SOAS
Department of Economics
Working Paper 128

BANKS AND THE DESIGN OF THE FINANCIAL SYSTEM: UNDERPINNINGS IN STEUART, SMITH AND HILFERDING

COSTAS LAPAVITSAS
SCHOOL OF ORIENTAL AND AFRICAN STUDIES
THORNHAUGH ST, RUSSELL SQ.
LONDON WC1 0XG
UK
CL5@SOAS.AC.UK

ABSTRACT

Banks in bank-based financial systems tend to engage in long-term lending that requires substantial own capital to guarantee solvency. In market-based systems, in contrast, they tend to undertake short-term lending that requires adequate reserves to guarantee liquidity. Theoretical support for these two approaches to banking can be found in, respectively, Steuart and Smith. The innovative Marxist analysis of banking by Hilferding combined elements of both. Banks in the early stages of development are Smith-like but, as the scale of fixed investment in industry grows, they lend long-term and become Steuart-like, also developing 'commitment' relations with enterprises. However, Hilferding also implied, erroneously, that financial systems historically evolve in a bank-based direction. Based on Hilferding but also drawing on Japanese Marxist analysis of finance, it is suggested instead that bank behaviour in bank-based systems results from institutional changes imposed by policy-makers in order to achieve 'catching up.'

KEYWORDS: Adam Smith, James Steuart, Rudolf Hilferding, banking theory, Marxist theory of finance

1.Bank-based and market-based finance in contemporary capitalist development. [1]

The design of the financial system is a major concern of the recent literature on finance and development. Attention has focused especially on the distinction between bank-based (indirect, or German-Japanese) finance, in which banks typically make long-term loans to enterprises, versus market-based (direct or Anglo-American) finance, in which bank loans are for shorter duration. It has been claimed that bank-based systems provide scope for superior monitoring of enterprises by banks, but also for monitoring of both banks and enterprises by the state (very selectively, Stiglitz 1985, 1994, Mayer 1987, Wade and Veneroso 1998). There is, presumably, a 'relational' or 'commitment' aspect of banking in such systems, which contributes to better performance of firms essentially through easing constraints posed by information asymmetries. In contrast, it has also been claimed that, in market-based systems, stock markets provide financial services that are supplementary to those of banks and vital for development, such as allocation of risk and monitoring through shareholder action (again selectively, Demirguc-Kunt and Maksimovic 1996, Levine and Zervos 1998, and Demirguc-Kunt and Levine 1999.) It appears, moreover, that Anglo-American financial practices have become more prevalent in the developing world in the 1990s. Singh and Hamid (1992), Glen and Pinto (1994) and Singh (1995), for instance, have found that corporate investment in developing countries in recent years has depended more heavily on external funds, particularly on new issues of shares rather than debt.

[1] Ben Fine, Alfredo Saad-Filho, Jan Toporowski, Kazutoshi Miyazawa and Sedat Aybar commented on the manuscript. Thanks are also due to Richard Werner and other participants at the ESHET conference at Rethimnon, 2002, where a related paper was presented. All errors are my responsibility.

This debate has a long and, to some extent, unrecognised historical pedigree, in both theory and policy (Cameron 1967, Cameron and Bovykin 1991). However, this essay does not trace the lineage of views on banking in contemporary development literature. Rather, it establishes affinities between modern views and those of Steuart and Smith as well as, making a great historical leap, Hilferding. From these older writings insights can be obtained into the relationship between banks and enterprises that are, perhaps, not so evident in contemporary information-theoretic literature. Specifically, section 2 considers the implications of the design of the financial system for the lending operations and own capital of banks. It is suggested that, in this respect, the approach of the bank-based current has affinities with the mercantilist tradition, especially with Steuart. His treatment of bank lending and bank capital is consistent with banking practices within bank-based financial systems. In contrast, the market-based current has affinities with Adam Smith, who advocates principles for the lending and capital of banks that are characteristic of banking practices within market-based financial systems.

Section 3 turns to the same issue from the standpoint of Marxist political economy, for which the design of the financial system, the relationship between banks and enterprises and the lending practices of banks have always been matters of the first importance. [1] However, Marx's own work is not particularly informative in this respect. By far the most relevant reference is Hilferding (1910), who drew on the experience of Austria and Germany. It is suggested that Hilferding's analysis of banks contains elements of both Steuart and Smith. For Hilferding, the primary form of capitalist finance is market-based, but tends to become bank-based as capital accumulation evolves.

Hilferding's work is of particular interest because, in order to establish the character of the financial system, he focuses on the varying requirements of industrial accumulation and relates them to changes in bank lending. However, his claim that capitalist financial systems evolve in a bank-based direction in the long term is evidently problematic. An alternative suggestion is briefly sketched in section 4, drawing on Hilferding but also on Japanese Marxist analysis of finance. It is argued that the capitalist financial system possesses a spontaneous form (described as a pyramid) with market-based characteristics. However, the appearance of bank-based systems does not represent evolution but institutional transformation imposed from above in order to allow late developers to 'catch up'. Section 5 concludes.

2. Steuart and Smith on the relationship between banks and enterprises in the course of capitalist development.

For sophistication and depth, Steuart's views on banking and finance represent the pinnacle of mercantilist thought. [2] Writing on the cusp of the industrial revolution and the capitalist transformation of Western Europe, Steuart wants to establish principles that would be of help to 'the statesman' in shaping economic and social policy. In mercantilist fashion, Steuart believes strongly that money could revitalise economic activity and transform society. The underlying problem for the policy-maker is to ensure 'a just proportion between the produce of industry and the circulating equivalent available to purchase it' (Steuart, 1767, ch. XXVIII, bk. II, p. 53.) Too little money would lead to stagnation of activity; too much of it would lead to 'prodigality' that would give rise to

balance of trade deficits. It is clear, however, that he is mostly concerned with shortage rather than overabundance of money. Thus, 'the statesman' must be prepared to deploy policies that draw metallic money out of hoards, or supply 'symbolical' paper money. For Steuart, a country's economic stagnation is tantamount to inability of those who sustain consumption to absorb the produce of industry, because they lack 'circulating value' (money) and cannot obtain credit to effect purchases. Hence, the country needs a mechanism for 'liquidating' assets of those who would consume, especially land they might hold, thus providing them with the wherewithal to make purchases (ibid. p.59.) In short, it is incumbent upon the 'statesman' to provide mechanisms for making credit available to those who would consume the product of those who exercise their 'industry.' Such credit could create a 'circulating fund' of paper money for the country and spur economic activity.

Steuart's analysis contains confusion between the money revenue of consumers and the money capital of industrialists (or between the supply of money and the available money capital.) This is a characteristically mercantilist confusion, noted by Heckscher (1935, pt. IV, ch. II, sec. 5.) In terms of Marxist political economy, the money capital used to hire workers and purchase means of production is a very different economic category from the money income of individuals spent on means of consumption. The economic properties of money capital are accounted for by the generation and accumulation of money profit, while those of money income by the need and desire to consume useful things. Thus, a country might not have sufficient money capital to sustain rapidly expanding accumulation, while possessing adequate money to circulate private

income. However, for the purposes of this article, what matters is Steuart's perception of credit as a catalyst of development that could be consciously manipulated by policy-makers. Steuart essentially claims that, if economic development is lagging, effective demand must be continually weak due to a deficiency of money and credit. The 'statesman' should make good this deficiency, either through mobilisation of money hoards, or through introduction of appropriate institutional changes in the economy to generate credit. As is shown below, these changes amount to creation of banks that facilitate consumer borrowing against their fixed assets, particularly land. [3]

The influence of John Law on Steuart is striking in this regard. Law's (1705, ch. VIII) best-known work on money and credit is explicitly concerned with Scotland lagging behind Holland in economic development. [4] Scotland's weak development is due to poor trade performance, both domestically and internationally, which Law attributes to lack of money in the country. The mercantilist confusion between money capital and money revenue is again evident: 'Domestic Trade depends on the Money. A greater Quantity employs more people than a lesser Quantity.' (ibid. p. 11), and 'The first Branch of Foreign Trade, which is the Export and Import of Goods, depends on the Money.' (ibid. p. 12.) The implications of money shortage for national development are stark:

> National Power and Wealth consists in Numbers of People, and Magazines of Home and Foreign Goods. These depend on Trade, and Trade depends on Money. So to be powerful and wealthy in Proportion to other Nations, we should have Money in Proportion with them; for the best Laws without Money cannot employ

the People, improve the Product, or advance Manufacture and Trade.' (ibid. p. 49.)

To increase 'money', Law considers various methods of expanding metallic circulation, such as allaying existing coin or mobilising money hoards, but thinks that they are unlikely to have a sufficiently strong effect. His preferred method is to increase 'money' through credit. Nevertheless, Law (ibid. ch. V) is adamant that credit based on promises to pay money in the future is insufficient for the purpose of spurring development, as there is not enough money in the country to support such credit and make it safe. Thus, he alights upon his preferred institutional transformation of the economy, farsighted and notorious in equal measure, namely establishment of a land bank, i.e. a bank that would lend its own banknotes secured by land pledged against them. Law's proposal did not persuade the sober denizens of the Scottish parliament, and his disastrous attempt to put his ideas into practice in France are not of immediate relevance here. It should be noted, however, that Law (ibid. 10) understood fully that an expansion of money and credit was also likely to mean a decline in the power of landed aristocracy, whose land would become commodified. Murphy (1997) has shown that the established 'old' financiers of France, behind whom lurked the landed aristocracy, played an important role in bringing the downfall of Law's 'System.'

Similarly, Steuart's preferred method of expanding credit and money and achieving development is the establishment of banks that hold pledges of land. However, his analysis of the operations of such banks is deeper and more detailed than Law's. [5] For

Steuart (1767, bk. IV, pt. I, ch. I), there are three generic types of credit. First is 'private' credit, which is advanced against real or personal security (i.e. it either has a specific real asset as collateral, or is based on the entire personal wealth of the borrower). This is the best form of credit, and its broader social significance lies in converting ('melting down') solid property into money (ibid. p. 196). The soundness of the 'melting down' operation depends on the ability of the collateral asset to maintain its value, with land being by far the best. Second is 'mercantile' credit, advanced against the creditworthiness of a borrower engaged in trade. 'Mercantile' credit is the most precarious of the three, since it is advanced by traders to each other in the course of their business and has no solid backing. Third is 'public' credit, advanced by the state against its ability to command future income due to tax. Its reliability depends on historical and political circumstances.

If industry does not exist and trade is in its infancy, all credit would be scarce, thereby preventing economic development (ibid. p. 197). Steuart argues that the statesman should promote establishment of 'banks of circulation upon mortgage', i.e. banks that issue banknotes against securities backed by pledges of land. These banks would normally lend for long periods of time. Steuart explicitly states that they would be unsuitable for developed countries, such as England, for which banks based on mercantile credit are more appropriate (ibid. p. 197). The Bank of England is the model bank for developed countries – it engages in commercial banking, i.e. lending against trade bills and making short-term loans to the government. For Steuart, necessary foundations for commercial banking are provided only by extensive and regular commercial transactions in developed countries, which are not present in developing countries.

The true measure of Steuart's originality in this connection, however, lies in differentiating between his banks and standard commercial banks in terms of their respective policies on capital and reserves. His distinctions are directly relevant to the present-day literature on financial systems. The capital of 'banks upon mortgage' comprises any 'species of property' (metallic money, public securities, real estate, and so on) that its owners put together in order to provide 'security' for the banknotes they have issued (ibid. p. 201). The point bears restating in a slightly different way: the main purpose of the bank capital of these banks is to ensure public confidence in their liabilities. [6] Clearly, if banks are obliged to convert their banknote liabilities into legal money, they must also hold reserves (of coin, if legal money is metallic.) But that is hardly a major concern, since their assets will be long-term and solid, other liabilities will be insignificant, and banknotes will be easily honoured as assets mature. For Steuart, the primary purposes of bank capital are to foster confidence among the public and to cover improper use of bank credit, as when, for instance, loans have been made against poor collateral or to pay for the bank's own expenses.

In short, Steuart is deeply concerned with the solvency but not the liquidity of banks. The latter is unimportant, except in the subsidiary sense of providing a small reserve of coin for occasional requests to convert banknotes. His neglect of liquidity derives from the nature of the assets that are to be held by his banks: the loans they would make would be aimed at sustaining spending by otherwise illiquid social classes, not financing the short-term activities of merchants. Land bank liabilities would be short-

term, but would not be issued in relation to trade operations. Hence they would be unlikely suddenly to return to the banks in large volumes demanding conversion into reserves. Steuart (ibid. p. 197) is fully aware of the fact that sudden losses of reserves could easily occur if a country faced balance of trade deficits, so he advocates establishment of his banks in countries that have regular trade surpluses. His only genuine and persistent concern is of a run on the banks arising from loss of confidence in their solvency, which would deplete their reserves. Hence the importance of possessing solid and secure assets, and sufficient capital to provide confidence and solvency. For him, moreover, only land banks are able safely to issue very short-term (money-like) liabilities. In contrast, commercial banks that are based on mercantile credit issue their banknotes against trade bills that are inherently less safe than land-backed assets. To ensure an adequate supply of mercantile credit, it is better to establish institutions that do not issue notes but borrow from land banks for the explicit purpose of engaging in trade bill discounting (ibid. p. 208).

The contrast with Adam Smith, writing less than a decade later, is stark. [7] For Smith, economic development is the outcome of the division of labour and the accumulation of capital through saving, while money and credit play a secondary role. Smith (1776, bk. II, ch. II) barely devoted a single chapter of his classic to the operations of banks. [8] His work, however, is largely free of the confusion between money revenue and money capital that stamped Law's and Steuart's. Hence, his discussion of the role of banks in supplying money to industry, and of the place of credit in the operations of capitalist enterprise, has strengths that are sorely absent from the other two.

It is notable that Smith's analysis of banking is concerned precisely with those banks that Steuart had considered unimportant, namely commercial banks that lend to merchants by discounting bills of exchange. Moreover, Smith analyses commercial banks as capitalist outfits subsisting independently amidst merchant and industrial enterprises, rather than as institutions set up by the 'statesman' in order to provide credit that would spur economic activity. Smith's primary concern, in contrast to Steuart, is to analyse the availability of liquidity for those banks, which essentially means determining the volume and nature of their reserves. Solvency is a lesser concern, as also follows from his analysis of bank lending policy. For Smith (ibid. pp. 318-323), the proper lending business of such banks is to discount short-term bills that arise in the course of commercial transactions among capitalists of established reputation, that is, 'real bills'. To sustain this business, banks need either to keep reserves of gold or silver, or to be able rapidly to obtain backing for their notes in the open market. Keeping metallic reserves is costly because interest is foregone; it is also expensive to procure additional reserves at the moment when pressing needs arise. But if banks stuck to 'real bills' lending, their reserves would be regularly maintained as assets matured, thus minimising the cost. Economic theory has known for a long time that a 'real bills' policy for banks is a fallacy on several scores, including purely monetary ones, but this is not of critical importance here. [9] The power of Smith's analysis of banking compared to Steuart's comes from his discussion of bank lending policy in relation to reserves, given that banks are independent profit-making capitalist concerns. Smith's view that the appropriate business of commercial banking is short-term lending backed by adequate but minimal reserves

captures a fundamental element of banking practice in market-based systems of developed capitalism.

Unlike Steuart, Smith (ibid. pp. 323-4, pp. 341-2) is concerned with ascertaining which part of the capital of a functioning capitalist can be provided by a bank 'with propriety'. Thus, a bank should certainly not advance to capitalists the funds necessary for their fixed capital, as that is long-term investment. Even more strongly, a bank should not supply the part of circulating capital (working capital) that is necessary for regular commercial payments, wages, and so on. The appropriate source of these funds is, presumably, own capital provided by the entrepreneur. By this token, the appropriate role of banks is to supply functioning capitalists with money that they would have kept idle in the normal course of their business. Banks should supply functioning capitalists with the reserves of ready money that must be kept while running any capitalist business. If commercial banks exist that lend against good bills or through overdrafts, capitalists need not hold a 'dead stock' of money reserves, but could convert it into active capital, invested in materials, machinery, and so on (ibid. p. 340). Moreover, by exclusively discounting 'real bills', banks can ensure that they supply only this part of the capitalists' funds and no more.

Thus, in contrast to Steuart, who examines (and advocates) banks that supply liabilities against pledges of land, Smith analyses commercial banks that supply liabilities in discount of bills of exchange. These banks cannot spur capitalist accumulation by augmenting either the fixed or the variable capital of enterprises. Moreover, Smith

advocates a definite bank lending policy, namely short-term lending against 'real bills'. This policy would, presumably, maintain the necessary minimum of bank reserves (liquidity), while supplying capitalists with the money reserves required in their business and no more. This is a prescriptive principle ensuring the viability of banks as capitalist concerns, as well as guaranteeing their creditworthiness. The size and uses of banks' own capital, especially in terms of providing solvency and sustaining their liabilities, were not of vital importance to Smith.

The same spirit is evident when Smith analyses the contribution that banking makes to the national economy as a whole, drawing conclusions about the banks' monetary role. After differentiating between gross and net money revenue, he focuses on the replenishment of fixed and circulating capital as deduction from gross revenue (ibid. p. 303-5.) [10] Smith thinks that the replenishment of the aggregate circulating capital of society does not represent a deduction from gross revenue on the mistaken grounds that the goods that replenish it will eventually be consumed hence they belong to net revenue (ibid. p. 305). But on money he is on more solid grounds. The aggregate quantity of money, though part of circulating capital, he likens to fixed capital, 'the great wheel of circulation' possessed by society to facilitate its economic reproduction. Replenishing this quantity is a net deduction from gross revenue, as long as money is metallic, i.e. has to be extracted from the bowels of the earth through expenditure of labour. By providing a solid paper money, banks can save this expense, as well as allowing the metal to be exported for goods. However, bank credit certainly does not augment society's capital - that increases only through saving and accumulation. The most that banks can do, as

already seen, is to reduce the pressure on capitalists to hold money reserves, hence allowing conversion of reserves into active capital:

> This part of his capital which a dealer is obliged to keep by him unemployed, and in ready money for answering occasional demands, is so much dead stock, which so long as it remains in this situation, produces nothing either to him or to his country. The judicious operations of banking enable him to convert this dead stock into active and productive stock;' (ibid. p.340-1).

In conclusion, two opposing views on banks and their relationship with enterprises were identified above. The first is associated with Steuart, has a mercantilist aspect, and stresses the catalysing role of finance in capitalist development. Banks should be created to provide fresh money that is instrumental to development. However, to do so successfully, bank assets should be long-term and backed by solid collateral (preferably land) while, on the liability side, banks should possess substantial capital that would guarantee their solvency and generate trust in bank-created money. Reserves are necessary but not of especial importance to these banks. The second is associated with Smith, has classical features, and shuns the belief in the efficacy of credit as catalyst of development. Banks are independent commercial concerns, and the state has no business setting them up. They do not provide fresh capital to enterprises and, therefore, cannot significantly affect a country's development path. Banks' contribution to capitalist development derives from ridding capitalists of much of the cost of holding money reserves (and from reducing the costs of metallic circulation). For Smith, bank assets should be short-term and finance 'real' transactions among capitalists. To sustain their

assets, banks should possess liquidity, i.e. costly reserves. Own capital and solvency are important but not critical issues for these banks. Important elements of both Steuart's and Smith's views on banking can be found in Hilferding's analysis of banks and the evolution of the capitalist financial system, as is shown in the next section.

3. Hilferding and Marxist political economy of financial system design.

Hilferding (1910) has written the outstanding piece of Marxist political economy on banking and finance. His distinctive position on banking in the course of capitalist development is the most important Marxist contribution to this debate, and echoes both Steuart and Smith. It is possible for Hilferding to adopt elements of both without contradiction because of two closely related theoretical postulates that set Marxist theory of finance apart. The first is that financial institutions deal in loanable money capital, which is neither loanable funds created as saving out of income, nor liquidity accumulated by storing the means of exchange; the second is that the average rate of interest tends to be below the average rate of profit. Loanable money capital is a special form of capital that is qualitatively different from industrial and commercial capital. There is some ambiguity regarding the sources of loanable money capital but, as argued elsewhere (Lapavitsas 2000), strong support can be found in Marx's own work for the view that loanable money capital derives from idle money hoards formed by industrial enterprises and mobilised by financial institutions. Hilferding (ibid. pp. 70-81) carefully analyses the creation of idle money capital and stresses its significance in creating the wherewithal of bank lending. By this token, loanable money capital is not a functioning

part of a country's total social capital, though deriving from it. Since it is not directly engaged in production of aggregate profit (surplus value), it cannot earn returns on the same basis as industrial and commercial capitals. Rather, interest is a share of profits generated in production through employment of loanable money capital. There is no 'natural' rate of interest, and the market rate is determined purely through demand and supply of loanable money capital. It is evident in Hilferding's analysis (for instance, ibid. pp. 108-112) that he adopts Marx's view (1894, p. 482) that the rate of interest on loanable money capital tends to be below the average rate of profit on capital engaged in production or circulation [11]

Hilderding's analysis of banks as capitalist enterprises that specialise in collecting and advancing loanable money capital has similarities with Smith's. [12] As seen in section 2, for Smith, the appropriate lending operations of banks are short term, and should not aim at financing investment in plant and equipment or even working capital. Hilferding (ibid. pp. 82-3) starts with the financing requirements of industrial firms and identifies 'circulation credit.' This is trade credit that involves the sale of finished commodity output against promises to pay (bills of exchange) rather than money. Characteristically for Marxist political economy of finance, Hilferding stresses that capitalist enterprises (industrial and commercial) spontaneously create mechanisms to supply 'circulation' credit to each other. These mechanisms rest on inter-firm relations that allow systematic drawing, settlement and circulation of bills of exchange. They do not rely on the prior existence of financial institutions but on the contrary act as foundation for the emergence of capitalist finance. Banks, at their commencement as

capitalist businesses interacting with industrial and commercial concerns, typically undertake operations that relate to credit among enterprises. They provide their own (bank) credit by discounting bills of exchange, while replacing circulating bills with their own instruments of indebtedness, i.e. bank notes. [13] When a system of banks emerges, bank credit substitutes itself for spontaneous trade credit among enterprises, and banks take over the clearing and settlement operations relating to bills. Thus, capitalist banks are originally providers of short-term credit to finance commercial operations, and consequently need little capital of their own:

> Since the banker substitutes his own credit for the commercial bills, he requires credit, but only a relatively small money capital of his own, in order to guarantee his ability to pay (ibid. p.86).

Their liquidity is secured by attracting deposits from industrial capitalists, especially money that would have previously lain in reserve to pay for bills of exchange.

Hilferding (ibid. p. 88) then introduces 'capital or investment' credit, which is the advance of loanable money capital, that is, the mobilisation of hoarded money across the economy through lending operations. This is qualitatively different from trade credit, not least because it evidently increases the amount of active money capital at the disposal of the capitalist class as a whole. Bank deposits are the main mechanism for collecting loanable money capital. Here the similarities with Steuart's analysis are strong. 'Investment' credit provided by banks can be used by industrialists to increase either their fixed capital (lasting several turnovers) or their circulating capital (lasting one turnover). In case of the former, and since the money lent is tied up for a long period of time, the

bank loses some degrees of freedom and becomes 'a participant in the fortunes of the enterprise' (ibid. p. 91.) Consequently,

> To the extent that banks tie up their funds, they are obliged to keep a comparatively large capital of their own, as reserve fund, and as a security for the uninterrupted convertibility of deposits. Thus banks which are engaged in supplying long-term credit, in contrast to pure deposit banks, must have at their disposal a substantial capital. (ibid. p. 91.)

When the scale of capitalist production is relatively small, the need of industrial capitalists for 'investment' credit is small. Fixed capital requirements are typically met by the capitalists' own capital, while credit supplies the bulk of circulating capital (ibid. p. 94). But as the scale of production grows, capitalists seek recourse to outside funds for fixed investment, which means borrowing from banks. Since bank liabilities are mostly short-term (deposits), banks can advance only a fraction of their loanable money capital as 'investment credit.' Moreover, to be able to do so with security, they have to reach a minimum size, as well as diversifying the risk by lending to several enterprises.

Profound implications follow from banks supplying long-term funds to enterprises for fixed investment. As long as banks are simply advancing 'circulation credit', what matters to them is simply the ability of the borrowers to repay, which might well be unrelated to the specific business transaction for which the advance of bank credit has taken place. However, when banks lend to industrialists for fixed capital, they have to ascertain their future prospects and develop a close relationship in order to monitor their performance (ibid. p. 95.) By doing so, their influence over enterprises increases:

> In this relationship the bank is the more powerful party. The bank always disposes over capital in its liquid, readily available form, money capital. The enterprise, on the other hand, has to depend upon reconverting commodities into money … The bank enjoys an additional advantage by virtue of the fact that its capital is relatively independent of the outcome of any single transaction, whereas the fate of the enterprise may depend entirely upon a single transaction (ibid. p. 95.)

The power of large banks over enterprises tends to rise over time as a result of three factors: first, trade credit has an increasingly international character, requiring wide business contacts and large volumes of liquid resources; second, the need for 'investment' credit rises as the scale of capitalist production grows; and third, there is increasing involvement of banks in managing flotations of shares in the stock market. The last point is fundamental to Hilferding's analysis of the financial system and needs to be examined in more detail.

Hilferding's analysis of equity as opposed to debt starts with the joint-stock company and the separation of ownership from control (ibid. p.107). Joint-stock corporations are substantially different from individually owned enterprises, not least because shareholders function similarly to money-lending capitalists: they risk only a sum of money, but receive an uncertain share yield rather than interest. To secure return of their invested principal, moreover, they have to sell their shares. Shares are sold at prices that derive from discounting expected returns of the project at hand, and the rate of discount is the appropriately risk-adjusted rate of interest. The reason for discounting at this rate is that competition pushes the yield of shares toward the average rate of interest,

since idle money available for investment can be freely allocated between equity and debt (ibid. p. 109). But the funds actually necessary for investment in any project are equivalent to the expected returns from it discounted by the average rate of profit prevailing in industry. Since the rate of profit tends to be above the rate of interest, the funds obtained in the stock market through share flotations systematically exceed the funds actually invested, for any given project. This is 'promoter's profit' (ibid. p. 112), which also accrues to those who oversee share flotations.

Corporations are formed when the scale of project makes it necessary to pool capital from many sources. They are 'associations of capitalists' (ibid. p.118), who are attracted because they can participate as shareholders, i.e. by minimising their exposure while retaining the fluidity of their capital. For Hilferding, the typical example of a project requiring the formation of corporations is railway construction. But corporations also offer competitive advantages, since they make it easier to obtain fresh supplies of money capital through equity as well as restructuring production. Not least, corporations offer advantage in terms of mergers and acquisitions that allow ever-greater concentrations of capital to emerge. As capitalism develops and the scale of production grows - requiring ever-larger injections of fixed capital - corporations become the most suitable institutional form of capitalist enterprise. One of the strongest advantages they offer to industrial capitalists is access to credit and the uses to which borrowed funds can be put. Banks would more easily lend to a corporation than an individually owned enterprise:

> because its structure greatly facilitates supervision. One of the bank's employees can be delegated for this purpose, and the private banker is thus replaced by the bank official. The bank will also provide large amounts of credit more readily to a corporation, because the corporation itself can easily raise capital. There is no danger that credit which has been provided will be immobilized. (ibid. p. 124.)

Thus, Hilferding draws a connection between lending activities of banks and fund raising activities in the stock market by arguing that a uniquely strong relationship exists between large banks and corporations. This is especially so since large banks can provide 'investment' credit to corporations much more easily than to individually owned enterprises (ibid. p. 120). Consequently, they develop a close 'commitment' relationship, which often means that large banks establish regular mechanisms of supervision over corporations. For that they rely on obtaining permanent representation on the board of directors of corporations, as well as owning their shares. The closer banks become with corporations, the more intricately involved they are with managing share flotations in the stock market. Thus, investment banking functions accrue to large banks as corporations become increasingly important in industrial capitalism, and bring to them additional scope for profit (largely 'promoter's profit'). Hilferding's celebrated concept of 'finance capital' is founded on the close relations between banks and corporations, and the power the former exercise over the latter. 'Finance capital' is the inevitable outcome of the development of capitalism, an amalgam of banking and industrial capital - with banks in the ascendant - that sustains capitalist imperialism.

To recap, for Hilferding, capitalist development leads spontaneously to advance of trade credit among enterprises, which is gradually replaced by bank credit. The original character of capitalist banks is Smith-like, that is, they are commercial banks supplying 'circulation' credit through bill transactions, with low requirements of own capital, while their liquidity is secured through attracting deposits. However, as the scale of production grows and fixed capital requirements become larger, banks increasingly supply 'investment' credit, i.e. they advance loanable money capital collected across the economy. Lending for fixed capital investment gives to banks a Steuart-like aspect, since their assets are now long-term and they need substantial amounts of own capital. Moreover, banks have to monitor their 'investment' credit and thus acquire close 'commitment' relations with firms. These are especially pronounced between banks and joint-stock companies. For Hilferding, as the scale of production continues to increase in the course of capitalist development, joint-stock corporations become the most suitable institutional form of capitalist enterprise. Banks can lend to them for fixed investment with greater security; they can also obtain investment-banking profits from managing corporate share flotations. Hence the Steuart-like character of banks becomes even stronger as capitalism develops and corporations dominate the economy. Large banks and industrial corporations are bound together in a very close 'commitment' relationship, in which the balance of power favours banks. 'Finance capital' represents a stage in the development of capitalism, which corresponds with a financial system that contains a large stock market but also has a strong bank-based character.

4. Banking and the pyramid of the credit system

Hilferding's analysis of capitalist finance is evidently sophisticated and informative, but his claim that the capitalist financial system evolves structurally and historically in a bank-based direction has not stood the test of time well. It is clearly contradicted by the persistence of market-based systems that have been thriving in the last quarter of the twentieth century. It is probable that Hilferding was overly influenced and generalised inordinately from the historical experience of Austria and Germany at the turn of the twentieth century. However, his analysis of the spontaneously emerging forms of credit and of the financing needs of industrial enterprises could still afford insights into the design of capitalist financial systems, if Steuart's analysis of finance is more explicitly relied upon. Steuart essentially claims that, for late developers to 'catch up', long-term bank finance has to be mobilised by policy-makers, but for banks to be able to operate accordingly their solvency and levels of own capital have to be adequate. It is notable that, in contrast to Steuart, state intervention in finance plays a negligible role in Hilferding's analysis of emergence of bank-based systems. Consider therefore the following alternative suggestion for analysing financial system design that draws on Japanese Marxist political economy, especially the theory of finance associated with the Uno school (Itoh and Lapavitsas 1999, ch. 4).

In this view, the spontaneously emerging form of capitalist finance comprises a pyramid-like credit system supplemented by a stock market. The pyramid of the credit system represents a layering of credit relations, rising from credit that is particular and individual to credit that is general and social. Along lines similar to Hilferding, the first

layer comprises trade credit relations, which are highly specific to enterprise, economic sector and geographical area. The second layer comprises banking credit, i.e. collection and advance of loanable money capital by banks. By collecting idle money from several sources and using it to participate in the operations of a great number of enterprises in different sectors of the economy, banks begin to homogenise credit and to attenuate its highly individual character specific to person, enterprise and sector. The third layer comprises money market credit, which arises as loanable money capital is traded among banks. In the money market the particularities of trade and banking credit are further disregarded, and credit is traded in large homogeneous lumps. Money market credit is a general economic relationship that draws validity from the whole of the capitalist economy rather than from individual capitalist enterprises. In the money market, the rate of interest acquires a precise numerical expression that applies across society. The fourth layer, and apex of the pyramid, comprises central bank credit. The central bank is the leading bank of the money market, and through its operations capitalist credit is given a clear social aspect, which is partly the result of conscious management of credit across the economy.

The pyramid of credit stands for a market-based system, in which banks undertake short-term lending, partly related to trade credit instruments. Banks in the pyramid are commercial banks, concerned with liquidity and adequacy of reserves, to which purpose they commit their capital. The financial system is complete when a stock market is established that complements the market-based credit system. As for Hilferding, the stock market is a venue for mobilisation of idle money to finance large

and long-lasting projects on the basis of equity rather than debt. Credit system and stock market are organically related, as both attract funds from the social pool of idle money and as lending by the credit institutions sustains operations in the stock market. The connecting links between the credit system and the stock market are summed up in the rate of interest, which tends to be below the rate of profit. Unlike Hilferding, however, there is no presumption that this structure becomes spontaneously bank-based as capitalism develops. Hilferding makes the assumption that, with capitalist development, the scale of production grows and banks are inexorably drawn into long-term lending to finance fixed capital investment. This is a plausible prospect, but there is no clear historical support for its universality. On the contrary, there is evidence that the vast bulk of investment in contemporary capitalism is financed by retained profits of corporations (Corbett and Jenkinson 1997). Emergence of bank-based systems could be more plausibly explained if Hilferding's emphasis on fixed investment requirements was combined with the factor that Steuart stressed but Hilferding left out of account, namely state intervention.

If a less developed country adopted a state policy of 'catching up', institutional changes would be inevitably imposed upon the spontaneously emerging form of the capitalist financial system. 'Catching up' is likely to require large-scale fixed investment in key sectors of the economy, for which sufficient finance has to be actively mobilised by policy-makers. Banks are more appropriate policy vehicles for this purpose than stock markets. Due to their discounting operations, for instance, banks have immediate access to idle money that is constantly created amongst enterprises. Discounting operations also

afford them knowledge of the prospects and performance of enterprises and entire industrial sectors. In contrast, stock markets rely on attracting idle money generated across society. Such savings are unlikely to be readily available at low levels of development, leading to thin and unreliable supplies of funds to the stock market. Moreover, information about enterprises and sectors of industry would not be immediately available to holders of funds prepared to invest in the stock market. The required flows of information and sufficient confidence in the stock market could only be ensured after creation of appropriate institutions to buttress it, but this is a complex and highly uncertain process.

Thus, in the historical context of late development and under competitive pressure to 'catch up' bank-based systems better serve the needs for large-scale fixed capital finance. However, bank behaviour is spontaneously market-based and banks have to be made to operate in ways appropriate for bank-based systems. In other words, if banks are to be mobilised for development, their operations must acquire Steuart-like aspects, which is unlikely to happen without strong government intervention. Specifically, the liability side of bank balance sheets has to become solid enough to sustain long-term lending. It is necessary for banks that lend long term to have access to long-term liabilities (own capital and borrowed funds) on terms compatible with their existence as independent profit-making concerns. Consequently, institutional change has to be implemented by the state, enabling banks to issue long-term liabilities (bonds or equity) on preferential terms compared to other enterprises. Similarly, only if their solvency were secured, through explicit or implicit state guarantees, would banks be able to lend freely

for long-term investment. Finally, if banks undertook long-term lending, close relations would inevitably arise between banks and enterprises, exhibiting 'commitment' and exercising 'monitoring' on the part of banks. But such close relations would rest on state policy that sustained bank operations and actively determined the bank-based character of the system as a whole.

In this light, Hilferding rightly stresses the advantages of bank-based finance in meeting large fixed capital requirements. However, he is on very shaky ground when he claims that bank-based systems are an inevitable outcome of capitalist development. Instead, bank-based finance should be treated as a historically specific transformation of the capitalist financial system imposed from above to suit the needs of late developers. Countries that are attempting to finance large fixed capital requirements in order to 'catch up' create bank-based systems through state policy. Capitalist finance is peculiarly susceptible to state manipulation, despite the fact that it has a spontaneously arising market-based form. The fluidity and flexibility of loanable money capital allow policy-makers to alter the operations of financial institutions in line with conscious policy. Far from being an inevitable outcome of capitalist development, bank-based finance represents an institutional transformation adopted in order to foster capitalist development. By this token, withdrawal of state support would tend to undermine its bank-based character.

5.Conclusion

Bank-based finance has roots in Steuart's mercantilist argument that credit could play a catalysing role in fostering capitalist development. Banks that provide long-term investment funds to enterprises must have appropriately structured liabilities, especially adequate capital to guarantee their solvency. Market-based finance, on the other hand, is consistent with Smith's argument that banks should only provide short-term loans related to commercial transactions. For Smith, independently operating commercial banks are not in a position to provide financial services requisite for long-term investment. Moreover, these banks focus on liquidity and reserves, unlike banks in bank-based systems that require substantial amounts of capital to guarantee their solvency.

Hilferding's distinctive Marxist position on market-based versus bank-based finance has affinities with both Steuart and Smith. For Hilferding, commercial banks emerge spontaneously and operate along market-based lines (Smith-like). However, the capitalist financial system inexorably acquires a bank-based character as enterprise requirements for fixed capital investment grow. Thus, banks supply long-term finance to enterprises, operating along Steuart-like lines and creating very close 'commitment' relations with enterprises. This is the foundation of Hilferding's 'finance capital', a union of banks and industry with banks in the ascendant, which is supposed to characterise advanced capitalism.

Despite the insights offered by Hilferding's analysis of the financing requirements of industrial enterprises, his claim regarding the historical evolution of financial systems in a bank-based direction has not stood the test of time well. An alternative suggestion for

the emergence of bank-based systems was put forth, drawing upon Hilferding but also utilising insights from Japanese Marxist political economy of finance. Specifically, the spontaneous form of the capitalist financial system is market-based, comprising a pyramid-like credit system and a stock market, but without a tendency to become bank-based. Rather, bank-based systems represent institutional transformations imposed from above in order to effect 'catching up.' State intervention is required to allow banks to lend for long-term investment, while meeting their own capital requirements and sustaining their solvency.

NOTES

[1] The revival of interest in financial system design in the literature on finance and development owes much to Gerschenkron (1962), who was well versed in Marxist political economy.
[2] Interest in Steuart has mushroomed in recent years, for instance, Doujon (1994), Yang (1994), Brewer (1997), and Dome (2001). However, Steuart's views on money and banking, though arguably his most important contribution to political economy, have attracted comparatively little attention. This relative neglect is particularly surprising for a reason that is not directly relevant here but is still worth mentioning. Since the early 1980s, the Law of the Reflux has been extensively re-examined, and the writings of Smith and the Banking School have been frequently trawled in order to establish origins and nuances of the concept of Reflux. Much of this literature belongs to the Free Banking current and several references can be found in Horwitz (1994), mentioned in a different context below. Yet, despite intense interest, it is not generally appreciated that Steuart was the first to note that credit money is subject to Reflux. Indeed, his claim that superfluous credit money 'regorges' back to its issuer can be considered as the earliest formulation of the Law of the Reflux (Itoh and Lapavitsas 1999, ch. 1).
[3] Steuart (ibid.) appreciated that such institutional changes would contribute to dispossession of the landed aristocracy. They were the main social class that was short of money but in possession of fixed assets (land) most likely to be sold or used as collateral. The old Jacobite did not flinch from the implied social transformation.
[4] Murphy (1997) has provided an incomparably detailed history of Law's intellectual trajectory and the development of his 'System.'
[5] Indeed, as Murphy (1997, 60-2, 113-5) points out, Law probably considered the equity of banks as a new kind of money comparable to their banknotes. That indicates a profound misunderstanding of the role of own capital in banking.
[6] Redlich (1951) has emphasized the importance of this idea for the early development of US banking.
[7] Nevertheless, both belong to the broad anti-quantity-theory tradition, as far as the quantity of bank-money and its effect on prices are concerned (Itoh and Lapavitsas, 1999, ch. 1). Mints (1945, ch. III) notes the affinity between Steuart and Smith on the subject of banks and the quantity of money, but finds that Smith downplayed the need of banks to hold reserves. That is not correct, as is shown below. Mints' opinion is probably due to his analytical reliance on fractional reserve banking.
[8] Smith's work on banking has been the object of consistent attention, for instance, Checkland (1975), Laidler (1981), Santiago-Valliente (1988), and Gerighty (1994). Interest has typically focused on the monetary aspects of his analysis, particularly the significance of 'real bills' for determining the quantity of credit money in circulation. In this essay, Smith's work is considered purely in terms of banking theory, i.e. as analysis of the banking firm.
[9] The literature on 'real bills' is very large and not directly relevant here. For a discussion of 'real bills' and the Law of the Reflux from a Marxist perspective see Lapavitsas (1994).
[10] Marx (1969, pp. 97-103) remarked on the confusion in Smith's discussion of gross and net revenue. There is no doubt, however, that Smith clearly distinguished between money revenue and money capital, while Steuart certainly confused them.
[11] Hilferding does not offer a full discussion of this difficult issue. For an analysis that draws upon the mechanisms of mobilisation of loanable money capital as the total social capital goes through its cyclical motion see Itoh and Lapavitsas (1999, ch. 6).
[12] Horwitz (1994) has rightly identified analytical similarities between Hilferding and the contemporary Free Banking current. However, it should be noted that, for Marxist political economy, central banks are a necessary outgrowth of capitalist finance and not an 'unnatural' imposition upon it (Lapavitsas 1997). Moreover, Horwitz's (ibid. 227-8) claim that, for Hilferding, banks are 'pure financial intermediaries' is incorrect. As is shown in the text, Hilferding's banks are initially providers of 'circulation' credit and the function of financial intermediation accrues to them subsequently.
[13] This is not an argument about the historical appearance of banks, an ancient phenomenon related to the lending of money (Marx, 1894, ch. 20.) Rather, it refers to establishment of the banking business within a capitalist economy structured around the generation of money profit by industrial capitals. There are similarities here with what Schumpeter (1954, p. 729-730) calls the 'Commercial-Bill Theory of Banking',

which he partly associates with the Banking School. Schumpeter is rather too easily dismissive of this approach to banking, his views probably marred by his notorious lack of regard for Smith.

REFERENCES

Brewer A. (1997). 'An eighteenth century view of economic development: Hume and Steuart', European Journal of the History of Economic Thought, 4:1, 1-22.

Cameron R. (ed). (1967). Banking in the early stages of industrialisation: a study in comparative economic history, New York: Oxford University Press.

Cameron R. and Bovykin V.I. (eds). (1991). International Banking, New York: Oxford University Press.

Checkland S.G. (1975). 'Adam Smith and the Bankers', in Essays on Adam Smith, Skinner A. and Wilson T. (eds), Oxford: Clarendon.

Corbett J. and Jenkinson T. (1997). 'How is investment financed? A study of Germany, Japan, the United Kingdom and the United States', Papers in Money, Macroeconomics and Finance, The Manchester School Supplement, LXV, 69-93.

Demirguc-Kunt A. and Maksimovic. (1996). 'Stock market development and financing choices of firms', The World Bank Economic Review, 10(2), 341-370.

Demirguc-Kunt A. and Levine R. (1999). 'Bank based and market based financial systems: Cross country comparisons', World Bank Policy Research Working Paper no. 2143, Washington D.C.

Dome T. (2001). 'Sir James Steuart and a General Sales Tax', History of Political Economy, 33:2, 345-367.

Doujon, R. (1994). 'Steuart's position on economic progress', European Journal of the History of Economic Thought, 1, 495-518.

Gerschenrkron A. (1962). Economic Backwardness in Historical Perspective, Cambridge, MA: Harvard University Press.

Glen J. and Pinto B. (1994). 'Debt or Equity? How Firms in Developing Countries Choose', IFC Discussion Paper 22, Washington D.C.

Heckscher E. (1935). (1994). Mercantilism, London/New York: Routledge.

Hilferding, R. (1910). (1981). Finance Capital, London: Routledge & Kegan Paul.

Horwitz S. (1994). 'Complementary Non-Quantity Theory Approaches to Money: Hilferding's *Finance Capital* and Free-Banking Theory', History of Political Economy, 26:2, 221-238.

Gerighty J. (1994). 'The Evolution of Adam Smith's Theory of Banking', History of Political Economy, 26:3, 423-441.

Itoh M. and Lapavitsas C. (1999). Political Economy of Money and Finance, London: Macmillan.

Laidler D. (1981). 'Adam Smith as a Monetary Economist', Canadian Journal of Economics, 14(2), 185-200.

Lapavitsas C. (1994). 'The Banking School and the Monetary Thought of Karl Marx', Cambridge Journal of Economics, 18:5, 447-461.

- (1997). 'The Political Economy of Central Banks: Agents of Stability or Source of Instability?', International Papers in Political Economy, 4:3, 1-52, reprinted in Money, Finance and Capitalist Development, Arestis P. and Sawyer M. (eds), 2001, Edward Elgar: London.

- (2000). 'On Marx's Analysis of Money Hoarding in the Turnover of Capital', Review of Political Economy, 12:2, 219-235.

Law J. (1705). (1720). Money and Trade Consider'd, London: W. Lewis.

Levine R. and Zervos S. (1998). 'Stock markets, banks, and economic development', American Economic Review, 88, 537-588.

Marx K. (1894). (1981). Capital, vol. III, London: Penguin/NLR.

- (1969). Theories of Surplus Value, Part I, Moscow: Progress Publishers.

Mayer C. (1987). 'The assessment: financial systems and corporate investment', Oxford Review of Economic Policy, 3(4), i-xvi.

Murphy A. (1997). John Law, Oxford: Clarendon Press.

Redlich F. (1951). (1968). The Molding of American Banking, New York and London: Johnson Reprint Corporation.

Santiago-Valliente W. (1988). 'Historical Background of the Classical Monetary Theory and the 'Real Bills' Banking Tradition', History of Political Economy, 20:1, 43-63.

Schumpeter J.A. (1954). History of Economic Analysis, London: Routledge.

Singh A. (1995). Corporate Financial Patterns in Industrializing Countries: A Comparative International Studies', IFC Technical Paper 2, Washington D.C.

Singh A. and Hamid J. (1992). 'Corporate Financial Structures in Developing Countries', IFC Technical Paper 1, Washington D.C.

Smith A. (1776). (1950). The Wealth of Nations, 6th ed., London: Methuen.

Steuart J. (1767) Principles of Political Economy in Collected Works of James Steuart, (1995), London: Routledge/Thoemmes.

Stiglitz J. (1985). 'Credit markets and the control of capital', Journal of Money, Credit and Banking, 17(2), 133-152.

- (1994). 'The role of the state in financial markets', Proceedings of the World Bank Annual Conference on Development Economics 1993, 19-52.

Wade R. and Veneroso F. (1998). 'The Asian crisis: the high debt model versus the Wall-Street-Treasury-IMF complex', New Left Review 228, March/April.

Yang, H.S. (1994). The Political Economy of Trade and Growth: An Analytical Interpretation of Sir James Steuart's Inquiry. Aldershot, UK: Edward Elgar.