

Stern School of Business, New York University

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Prof.
KMC

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The Development of Financial Institutions and Markets

Course description: The credit crisis of 2007-08 came as no surprise to financial historians who have studied such events going back four or more centuries. This course studies the historical development of financial institutions and markets, in a comparative international context with emphasis on the USA. It covers monetary, banking, central banking, and securities market history, as well as pertinent aspects of the history of government finance and the emergence of corporations as a dominant business form. Topics include the emergence of modern financial systems in history, including the roles of public finance and money, banking and central banking, and securities and insurance markets. We study the composition, growth, fluctuations, and determinants of the money stock; the development of banking systems and their regulation; the emergence of central banking and its key role in modern financial systems; monetary policies; major trends and fluctuations in stock, bond, and money markets; and, of course, the history of financial crises.

Readings: For a course such as this there are no ideal texts, despite the richness of the literature in book and article form. As a compromise between ideal and real, I have chosen several books that are comprehensive in treatments of their subjects (and perhaps one or two are worth keeping on your shelf after the course is over).

The books we will use are:

(1) Jonathan B. Baskin and Paul J. Miranti, A History of Corporate Finance (Cambridge pbk, 1999). This book covers its subject from the Middle Ages and Renaissance to LBOs and 1990s corporate governance issues (with an appendix on ancient Greece and Rome for those with broad interests). It "confronts" some tenets modern finance theory (e.g., Modigliani-Miller on capital structure and dividend policy—'dividends don't matter') with evidence from history ('dividends matter').

(2) Edward Chancellor, Devil Take the Hindmost--A History of Financial Speculation (Farrar Straus Giroux, 1999; more recent pbk). A readable account of past financial excesses, from the tulip mania of the 1630s to LTCM of 1998. Interesting account of the Japanese bubble of the 1980s, "Kamikaze Capitalism." Fleshes out Kindleberger (see below), covering intensively what K does extensively.

(3) Charles P. Kindleberger and R. Aliber, Manias, Panics, and Crashes--A History of Financial

Crises, 5th ed (Wiley pbk, 2005). Lays out a model of how financial crises arise, and uses several centuries of history to elucidate and confirm typical patterns. Raises issues of how, if crises cannot be avoided, the damage can be contained.

(4) Robert L. Hetzel, The Monetary Policy of the Federal Reserve: A History (Chicago, 2008). A new history with emphasis on the period from the 1960s to the present, by a long-time economist at the Richmond Fed.

(5) Robert Bruner and Sean Carr, The Panic of 1907: Lessons Learned from the Market's Perfect Storm (Wiley, 2007). A detailed look at the financial panic that led U.S. policymakers to reinstitute a central bank, the Federal Reserve, after a hiatus of seven decades without one. It came out just as the latest perfect storm hit in the summer of 2007 and grew stronger in 2008.

Also recommended:

(6) S. Homer and R. Sylla, A History of Interest Rates, 4th ed revised (Wiley, 2005). This contains most of what a layperson, although perhaps not an MBA, might want to know about the subject

(7) Larry Neal, The Rise of Financial Capitalism--International Capital Markets in the Age of Reason (Cambridge pbk, 1993). Neal describes and documents activity in the world's first regular securities markets, Amsterdam and London, in the 18th C., including a century or so of end-of-month price data for leading issues and a study of the famous and influential South Sea Bubble. He tests history with modern finance analysis, and finds that it passes. Baskin and Miranti summarize parts of it.

(8) Niall Ferguson, The Cash Nexus: Money and Power in the Modern World, 1700-2000 (Basic Books, 2001). Emphasizes the politics and political economy of finance and financial systems in modern European and world history.

(9) Robert E. Wright, The Wealth of Nations Rediscovered: Integration and Expansion in American Financial Markets, 1780-1850 (Cambridge, 2002). A wealth of details on the precocious banking, securities-market, and corporate developments of the early USA, which the author argues were the real reasons for the long-term economic success of the country.

(10) Roger Lowenstein, Origins of the Crash: The Great Bubble and Its Undoing (Penguin pbk, 2005). A top financial journalist's account of the 1990s and the antecedents and aftermath; journalists often do the first drafts of history.

(11) Richard H. Timberlake, Monetary Policy in the United States--An Intellectual and Institutional History (Chicago pbk, 1993). This is a comprehensive if eclectic discussion of U.S. monetary, banking and central banking institutions and policies from the 1780s to the 1990s. Shows how US history impacted the financial system, and vice versa. Strong on legislative developments as shapers of the system. The author, a libertarian, would like to get rid of the

central bank. The issue is worth considering because the US did not have a central bank in the middle period of its history, although we'll see that there were substitutes of sorts for it.

(12) Robert J. Shiller, *Irrational Exuberance*, Second ed. (Princeton, 2005). The first edition called the end of the late 1990s stock bubble and appeared just as it was ending in 2000. The second edition updates the first and adds new material on the real estate bubble of recent years, calling it unsustainable, and predicting (correctly) its imminent end. Shiller's two excellent calls based on studies of financial history illustrate the value of the subject for MBAs and others.

(13) Milton Friedman and Anna J. Schwartz, *A Monetary History of the United States, 1867-1960* (Princeton pbk, 1963). A Nobel-Prize caliber classic.

Expectations: Plan on doing assigned readings and participating in class discussions; to help that along, there will be frequent one-page max. (typed) writing assignments that address questions about the readings. Your one-pagers will be read and returned to you, creating an accumulating record of the course as it develops. They won't be graded, but each one not completed reduces your grade by a mark (e.g., a B becomes a B-). One-pagers can be handed in at class, or emailed. To get the most out of the course, you should do these assignments in the week they are assigned.

As for graded stuff, there will be (1) a take-home midterm essay assigned the week of **March 10-12** and due no later than **March 27**. (2) A 'final' that has two parts: 1) a two-person team presentation (PowerPoint) to the class comparing two financial crises (to be assigned), and 2) an individual paper on the crisis you studied for the team presentation. The team presentations will be scheduled in April, and the final paper will be due no later than **May 7** (but you may want to get it in earlier). The 'final' may change some, depending on class size.

Course grades will be a weighted average of midterm (40%) and final (60%, 20% on the team presentation and 40% on the individual paper) grades, adjusted if necessary for weekly assignment deficiencies. Active participation in class discussions will break borderline grade averages in your favor.

Financial Development of the US Outline and Readings

I. Introduction to course; historical background. (1/27-29)

A. What is a modern financial system? What are its key institutional components? Its key functions? Why do they matter?

B. Medieval and early modern finance. Financial system innovators: The Dutch Republic and Great Britain, 16th-18th centuries.

Baskin, Intro. and Chs. 1,2
Chancellor, Preface and Ch. 1

II. The first modern financial systems and their famous first bubbles. (2/3-2/5)

A. Early capital markets and their famous bubbles through 1720.

B. Maturing and integration of 18th-century capital markets. British financial developments, and financial relationships with the America.

Baskin, Ch. 3
Chancellor, Chs.3-4

III. US financial history: public finance & debt, money, banking, central banking, securities markets and corporate finance.

(A, B, C roughly 2/10-19)

A. Creating the American financial system; Hamilton's strategic plan. The US as an "emerging market."

Sylla, "Hamilton and the Federalist Financial Revolution, 1789-1795." BB

Sylla, "Political Economy of Early US Financial Development." BB

B. Development and functions of banks and securities markets.

Sylla, "US Securities Markets and the Banking System, 1790-1840" BB

Sylla, Wilson, and Wright, "Integration of Trans-Atlantic Capital Markets, 1790-1845." BB

C. The monetary system: base money and bank money. Early US financial crises: 1792, 1819, 1837-1843.

Sylla, Wright, and Cowen, “Hamilton: Central Banker...” BB
Case: “The USA in the International Economy, 1820-1845: Growth, Financial Policy, and Crises.” BB, plus supplementary tables and charts.

(D, E, 2/24-26)

D. The maturing US financial system: Developments, reversals and transitions, 1830s-1870s.

Wallis, Sylla, and Grinath, “Sovereign Debt and Repudiation: The Emerging Market Debt Crisis in the US States, 1839-1843.” BB

E. Financial Modernization: International comparisons

Sylla, "Emerging Markets in History: the US, Japan, and Argentina" BB

(F, G, 3/3-3/5)

F. The Gilded Age: Railroad finance and capital formation.

Sylla, “Federal Policy, Banking Market Structure, and Capital Mobilization in the US, 1863-1913”

Baskin, Ch. 4

Chancellor, Ch. 6

G. Monetary History, 1860s to 1914: What base: paper, gold, silver? Deflation, resumption, and the ‘Cross of Gold’

Friedman and Schwartz, Chaps. 1-4 (recommended; discussed in class)

(H,I, 3/10-12)

H. The Panic of 1907. The National Monetary Commission. Restoring the central bank: The Fed arrives.

Bruner and Carr, Prologue and pp. 1-177.

Spring Break, week of March 17. Midterm essay due 3/27.

(I, J, 3/24-26)

I. The Fed's shaky start (1914-1920), high tide (1920s), and low tide (1930s Great Depression)

Hetzel, Chaps. 1-3.

Sylla, "The Great Crash of 1929 at Seventy-Five."

J. The rise of securities-market regulation

Baskin, Ch. 5

Chancellor, Ch. 7

(K,L, 3/31-4/2)

K. Bretton Woods system and the revival of monetary policy, 1940s-60s; the Great Inflation of the late 1960s and 1970s

Hetzel, Chaps. 4-12

L. Stagflation; 'center-firm' finance; international banking

Baskin, Ch. 6

Sylla, "United States Banks and Europe: Strategies and Attitudes"

(M,N, 4/7-9)

M. Financial innovation, 1970s-present.

Baskin, Ch. 7

Chancellor, Ch. 8

N. Monetary policy innovation and stabilization, 1979-present

Hetzel, Chaps. 13-26.

IV. Analyzing bubbles and financial crises.

(A, B, 4/14-16)

A. Money, credit, and the build-up to financial crises. The 1990s bubble

B. Manias, scandals and swindles

Kindleberger, Chs. 1-6

Team Presentations

(C,D, 4/21-23)

C. Financial crises: propagation, resolution, solution

D. Applications of the crisis model.

Kindleberger, Chs. 7-12
Chancellor, Chs. 5, 9, Epilog

Team Presentations

V. Asset price and yield history. (4/28-30)

A. Two centuries of US interest rates, bond yields and returns, and stock returns

Sylla, Wilson, Jones, "US Financial Markets and Long-term Growth" BB

B. Two centuries of US stock prices and returns

Sylla, "The New Media Boom in Historical Perspective," *Prometheus* 19, 1 (2001), 17-26. BB

Team Presentations

[Final papers due May 7]

Biographical Summary

RICHARD SYLLA

Richard Sylla is Henry Kaufman Professor of the History of Financial Institutions and Markets, and Professor of Economics at the Stern School of Business, New York University. He is also a Research Associate of the National Bureau of Economic Research.

Sylla received the B.A. (1962), the M.A. (1965), and the Ph.D. (1969), all from Harvard University.

He is the author of *The American Capital Market, 1846-1914* (1975); co-author of *The Evolution of the American Economy* (1993; 1st ed., 1980) and, with the late Sidney Homer, *A History of Interest Rates*, (4th ed., 2005); and co-editor of *Patterns of European Industrialization—The Nineteenth Century* (1991), and *The State, the Financial System, and Economic Modernization* (1999), as well as of journal articles, essays, and reviews in economics and economic history.

Sylla is a former editor of *The Journal of Economic History* and has served as a consultant on institutional history to such firms as Citibank and the old Chase Manhattan Bank. His current research focus is on the financial history of the United States in comparative contexts. He served as chairman of the board of trustees of the Cliometric Society, 1998-2000.

In 2000-2001, Sylla was president of the Economic History Association, the professional organization of economic historians in the United States. In 2002, he was elected trustee of the Museum of American Financial History, now the Museum of American Finance, a Smithsonian-affiliated museum in New York City that opened in grand new space at 48 Wall Street on January 11, 2008. In 2007, he was elected Vice Chairman of the museum's board of trustees. In 2005-06 Sylla served as president of the Business History Conference, an international association of business historians.