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Political Economy Origins of Financial Markets in Europe and Asia

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Summary. — We provide historical evidence from London, Amsterdam and Hong Kong which highlights the essential role played by governments in kick-starting financial development. In the cases of London and Amsterdam, the emergence of financial markets was a by-product of the rise of large trading monopolies. These monopolies, partly created to improve public finances, were responsible for major financial innovations and helped to strengthen investors' property rights. In Hong Kong, where the financial development model was bank-based, a large banking monopoly with close links to both the British and Chinese governments, set up to finance international trade, played a similar role.

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1. INTRODUCTION

A broad consensus has emerged in the finance-growth literature suggesting that well functioning banking systems and capital markets help to enhance long-run growth.¹ Moreover, the positive causal impact of finance on growth appears to have been present from the earliest stages of financial development in the Netherlands, England, United States and Japan (Rousseau, 2003; Bordo & Rousseau, 2006). This literature is, therefore, increasingly shifting its focus towards understanding the mechanisms that promote financial development. Recent contributions suggest that political economy factors, such as the role of industrial and financial incumbents, may hold the key to successful financial development. Rajan and Zingales (2003), for example, suggest that trade and financial openness, which curtail the power of incumbents and change their incentives, may be a useful mechanism of financial development. Acemoglu, Johnson, and Robinson (2005a) sketch a dynamic political economy framework in which economic institutions that facilitate economic development are social decisions chosen for their consequences by the interaction between powerful political and economic forces. These authors strongly emphasize the role of broad based property rights protection for economic development in general and the development of financial markets in particular. Much of this literature utilizes a variety of stylized facts or historical examples, mainly drawn from the colonial period, which are primarily aimed at explaining the factors that explain institutional development in the 'colonies'. With few exceptions (Acemoglu, Johnson, & Robinson, 2005b; Rousseau & Sylla, 2003; Sylla, Tilly, & Tortella, 1999) there has been little attempt in the finance-growth literature to gain an understanding of the factors that explain the emergence of financial markets in the colonizing powers themselves.

This paper aims to contribute to the finance-growth literature by examining the political economy origins of some of the most successful financial markets in Europe and Asia, drawing on a variety of historical sources. Specifically, it provides historical evidence primarily from London, but also from Amsterdam and Hong Kong, that highlights the essential role played by the government in kick-starting financial development. While there are important differences between these examples, we show that the emergence of financial systems did not occur spontaneously and that secure property rights alone were not sufficient for financial development. In the cases of London and Amsterdam governments created large trade monopolies—the English East India Company and its Dutch equivalent—which became the leading joint-stock companies and were responsible for all the important financial innovations of the time, including the emergence of trade in shares and the strengthening of investors' property rights. In the case of Hong

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Kong, where the financial development model was bank-based, large banking monopolies with close links to the state were created (e.g., the Hongkong and Shanghai Banking Corporation). These were modeled on the Bank of England—itsself a banking monopoly for fifty years with close links to government—which also became a template for the development of many other banking systems around the world (Goodhart, 1988).

We argue that the three examples we provide in this paper are not special cases. The role of government in the early stages of financial development has been widespread world-wide, including the Italian city-states of Venice and Genoa, the United States, and, more recently, in the newly industrialized East Asian economies of Japan, South Korea and Taiwan.

The idea that the government can play an important positive role in the financial system is, of course, not a new one. Stiglitz (1993) examines the role of the state in finance primarily from a modern, albeit developmental, perspective. A number of financial historians emphasize the importance of government in the early stages of financial development. Sylla (1999), for example, demonstrates the dominant role of public finance in shaping the US financial system during 1690–1913. Rousseau and Sylla (2003) provide a number of case studies of financial development in its early stages, including the Dutch state and Great Britain; these highlight the importance of the Dutch and English East India companies and allude to their close links with government, but do not explore the important role of monopolies. Sylla *et al.* (1999) provide an overview of the role of state from the early stages of the emergence of modern financial systems in England post-1688 and 17th century Netherlands; however, they do not explore the period before 1688 in which trading in shares emerged.

Our paper complements these historical studies by exploring the role of both government and trading monopolies in the emergence of financial markets in England during 1672–88. This period is particularly interesting because it was characterized by the collapse of the government's credibility as a reliable debtor as a result of the temporary suspension of all loan repayments by Charles II in January 1672. We show that, notwithstanding the erosion of property rights of investors vis-à-vis the state this development entailed, financial markets nevertheless emerged as a by-product of the government's attempt to improve the state of public finances by granting monopoly rights to trading companies. In line with Sylla *et al.* (1999) we argue that investors saw these companies as offering an attractive combination of expected return, default risk and liquidity. However, in contrast to other studies, we demonstrate that this was already in place before 1688. Moreover, we show that the deeper fundamental that made it possible was the rise of the trading monopolies, which were not only responsible for all the major financial innovations of the time but also helped to strengthen investors' property rights.

The paper is organized as follows. Section 2 documents the emergence of London as a financial market, highlighting its close connection to the rise of trading monopolies. Section 3 delves further into the ways in which the monopolies helped to promote financial development. Section 4 documents the rise of finance in Amsterdam and Hong Kong, and provides an overview of other cases. Finally, Section 5 summarizes and concludes.

2. THE EMERGENCE OF LONDON AS A FINANCIAL MARKET

A variety of historical sources suggest that London's stock market emerged during the latter part of the 17th century

and continued to develop during the early part of the 18th century. Drawing on these sources, this section documents (i) the emergence of trading in stocks which dates back to 1661; (ii) the institutional changes that, as has been previously argued, facilitated the development of the stock market, (iii) the improvement in public finances and its relationship to stock market development. In so doing, it identifies the key players in the private and public sectors in this process, namely the leading joint stock companies, the monarch and parliament. This examination reveals the following inter-related political economy aspects, which played a critical role in the emergence of London as a major financial market:

- The monopoly rights granted by the public sector (initially by the monarch and subsequently by parliament) to all the leading joint stock companies.
- The long-term loans provided by the leading joint stock companies to the public sector in exchange for their monopoly positions.

Additionally, our analysis also highlights the role of foreign trade in the process, in the light of the fact that all but one of the leading joint stock companies in that period were involved in trade with different parts of the world.

(a) *The emergence of trading in stocks: 1661–1703*

Even though the London Stock Exchange was formally established in 1773, there is evidence of stock transfers taking place as early as 1661 while the publication of security price movements began in 1681.² Scott (1912)—one of the most authoritative historical studies of the emergence of joint-stock companies in Britain and Ireland—provides, among other rich information, a useful list of tables described as “Statistics of the Chief Joint-Stock Companies of England, Scotland and Ireland to 1720”. The data, which include capitalization figures and other information on each company, show that by far the largest joint stock company throughout the 17th century was the East India Company (EIC), founded in 1599 to carry out trade with the East Indies and incorporated by Royal Charter in 1600. The second largest joint-stock company up to 1694 was the Royal African Company (RAC), founded in 1662 to carry out trade with Africa (Scott, 1912, p. 325). Table 1 summarizes the available data for share transfers of these two companies alongside Hudson's Bay Company, which was the third largest foreign trade company and is considered by historians as representative of smaller joint-stock companies at the time. In 1694, the market valuation of these three companies was £1,212,720 (EIC), £185,175 (RAC) and £52,762 (Hudson's Bay).³

All three companies had monopoly rights granted to them by the monarch in their charter. The EIC was granted monopoly rights over all English trade to the east of the Cape of Good Hope. The RAC was given monopoly rights over all English trade from Sallee to the Cape of Good Hope. Hudson's Bay Company, incorporated in 1670, had a monopoly over trade in the region watered by streams flowing into Hudson Bay in Canada.

The stock exchange was highly localized, with the trades and the circulation of information about the current share prices and profitability prospects for joint stock companies taking place in the coffee houses of Exchange Alley. Table 1 shows that a market for EIC shares existed as early as 1661, while trade in the shares of the other two companies emerged in the 1670s, soon after their establishment, predating the Glorious Revolution of 1688.

In 1694 the Bank of England (BoE) was established by parliamentary statute which provided it with a monopoly right to

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