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12 ROZMÓW NA TRUDNE CZASY

What is the banking system and how has it evolved?

Discussion between Prof. Paweł Grata and Prof. Cecylia Leszczyńska University of Warsaw

Paweł Grata: Welcome to the next podcast in the series 'What does economic history teach us? 12 conversations for tough times". The series is part of a project under the same title, funded by the Ministry of Science and Higher Education under The Social Responsibility of Science programme. Our guest today is Professor Cecylia Leszczyńska, an economist from the University of Warsaw, a specialist in banking, finance and monetary policy. The topic of our meeting will be the banking system and its evolutionary path. So what is the banking system? We must start by defining the basic concept.

Cecylia Leszczyńska: We have two parts to this phrase - 'system' and 'banking'. Banking, of course, we presume, means banks, although in this system, I will come to the word 'system', there are also other, so-called financial intermediaries, although their role is usually much weaker in banking systems than in banks themselves. The word system presupposes that we are dealing with some sort of orderly structure, so we have a fiscal system, a political system, a treasury system, and so on. This word system assumes that the structure in which these entities function, between which there are some relations, all this is somehow regulated, ordered. In a word, we have certain interactions and their ordering. This is usually done through regulation, regulators who create the legal framework within which this banking system operates. That is, we have banking law, of course, in the background civil law, which applies to all economic entities, or historically commercial law, company codes and so on. Thus, the banking system is a set of entities that function in the money market, where money is traded, let's say colloquially, and relations, rules of functioning, functions, activities. At the same time, the organisation of these entities is somehow ordered and this orderer is the state, is the regulator, who does it on the basis of laws. The basic law is usually the banking law and it defines the framework for the functioning of this system. This system has been called, since the second half of the 19th century, the two-tier system. The two-tier system assumes that there are two structures operating side by side and within this two-tier system we have, on the one hand, the central bank and, on the other hand, what is called commercial banking, i.e. various types of entities operating in the market. And here again, the relationship between the central bank and commercial banking is a product of history,

and along with the evolution of economic systems, certain changes are also taking place here.

We will, of course, come back to this, how it works today. The aim of our meetings is to show how the past determines current economic solutions and how it affects society today. The banking system is something very important and determines how we function in the market, in a market economy. So where did banks come from? What is the genesis of their creation and this evolution leading to the formation of this modern banking system in the 19th century?

When we say banks, we usually think of commercial banks. And at the moment when the Professor asks about the roots, I have to point out or make a certain distinction here, because these roots have a different nature, a different character in the case of the different components of this banking system, these commercial banks. In a certain simplification we can say that we have classical commercial banks, historically they were called merchant banks, we have cooperative banking, there were also separate municipal banks, separate mortgage banks, land credit societies, municipal credit societies. In a word, this system was quite diverse. With the passage of time, it has become a kind of homogenisation, perhaps not completely, but nevertheless today's cooperative banks remind us to some extent of such standard commercial banks. Historically, of course, they were different. And this process of change has led to, so to speak, a kind of homogenisation of these institutions in terms of their scope of activities. However, their organisational structure is still different to some extent. And to the question of what were the sources, where did banks come from, of course, here a distinction should be made with regard to these particular types of banks, because the sources of these banks were different. Standard commercial banking, that is the term I will use, interchangeably, as I said, it was called commercial banking. The adjective 'commercial' explains well the genesis of these banks. They arose, as it were, on the periphery of commercial operations. One could say that banks grew out of commercial intermediation. When, in commercial intermediation involving purchase and sale transactions, the money economy emerged, money appeared, specialised institutions began to emerge, specialised precisely in money transactions, although for a long time these commercial operations and money operations were concentrated in one institution. In a nutshell, one could say that banks emerged from the thicket of intermediaries of various kinds, at the moment when it became profitable to handle money exclusively. That is to say, the scale of economic operations had already expanded to such an extent that institutions acting exclusively as "traders", as intermediaries, as money handlers, could emerge from it. And therefore this is the genesis of merchant banks. It is obvious that they will emerge in centres of trade, whether

centres of local trade or international trade. It is no coincidence, by the way, that European banking is thought to have been born in Italian cities. Florence, Venice, Genoa and other cities, i.e. centres of international trade between Europe and Asia, are where the first banks were established. Anyway, we have a number of terms that functioned in old banking, such as 'giro', 'banco' (that's a bench) and so on, so the whole origin comes from that region. And later, in other parts of the world, where international and local trade was developing, banking was also emerging, so the Dutch cities, the cities of southern England. In modern times, when trade was concentrated in these centres, great merchants were active, instruments such as bills of exchange, money broking, handling transactions, also on an international scale, began to emerge there. For a very long time they were just called merchant banks, later adapting to the scale of operations and the type of economic operations they began to specialise. For example, clearing banks. They performed a number of functions, but among others, they cleared, intermediated commercial transactions between entities A, B, C, D, E. And so they were clearing more than just trade and they were doing it with more specialised instruments. So here we have this evolution, this type, that discount banks, for example in London, city banks, in Amsterdam and so on. Here there was some specificity, these institutions were not yet homogeneous. It was only later that they started to resemble each other. The genesis of cooperative banks was different. They were established in our part of Europe, and here our region, I would say, did some work in Central and Eastern Europe. They came into being as an expression of the need for local credit. We know here the history of Raiffeisen-type cooperative banking, or Schulze-type cooperative banking. They came to our part of Europe from German countries, and we can say that the roots of this were precisely in the needs of local communities that had no credit. They did not have sources of credit, sometimes they already had some surplus savings and these savings were kept at home. And co-operative banks enabled these two groups of actors to meet - those with surplus savings and those who needed the money. Only that it was on a local scale. The idea was that these entities should have simple procedures, uncomplicated, adapted to the needs of these local communities. This is how people's banks came into being in Wielkopolska. They are of this nature. Then in the Russian partition, in the Kingdom of Poland, co-operatives are established, sometimes called associations. They do not yet have regulated legal principles, they are based on statutes created by the founders, and only in time will regulations for their functioning emerge. In Galicia it would be the Kasy Stefczyka and so on. So we have a slightly different source. It can be said, as an aside, that somewhere out there, far away, one can look for some analogies in the so-called *montes pietatis*, mountains of charity, or so-called pious banks functioning like pawnshops. I don't know if such pawnshops still function today, where you go to get money by pawning some durable goods. And these were set up in the late Middle Ages

precisely to enable people, usually poor people with no monetary resources, to borrow money by pawning it. Here I would add another interesting thing, namely that the functioning of banking has always involved a certain problem under the title of interest rates. The issue of usury, the prohibition of interest rates in the Middle Ages and earlier times. For those who are interested, I refer you to the writings of Jacques Le Goff, who brilliantly described, using the example of medieval France, how this problem of the prohibition of lending at any interest rate worked. Well, going further, when I mentioned that each of these types of banks had a slightly different genesis, and sometimes more different, we can recall the credit societies. Those of the nineteenth century, which, in turn, came into being as a response to the demand for credit of large landowners, indebted, with liabilities, well, with no money. And they came up with something excellent, which was actually only later abolished finally in 1948, as part of the banking reform of 1948. So a group, that's again, a society, that is some company, some association, of people who have land, who have large properties, but they also have the problem of obtaining money. Well, because it can only be obtained by selling goods, and they are in debt for "fairy tale sums" and they come up with the idea that they form an association. We form an association, we call it a credit society, we issue mortgage bonds. These are the bonds of today. The collateral for these mortgage bonds is our property, so the collateral is good. The only question is who will buy these mortgage bonds. This is where the state comes in, steps in, creates regulations, and assumes that, for example, the Bank of Poland should buy them. These letters can go on the open market, but first you always have to overcome this barrier of uncertainty, the risk of those who could potentially buy such mortgage bonds. And this succeeds. And it succeeds, these letters are interest-bearing, those who have savings can buy these letters, but mainly, however, they are bought by public institutions. For some, it is a form of storage, of investing savings, while others raise money in this way. What then, if the landowner in question defaults on his obligations? It comes to auctioning off the property. Because this association is, we have to say, full participation, and these people agree in this association that if these letters are not redeemed, just like bonds are redeemed in specific cycles according to the rules of issuance, there was a so-called drawing of these mortgage bonds, they were bought, and if someone does not participate in the creation of the fund from which these letters are redeemed, well, unfortunately, their property is subject to auction. This is how the funds for redemption are obtained. The state savings banks, for example, have yet another source of origin. These were established by the state in the 19th century in many countries. You could say, as a kind of filling such a gap, where people, people have some savings, they don't trust the banks, they don't trust the credit unions or, the cooperative banks, or they, these cooperative banks are somewhere in some distance. And here is the state stepping in and offering citizens safe saving, in a

state-owned fund. We have a Galician bank, it has temporary problems, the business is not going well there, but then when the state enters, well, so to speak, with its security, the certainty that the state is behind the institution, it allows people to invest savings in a safe way, to transfer savings to this bank. And interestingly, as we know, these credit unions do not have a branch structure. They therefore operate through post offices. That is why later on there will be the name Postal Savings Bank. What does this fund do with these savings of the population? It buys government bonds, thus financing the public debt, the term pupillary, i.e. safe, securities is created. There are as yet no rating institutions to indicate what is safe and what is not. Here, however, the state, through these very institutions, provides these guarantees of security. This is becoming a bit of a competitor for cooperative banks. There is one more thing I should add about cooperative banks, and that is that they are associations where local farmers, craftsmen, entrepreneurs, I would like to say the small and medium-sized enterprise sector, contribute shares, that is, they, through their shares, a kind of company, create such an institution, which means participation in shares, in the capital of this enterprise, which gives the right to later participate, to obtain cheap, simple loans.

Exactly, by the way, cheap, simple credit. Bank and credit are two concepts that are inextricably linked. Today, after all, the interest rate, the level of this interest rate, is a very important determinant of both consumption and investment opportunities. and investment opportunities. How expensive credit was in the 19th century, when these banking systems, these different types of banks were coming of age. How would that compare with today?

Yes, these interest rates were quite stable. Of course, they wobbled in periods of turbulence, such as financial crises, or political crises, wars, but here rather Europe in the 19th century after the Napoleonic wars was quite calm. Somewhere there was the Crimean War, somewhere there was the Spring of Nations, something was happening in France and so on. But nevertheless, internationally there were no major conflicts until the First World War. There were, of course, banking crises and these made the uncertainty about stability, about deposit guarantees, difficult. As for interest rates themselves, I must return to usury for a moment. We must remember that all monotheistic religions in the Middle Ages and later, Islam to this day after all, applied restrictions on lending at interest. Originally, these restrictions were very radical, that is, any interest rate on loan interest was considered forbidden from the point of view of the religious canons. Of course, this inhibited credit, because the interest rate, we say is the remuneration for lending money, is a bit of a risk response. The higher the credit risk, the higher the interest rate. And the ban on charging interest at all was a killer for banking. Banks therefore learned to get around it. They used all sorts of workarounds that would nevertheless

justify the charging of the interest rate, here citing Saint Thomas Aquinas, who created so-called gateways to capitalism by interpreting the fair price etc. Then the states began to apply the principle of the maximum rate. That is to say, it is permissible to interest a loan, but up to a certain level, i.e. a maximum level. And these maximum levels were already applied in either municipal legislation, it depends on the political structure of the area, or in state law. And these interest rates, so-called maximum rates, were of the order of 6-7-8%. And they were stable for long, long years. In the 19th century, when the belief that the economy should be more market-based, unregulated, we have Adam Smith, we have the Physiocrats saying that this market should be free, some countries withdraw from interest rate regulation. And here we have a far-reaching variety, that is, where this market we have already said through financial institutions is filled, this supply of credit is relatively satisfactory, this credit is of the order of 5-6%. This is called the interest margin, that is, you pay 3-4% to the depositor, well we have a spread, the difference between the interest rate and the lending rate and this is usually 2-3 percentage points. So the interest rate on this loan is 6-7%, so it's a bit like that historically formed through state regulation. On the other hand, where these credit risks are either high, because the borrowers are unknown, or have not been in business, or have gone bankrupt frequently, well these interest rates reach 8-9%. And in some regions, as we often hear, especially somewhere in rural or small-town environments, where these institutions are few in number, where they serve farmers, where these farmers have quite unstable incomes, because they depend on the price of crops, on harvests, on various things, then usury reappears. And then, in part, the states step in again to regulate the level of interest, but no longer through separate legislation on the maximum rate, but through civil and criminal legislation. And then a justification is introduced, which worked a little in Poland in the 1990s, derived somewhat from the category of fair price. Because isn't it taking advantage of the borrower's difficult position in order to, precisely through a high interest rate on the loan, "make money" on this situation of an unequal, shall we say, relationship between the borrower and the lender. Let us add that in inter-war Poland, for example, in 1924, as part of Grabski's reforms, anti-lichvar legislation was introduced. And then at the beginning the maximum rate is 24%. This shows that the market rate was definitely higher, since 24% was in the legislation. On the other hand, the Minister of the Treasury had a separate right to determine the maximum rate for banks. At that time, the Bank of Poland, for example, applied a rate of 12%, a credit rate, other banks, it depends, twenty-something percent, but they could not go beyond twenty-four, so they were looking for some tools to possibly exceed that twenty-four. But they had to stick to that maximum, and then it was gradually lifted and lifted, and by the end of the twenties the credit in commercial banks is already on the order of nine, ten, eleven percent, and during the crisis of the thirties it goes down to the level of a few percent. But of course there is no single rate. You can

analyse some sort of average with these loans. Estimates showed that it was eight to nine per cent when you took into account all the banking institutions operating in the market.

Which shows that several hundred years of evolution did not necessarily have a great impact on interest rates, because today these rates are also at a fairly similar level. But if interest rates, then the central bank. What is the origin of the central bank and what was behind its creation?

The central bank is in general a late institution, yes, it is a late institution, and by the way, for a long time there was the term bank of issue, because the term "central bank" means that it occupies some central position in the financial system, in the banking system. On the other hand, there were no 'central' banks for whole centuries. The first, as we know, bank that is believed to have created such a model of central banking is the Bank of England, end of the 17th century, 1790s. The Bank of Sweden is established a little earlier, but it is short-lived. The origin of a central bank, or a bank of issue, is the need to create an institution to finance the public debt of the state. And we must remember that a central bank is an institution that markets paper money. Monetary money, whether gold or silver, is issued by the state. At different times, sometimes people themselves may carry this money to the mint, from some, I don't know, jewellery, or lumps of gold, or whatever they process into coin, and *vice versa*. Whereas the activity of the central bank, its fundamental, so to speak, essence, is that we say 'issuing institution'. So issuing what? Paper tickets. And let's note that on all the tickets we always have the name of its issuer, which is the Bank of England, or the Bank de France, or the American Fed, but the Fed is only 1913, and yet banking existed much, much earlier. And as I said this Bank of England is paving the way, showing how to do this issuing business. Because paper money, well, is what? What is paper? Well, it's a printed, you could say colloquially, piece of paper. Of course, later it will be backed up and so on, it will no longer be such standard paper. Paper money was born in China, but China never developed this kind of banking, it was developed by the British, and more specifically by the English. And the Bank of England is created as a partnership of a group of people who form a joint stock company called just the 'Bank of England' and agree with the state that we lend money to the state for public expenditure, for state activities, We often criticise the public debt in this colloquial way, but imagine that the state has expenditure and how do we finance it? Either from taxes, well, or, as in the Middle Ages, from the spoiling of money. So here the emergence of this paper money instrument is an excellent solution. That is to say, the Bank of England is created, a group of people set it up, they get the right from the state for 20 years to issue paper money, and let's remember that other banks also do this, but they don't have a contract with the state. They have the privilege of issuing for 20 years, they issue paper. It is an interest-bearing loan. Well, they earn money in this way, through

credit interest, and they lend to the state. And this is the original central bank-state relationship. At this point, by the way, these banks of issue, they are a bit of a competitor of commercial banks, normally operating, because you can imagine that those commercial banks, we know, after all, whether Spanish history, or Italian cities, or the Knights Templar, lent to kings, lent to the state for all sorts of purposes, but that was the era of money still fully monetary. So here we have the issue of paper money, and then the whole art and practice of banking and theory develops, which tell us what rules to adopt for the issue, so that it is not too large, but at the same time gives economic benefits. In the 18th century, the problem of relations between the central bank and commercial banks, as mentioned by the Professor, emerges. Let us remember that there are no central banks in continental Europe. There is John Law`s experiment in France, the 1920s, to create something similar to the Bank of England, it didn`t work out. There was too much "printing" in inverted commas of paper money, there was a situation where a different purchasing power was given to coins and a different purchasing power was given to this paper money by John Law. The whole party, sorry, fell down. The Bank of England worked out the rules.

Returning finally to the Bank of England and how central banks have shaped up, because we must be slowly moving towards the end of our conversation. How much has the role of the central bank grown today? How relevant is it compared to what it used to be? Why is the central bank, the monthly meetings of the Monetary Policy Council, so important to us?

Obviously. The central bank in the 19th century becomes the bank of banks. Here we must, but only lightly, mention financial crises. Who is supposed to, or should, help the commercial banks, and therefore lend to them in times of crises, when deposits are flowing away, when bank panics occur, and so on. And over time, the role of the central bank as a bank of banks, i.e. an institution that also lends to commercial banks under certain rules; again, built in England. And then those rules are somehow implemented there. And the problem is how to manage this issuance so that the different objectives are reconciled. Because if we assume that the goal of the central bank would be, as a joint stock company, because they are then still joint stock companies, profit, well, they should "flourish" in the issue of paper money, create loans, create loans for commercial banks, for the state and for economic entities as well. But of course, this excessive money emission will result in inflationary problems if the money supply grows too fast. Bullion money cannot be created quickly, because the supply of gold is limited in the short term, it cannot be increased. Paper, on the other hand, why not, it can go further. Well, that's when the appropriate bodies come into being in these companies, because they are joint stock companies. There are shareholders, these shareholders delegate the board of

banks, as in any joint-stock company, and here certain rules are adopted for managing the money supply. And in modern times, this management of the money supply, of the interest rate, historically this belonged to the bank, to some representation called the bank council. Today's banks are no longer joint stock companies, so this bank council is delegated by some representative body in the form of either parliament or the head of state, and this is how this bank council is set up. Nevertheless, its functions are historically continuous. In the 19th century and today, it sets basic interest rates. Whether it is the Lombard rate or the refinancing rate, and so on. These rates, which are a kind of benchmarks, parameters for commercial bank rates. Anyway, sometimes they go into the WIBOR algorithm, which is the rate at which commercial banks lend money, rates which are the basis of the central bank's lending activity. And the central bank has remained that bank of banks. Of course, there is a whole play here as to how it should fund these banks. In recent years, after the financial crisis of 2008-2009, and in the COVID era, a type of operation called quantitative easing has developed. What does this mean? The central bank lends to commercial banks, of course against the pledge of the assets that these commercial banks have. And it can adopt the principle that, okay, we give you these liquidity loans, against pledge, but for example, the best, only the best, safe; historically it was bills of exchange, then came bonds, never equities. Share prices are too volatile to be a secure security. In a word, this quantitative easing was developed after the 2008-2009 crisis and it is like a kind of new type of liquidity support for commercial banks. Open market operations developed here in the 20th century with this liquidity support. We will not elaborate on what they are, what types of these open market operations are. Here the security that operates between central banks and commercial banks is government bonds. So we have this central bank-commercial bank relationship; the bank of banks and how that is supposed to work. And the instruments - rates plus liquidity support operations. Still the central bank is the bank of the state. Well, and here again statutes, laws regulate. Before the war it was like that, in the 19th century it was like that, the legislature wrote it down in the statutes of the central banks, what they can, what they cannot. For example, in the interwar period the Bank of Poland could give the government interest-free credit up to 50 million zlotys. Later, it was 100 million, and then it changed once more at the end of the 1930s. What I am showing here is that this norm - the central bank as the bank of the state - can be regulated in different ways historically, and it depends a little on the context of the entire financial system and economy. That is to say, the bank of banks, the bank of the state, the bank of issue, the bank of clearing, and also today one of the important entities of the body, which are the so-called financial stability committees. Here, too, the role of the central bank is important, and decisions on these basic parameters - interest rates, but also the scope of various operations - are distributed between the board of directors and the councils of banks, but *the bulk of the*

competence belongs to these bodies, which are the councils of central banks. Almost all modern central banks have them and these councils also used to exist, although in the 1990s there was no Monetary Policy Council in Poland, for example. It only appeared as a result of a 1997 law, so in later years.

But that was an exceptional situation, but to sum up, we can say that the modern banking system and the role of the central bank as the foundation of this system is not only the result of centuries of development, but it is in fact a very stable system, a very stable structure, which we can say since the 19th century looks quite similar, and this is what economic history teaches us, that the banking system is something that came into being as a result of a long evolution, but something that has proven itself and continues to prove itself as this bloodstream of the economic system of a country.

One more thing to add, Professor, is that there is such a thing as a financial safety net. No other economic sector is so 'axed' with safety regulations as the banking system. We have banking supervision, which controls whether banks operate in accordance with the law, regulations, Basel committees, Basel standards, etc. We have a deposit guarantee fund. We didn't have one in the 19th century. When there were banking panics, the banks were really in massive, massive trouble. After the crisis of the 1930s, the United States was the first country to set up a mandatory deposit guarantee fund, not a voluntary one, which banks would create for themselves. And to this network today, the so-called safety net, the safety net, that is, the central bank as the bank of banks and a few other things, financial stability, banking supervision, in Poland today it is the Financial Supervision Authority, and guarantees of deposits. Again, this is also a product of history.

I agree. A very interesting topic, unfortunately we have to end. Thank you very much, our guest was Professor Cecylia Leszczyńska, with whom we talked about the banking system and its historical roots.

Thank you very much.