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Usury laws and private credit in Lima, Peru. Evidence from notarized records

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ABSTRACT

I examine the impact of usury laws on the Peruvian credit market between 1825 and 1852. Using a new data set of nearly 2,000 loans from archival sources, I show that the repeal of colonial anti-usury laws in early 1833 had an important effect on the allocation of credit in Lima. It increased interest rates and promoted access to credit. Furthermore, lenders made loans with greater maturities after the repeal of usury laws.

1. Introduction

Economists and historians have paid much attention to the relationship between institutions and credit markets. Interest restrictions, property rights and bank laws, among other institutions, may shape the development of financial markets.[1] Historically, usury laws have been one of the main institutions associated with the development of financial markets. For centuries, there have been restrictions on interest rates motivated by religious, political and economic factors. The Code of Hammurabi, the Old Testament and Roman law, for example, banned usury, and the Catholic Church restricted usury for more than a thousand years.[2]

Usury laws have received much attention in the literature. Some studies have focused on the political economy of usury laws and have showed that interest restrictions can be the outcome of public and private interests. Rubin (2009), for example, points out socially efficient reasons for the Church to impose interest restrictions, while Benmelech and Moskowitz (2010) show that political and economic factors can explain the imposition of usury laws in some U.S. states in the 19th century.[3] Other studies have focused on the effects of usury laws. In particular, Bodenhorn (2007) and Temin and Voth (2008a, 2008b) show that usury laws led to changes in the allocation of loans in the United States and England. Small risky borrowers, for example, were rationed due to interest restrictions.

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[1] North and Weingast (1996), for example, show that the Glorious Revolution led to a clear commitment to certain rules, promoting the development of public and private credit markets. La Porta et al. (1997) show that legal systems that protect creditor rights and enforce contracts encourage better functioning of debt and equity markets. Levine (1998) also shows that legal rights of creditors and the efficiency with which legal systems enforce those rights explain much of the cross-sectional variation in financial development. Rajan and Zingales (2003) argue that the strength of political forces in favor of financial development is a major variable in explaining differences in financial development. See also Haber (1991), Maurer (2002) and Rajan and Zingales (2004) for a discussion of political and legal factors and the development of financial markets.

[2] Bodenhorn (2007), p. 179, Reed and Bekar (2003), pp. 350–51.

[3] See also Reed and Bekar (2003) and Rubin (2010, 2011).

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In theory, usury laws may have a variety of effects depending on the strictness of the restrictions. If usury laws are not binding, then imposing usury laws will not have an impact on the allocation of credit.[4] If usury laws are binding, as the interest rate does not clear the market, lenders may adjust other terms of their loans to push the market to equilibrium. In particular, lenders may reduce the risk in the allocation of funds. For instance, as the distant future may be more uncertain than the near future, *ceteris paribus,* lenders may feel more uncertainty about being paid when loans are long-term than when they are short-term. Lenders may then restrict long-term loans and focus on making short-term loans when facing interest restrictions.[5] Lenders may also increase their collateral requirements in order to reduce the expected cost of default. In addition, lenders may prefer to allocate their loans to low-risk borrowers—such as large well-connected individuals—when the upper limits of interest are very low.[6]

Usury laws may then lead to changes in loan terms and to the rationing of small risky borrowers. After the repeal of usury laws, in the short run, some lenders can make extraordinary profits (i) by making loans to high-risk borrowers at high interest rates or (ii) by raising interest rates for longer term and less collateralized loans. The repeal of usury laws, however, does not necessarily lead to an immediate expansion in the supply. Some lenders may not be certain about the definite elimination of interest restrictions or may not even have the funds to expand their supply of credit. Over time, once it becomes clear that the elimination of interest controls is not temporary, lenders may opt for making more loans to high-risk borrowers. In addition, the opportunity of making extraordinary profits may attract new lenders.

Several studies have analyzed the impact of usury laws on credit markets in the United States and Europe. For Latin America, however, no study has focused on the effect of usury laws, in spite of the importance of usury restrictions in colonial times.[7] It is well known that the Catholic Church had significant power in colonial Spanish America, having a decisive influence on people´s everyday lives. The Church exerted influence in credit markets through the prohibition of usury. Interest controls were removed only after Latin Americans achieved independence in the 19th century and as the Church lost much political and economic influence.[8] In the case of Peru, as in the rest of the region, credit transactions in colonial times were subject to usury restrictions. In 1833, a decade after achieving independence, the Peruvian Congress repealed colonial usury laws. In the years that followed, interest restrictions were again imposed until a definite repeal in 1838. As with other Latin American economies, our knowledge of the impact of usury laws on credit markets in Peru is very limited.

This study relies on primary sources to analyze the impact of usury laws on the private credit market of Lima, Peru, in 1825–52.[9] I collected nearly 2,000 notarized loans from the National Archives of Peru at Lima. Notarized loan records contain useful information about the identities of borrowers and lenders, loan amounts, maturities, interest rates and the collateral. I also examined tax records to determine whether borrowers belonged to the elite. With this information, it is possible to determine the factors that influenced the credit market in the first half of the 19th century.[10]

This article shows that the repeal of usury laws had an important effect on the allocation of credit in Lima. Colonial usury laws were binding, so interest rates increased as colonial restrictions were eliminated in 1833. In particular, the average nominal interest rate increased from 4.5% in 1825–32 to 24.4% in 1834. Under usury restrictions, lenders did not take much risk because they could not charge high interest rates. In particular, small borrowers were rationed from the credit market: a large portion of loans went to the elite of real-estate owners and merchants. In addition, loans tended to be short-term, as lenders attempted to reduce uncertainty. When usury laws were repealed in the 1830s, the supply of credit expanded, especially for the non-elite, and maturities were longer. This study is then consistent with the view that usury laws lead to inefficiencies in the allocation of credit.[11]

This article constitutes a contribution to the literature on financial development. First, this article is one of the few historical studies that rely on micro data to analyze the impact of usury laws on the credit market. Among historical studies, only Bodenhorn

[4] Usury laws are not binding if market interest rates (interest rates in a market without restrictions) are below the usury limit.

[5] Temin and Voth (2008a), for example, show that the English Bank of Hoare granted loans with shorter maturities in the 18th century due to the imposition of stricter interest restrictions (p. 556), whereas Ostas (1976) shows that usury laws in the United States in 1965–70 led to a decline in loan maturities (p. 831).

[6] Bodenhorn (2007), for example, finds that high-risk borrowers from a 19th century New York bank were rationed when interest rates rose above the limit (p. 200); Benmelech and Moskowitz (2010) find that the relaxation of usury laws specially benefited small borrowers in the United States in the 19th century (p. 1050); and Villegas (1989) shows that usury ceilings in the United States in the early 1980s led to minimal critical credit rationing to the wealthy but severe credit rationing to the poor (p. 140).

[7] Several studies have focused on the impact of institutions on financial development in Latin America (see, for example, Haber, 1991; Maurer, 2002; Hanley, 2005; Zegarra, 2014a). However, none of them focuses on the impact of usury laws.

[8] Brazil eliminated interest restrictions in 1832 (Pimentel, 1975, p. 316). Colombia and Uruguay did the same in 1835 and 1838, respectively (Ortiz, 2016, p. 104; Caravia, 1867, p. 212). In Mexico, usury laws were repealed in 1861 (Levy, 2012, p. 39).

[9] The data set is available online (Zegarra, 2017b)

[10] Temin and Voth (2008a, 2008b) and Bodenhorn (2007) also look at archival sources to study the impact of usury laws on early credit markets. Other studies have also relied on notarial data for studying early credit markets although not the effect of usury laws. See, for example, Hoffman et al. (2000) for France. Notarial data from Lima has been previously used for the study of credit markets, but not for the study of usury laws. For Peru, Zegarra (2014b, 2016, 2017a) relies on notarized data to study gender discrimination in the allocation of loans, the impact of political instability on credit markets and the role of mortgage banks in the 19th century, and Suárez (2001) uses notarial information for the study of credit markets in the 17th century. For Latin America, Levy (2012) relies on notarial data to study credit markets in Yucatán, Mexico, in the 19th century.

[11] Some studies suggest that usury laws may produce efficient outcomes. In monopolistic credit markets, for example, market interest rates are higher than socially efficient rates. The literature also suggests that usury laws may be socially efficient when they serve as a means of social insurance (Glaeser and Scheinkman, 1998; Reed and Bekar, 2003, Rubin, 2009), or when they reduce investment in socially inefficient high-risk projects, encouraged by state subsidies (Posner, 1995). I argue that usury laws did not lead to efficient outcomes in Peru in the period under study. First, for 19th century Peru, the credit market was not a monopoly: for 1830, for example, I counted 141 different private lenders in Lima. Second, usury laws did not benefit small borrowers as to argue that usury laws served as means of social insurance: as this article shows, interest restrictions rationed small risky borrowers. Third, the argument that rationing borrowers was efficient in the presence of an income floor provided by the state that encouraged taking too much risk is not consistent with the reality as welfare programs were nonexistent in 19^{t+h} century Peru.

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