
Finland	1893 (disputed)
Denmark	1870-1900 (tentative)
Norway	Unclear (1849? 1888?)
Prussia	1850-1873
- A hypothesis: it seems that transition to the real bills policy preceded the take-off (if any)
  - Not necessarily a causal connection
  - Take-off and the transition to Real Bills policy may have a common cause
  - Part of the great transformation of the Baltic periphery



## Tentative explanations

- The changing economic structure in the countries: industrialization and the weakening of the land-owning interest groups
- New liberal economic policy favoured commercial rather than agricultural interests (cf. Corn Laws in Britain)
- The crisis of 1857 and the emergence of active discount rate policy after that
- International integration of money markets and the bills of exchange as the instrument of the foreign exchange market
- The attraction of the Gold Standard and the rise of London as the financial centre of the world, with Bank of England a role model for central banks



**Thank you!**