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Bills of exchange, interest bans, and impersonal exchange in Islam and Christianity ☆

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ABSTRACT

A vast economic history literature suggests that medieval institutions supporting contract enforcement were necessary for impersonal exchange to emerge. Yet this literature cannot account for the bill of exchange, an important financial instrument that had positive legal standing in both the medieval Islamic and Christian worlds but remained relegated to personal networks only in the former. This paper suggests that a seemingly innocuous difference – the involvement of currency exchange in European but not Middle Eastern bills, a difference resulting from the secular legalization of interest in Europe – encouraged divergent endogenous processes resulting in these distinct institutional arrangements.

1. Introduction

In recent decades, a large literature has emerged seeking the economic, geographic, institutional, and cultural causes underlying the "rise of the West" (North and Thomas, 1973; Jones, 1981; Diamond, 1997; Landes, 1998; Pomeranz, 2000; Acemoglu et al., 2005; Kuran, 2005a; Greif, 2006; Clark, 2007). An important subset of these works stresses the emergence of institutions which supported impersonal exchange in Europe as central to the divergence between the "West" and the rest of the world, arguing that such institutions facilitated the development of widespread financial markets, large-scale banking, and many other phenomena associated with economic growth. Yet, there is no consensus on why institutions that supported impersonal exchange emerged in Europe in the medieval period and not in other regions, such as the Middle East. A view championed by Douglass C. North, amongst others, is that the rise of political and legal institutions which ensured contract enforcement and property rights was the essential force driving the growth of impersonal exchange (North and Thomas, 1973; North, 1990, 1991). Avner Greif, on the other hand, argues that impersonal exchange was possible in an earlier period due to the "community responsibility system", an institution that supported such exchange through self-enforcing mechanisms (Greif, 2004b, 2006, chapter 10). Elsewhere, Greif and others have argued that the spread of impersonal exchange was facilitated in certain contexts by institutions (formal and informal) that mitigated the "fundamental problem of exchange" –

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the problem that individuals enter into exchange relationships only when the other party can commit ex ante commit to fulfill obligations ex post (Milgrom et al., 1990; Greif, 1992, 1993, 2000, 2004a; Greif et al., 1994; Clay, 1997a,b).

While each of these explanations sheds significant light on the emergence of institutions that made Western economic hegemony possible, there are many important historical phenomena that they cannot explain. One particularly significant historical feature unaccounted for in this literature is that long-distance financial instruments, particularly bills of exchange, remained confined to relatively small, personal networks in the Islamic world[1] but precipitated broader impersonal institutions in Europe (such as joint-stock companies and banks). Bills of exchange, described by Hunt and Murray (1999, p. 65) as "the most important financial innovation of the High Middle Ages", were known and employed in both the Islamic and Christian worlds and were generally *accepted* and *enforced* in courts wherever they were drawn. Hence, their relegation to personal networks in the Islamic world but not in the Christian world cannot be explained solely by differences in enforcement of property rights or institutions supporting community responsibility.

This paper employs a two-tiered argument to help account for the differing breadth of the networks associated with these financial instruments and institutions. The first tier suggests that differences in the institutions supporting (and supported by) European and Middle Eastern bills of exchange arose in response to a seemingly trivial difference in the method through which exchange transactions were conducted. In Europe, lenders profited from exchange transactions by buying and selling bills in different regions at different exchange rates. This provided wealthy lenders with a way of making profit while skirting the religious interest ban, and beginning in the fourteenth and fifteenth centuries, bills of exchange became an important financial instrument, rather than simply a means of decreasing transport costs. It was precisely because exchange transactions were closely tied with long-distance lending – due to the element of currency exchange – that they provided an incentive for European businessmen to establish organizations capable of extending impersonal credit.

On the other hand, in the Islamic world, bills of exchange (*suftaja*, plural *safatij*) did not involve currency exchange, but instead were written in one region for payment in the same specie in another region. The *borrower* (issuer) could charge a fee upon issue, but *lenders* could not profit from the exchange transaction itself, as gaining from differences in exchange rates was considered usurious and hence illegal. Thus, bills of exchange were rarely used for any purpose beyond their original intent – avoiding the costs and risks associated with moving specie in international trade. Unlike in Europe, *safatij* were not employed as instruments of finance, and lenders were thus not provided with the incentive to expand their operations beyond their prevailing network of personal relations, thereby inhibiting the growth of institutions capable of facilitating impersonal exchange.

This argument differs somewhat from Greif's analysis of impersonal exchange, which concentrates on institutions that mitigated the "fundamental problem of exchange" (FPOE). Instead, I suggest that specific institutional elements determined whether individuals had an incentive to enter into exchange agreements in the first place – even ones in which the FPOE was not a problem. This argument is complementary to Greif's – I propose that in cases where contracts are enforceable and the FPOE is not a problem (as the evidence suggests was the case with both European and Middle Eastern bills of exchange), divergent outcomes can still emerge as a result of differing institutional details.

The second tier of the argument addresses why European lenders were able to profit from differences in exchange rates but Middle Eastern lenders were not. I suggest that this difference was a result of the type of sanctions imposed on those who lent at interest (usury).[2] In particular, I argue that the greater degree to which political authorities depended on religious authorities for legitimacy in the Islamic world entailed an equilibrium in which interest was prohibited by religious *and* secular authorities. On the other hand, I argue that a late thirteenth-century decrease in the dependence of European political authorities on religious authorities sparked a series of interactions – commencing with the secular legalization of moderate interest – which gradually resulted in a complete removal of the interest ban. In this economic setting, lenders were permitted to respond to financial exigencies without fear of legal consequences, encouraging them to seek profit on exchange transactions despite condemnation by religious authorities. On the other hand, the significant level of "dependence" in the Islamic world supported an equilibrium in which the interest ban was never fully removed de jure (even though it was practically non-existent de facto). Under such conditions, it was quite costly for capital-wealthy lenders to openly react to financial exigencies in such a manner, and they were thus discouraged from "pushing the envelope" and seeking profit on bills of exchange.

Before concluding, I provide a "robustness check" of this hypothesis by briefly analyzing the history of interest and bills of exchange in medieval Byzantium. I find that, as in the Western Christian and Islamic worlds, the legality of profiting on the exchange portion of the bill was related to the secular and religious acceptance of interest, which itself stemmed from the relationship between the political and religious authorities.

This argument is not a deterministic one. At no point do I argue that Islamic institutions had to form like Western European ones in order to facilitate impersonal exchange, nor do I argue that Islam or Islamic institutions are incapable of change. Instead, I argue that incentives which encouraged the formation of institutions capable of supporting impersonal lending

[1] Throughout this paper, I use the terms "Christian world" and "Western Europe" to denote the pre-Reformation Christianized regions under the Church of Rome. I use the term "Islamic/Muslim world" somewhat broadly, comprising North Africa and the "Middle East" (that is, the entire Arab world, Iran, Turkey, the Balkan peninsula, and Spain up to the Reconquista). I recognize that this terminology is overly general and may at times be misleading, but this is not intentional – instead, I view this as an unfortunate consequence of the broadness of the subject matter at hand.

[2] Though the terms interest and usury have different meanings in their modern context, in pre-modern times they were largely synonymous, and will thus be used interchangeably throughout the paper (Divine, 1959; Persky, 2007).