

# Free or central banking? Liquidity and financial deepening in Sweden, 1834–1913

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## Abstract

During Sweden's nineteenth-century modernization, Enskilda banks contributed to economic expansion and integration by providing generally accepted means of payment beyond what would have been possible for the central bank, the Riksbank. The Riksbank was constrained by specie-convertibility requirements for Sweden's currency. Contrary to previous arguments, however, the Enskilda banks did not operate according to free banking theory. The Enskilda banks held Riksbank notes instead of specie as base-money reserves. This arrangement led to a higher supply of formal liquidity than what would have been the case with either a free banking system or a pure deposit-based commercial banking system. The consequence for Sweden was a rapid rate of monetization and financial deepening.

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## 1. Introduction

In 1834, Sweden re-established the silver standard it had abandoned in 1809. This action marked the beginning of a fixed exchange rate regime that lasted for more than

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eighty years, until the outbreak of World War I. During this entire period, the maintenance of the specie standard was the principal duty of the central bank, the Riksbank. Sweden's specie standard was important for growth and guaranteed international integration, but it impeded the provision of credit and acceptable means of payment in large sections of the country.<sup>1</sup> The nineteenth century witnessed great changes in the Swedish economy. Local, national and international markets became integrated during this epoch. These changes affected not only the money market, but also the very nature of the money in circulation.<sup>2</sup>

The initial extent of Swedish poverty during this period is well illustrated by the very limited and stagnant circulation of metallic coins, as well as a supply of specie metal insufficient to provide the country with an adequate supply of generally accepted means of payments. Instead, the Swedish economy relied heavily on personal credits, IOUs and other types of informal means of payments, accepted only on a personal or regional basis, thus hindering more widespread economic integration. In fact, financial development as such seems to have been as much in terms of quality of newer financial instruments as of their quantity. Sweden like many other economies in the nineteenth century had a large informal financial sector. The overall increase in size of financial services was not as impressive as it might seem once older, informal credit arrangements are taken into account.<sup>3</sup> During the era of rapid economic expansion Sweden was able to preserve a specie standard while simultaneously replacing the informal means of payments originally in circulation with means of payments accepted throughout the country.<sup>4</sup>

The dominant commercial banking system of the nineteenth century, the Enskilda banks, was based on unlimited liability and the right to issue notes. The right of the Enskilda banks to issue credit notes was established by Parliament in 1824. Because of the shortage of formal money (legal tender and specie), the right to issue notes was considered necessary for increasing the extent of banking.<sup>5</sup> Because of their note issue rights, the Enskilda banks made a major contribution in supplying Sweden with a means of payment that became accepted everywhere in the country. Notes issued by the Enskilda banks replaced the less formal means of payments that had circulated previously. The reason for the success of the Enskilda bank notes was that they were backed by reserves of Riksbank notes, by the banks' equity capital, and—because of unlimited liability—by the personal assets of bank owners.

<sup>1</sup> According to Eichengreen and Flandreau (1994), adherence of a country to a convertible specie standard has historically been of fundamental importance for economic growth. Despite being one of the poorest European countries operating under a convertible standard, Sweden in 1873 followed Germany in converting from silver to gold (Eichengreen and Flandreau, 1994).

<sup>2</sup> For a discussion of the effects of ongoing economic and financial integration on the role, as well as the form, of money, see Goodhart (2003).

<sup>3</sup> Lindgren (2002). Similar research has reached the same conclusions for Canada, France and the US, see Hoffman and Rosenthal (2000) and Di Matteo (1997).

<sup>4</sup> The pioneer in researching the importance of the financial system for growth in the Swedish economy was Lars G. Sandberg. Sandberg's work was criticized by Kindleberger who based on Sweden's most famous economic historian, Heckscher, argued that Sweden had no banking system worth mentioning before 1900 (see Kindleberger (1982) and Sandberg (1978, 1979, 1982)).

<sup>5</sup> KFO (1824), RdSkr, 1823, No. 346, see Ögren (2003a, Chapter 2) for an in-depth analysis of the political struggle in the establishment of the Enskilda bank system. The right of these banks to issue notes consequently was not the result of a coincidence or a misunderstanding when establishing the charter of the first bank, as previously has been argued (Brisman, 1924; Jonung, 1989; Nilsson, 1981).

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