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Enforcement of nineteenth century banking contracts using a marriage rule

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ABSTRACT

The enforcement of financial and banking contracts is commonly thought to lie within the domain of government law provision. This paper analyzes a case of self-enforcing financial contracts within a banking system in nineteenth century South India. The Chettiars, a merchant-banking caste, relied on religious homogeneity as well as an endogamous marriage rule, whereby members only married others from within the community, to enforce banking contracts within their system. Widely acknowledged to have been an important source of credit locally and throughout South East Asia, this paper describes and analyzes the enforcement mechanisms at work, in the absence of government involvement. Apart from presenting a new case of self-enforced financial contracts, this paper also represents a novel approach to interpreting the social institution of caste, as seen through the rational choice framework.

1. Introduction

The enforcement of banking and financial contracts is widely thought to lie within the domain of government law provision. The general argument underlying this view is that people are unable to overcome prisoners' dilemmas in the absence of an outside party to enforce contracts. This reduces the amount they repeatedly trade with one another, and thus not much contractual commerce could survive or flourish. Are there, however, circumstances when it may become possible for groups of people to enforce banking and financial contracts without third-party government enforcement? Historical experience provides some examples of such self-enforcing arrangements that call into question the scope of government enforcement of contracts.

This paper analyzes a new case of self-enforcing contracts within a network of bankers. The nineteenth century banking system of the Chettiars, an Indian banking caste, spread through many countries in South-East Asia and provided essential credit services to several new industries in those countries. Members of the caste formed separate banks that were closely connected in business to one another as important sources of each other's deposit liabilities and also via the discounting and re-discounting of one another's bills of exchange. This in turn created a need for the enforcement of business contracts between bankers, the mechanisms of which are discussed in this paper.

Conventional economic analyses of the caste system in India implicitly view it as a social institution that inhibits economic growth and progress. Does this view hold up in light of a rational choice model with a profit-seeking agent at its core? The case of the Chettiars suggests that it does not. In their case, it becomes clear that their caste ties and boundaries *created* the environment necessary for business to function. Thus, in their case, caste played a vital economic role, in the absence of government enforcement of their contracts. Existing economic analyses have been unable to uncover this function of caste because of their aggregative point of view. Thus this paper can also be seen as a step forward in applying the framework of rational choice to the complex social institution of caste while bringing it into contact with the wider literature applying rational choice to institutions.

In the absence of a third-party enforcer, it is various *other* mechanisms that must come into play to ultimately enforce contracts among people. Singling out the exact mechanisms at work allows one to postulate the possibility of such arrangements existing even outside of the specific case in hand. For the Chettiars, it was religious homogeneity within the caste and an endogamous marriage rule that allowed marriage only among caste members while restricting marriage to outsiders that enforced contracts. Apart from calling into question the scope of government

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enforcement of financial contracts, it also illustrates the possibility of similar arrangements existing within other castes in India, all of whom practice endogamy and are also usually religiously homogenous.

For the Chettiars, common religious practices allowed them to enforce financial contracts through the use of institutions such as temples and adjudication panels comprised of respected business elders. On the other hand, caste adjudicators used the marriage rule by threatening to restrict marriage between a guilty recalcitrant offender and other members of the caste. This in turn created a self-enforcing mechanism whereby judgments made by the adjudication panels were very likely to be accepted by disputing parties. This was because a member risked losing not only his social reputation, since no other member of the caste would be allowed to marry him, but, as a secondary effect, his business reputation as well. This enforcement mechanism was used successfully by the Chettiars in their banking system for several decades up until the early twentieth century when increasing government intervention and rising nationalist movements led to a complete restructuring and decline of their business.

The literature on self-enforcement encompasses a diverse set of economic arrangements across time and space such as the 11th century Maghribi traders (Greif, 1993) to the origins of the Law Merchant (Benson, 1990) to cyber space security (Benson, 2005). These cases, in turn, exhibit varying mechanisms that ultimately enforce the economic arrangements among individuals (Powell & Stringham, 2009). Although such case studies seriously challenge conventional ideas about governance and governmental involvement in the market, case studies involving self-enforcement in financial and banking markets are rare (Stringham, 2002, 2003). The first subsection places the Chettiar banking case and the enforcement mechanisms therein within the relevant self-enforcement literature. In particular, their use of marriage ties is shown to be unique within the existing literature while religious homogeneity is shown to be a common mechanism used in the several other instances as well. The second subsection takes up the issue of caste as a social institution and its current theoretical treatment in the economics literature. Here, the analysis of the paper is shown to break from existing economic analyses of caste.

1.1. Enforcing contracts

Cases documenting the self-enforcement of financial and banking contracts are rare. Stringham (2002, 2003) provide evidence of self-enforcing financial contracts in the early history of the London and Amsterdam stock exchanges. Socially diverse traders in the world's first stock market in Amsterdam used reputation as a mechanism to enforce sophisticated financial contracts like options, forward contracts and short sales, in the absence of formal government enforcement (Stringham, 2003). A similar mechanism was at work in the London Stock Exchange through the eighteenth century whereby brokers formed a private club that penalized defaulters and shared information with member brokers. These cases show that even sophisticated financial contracts can come into being and flourish in an environment with little to no government enforcement.

Though not involved in a stock exchange, the Chettiars were bankers; each member bank accepted deposits and made loans. Other than that, they also issued bills of exchange that facilitated the movement of money across South-East Asia. Their banking system represented a complex network of several large and small size member banks dependent on one another for deposits as well as discounting one another's bills. Unlike the enforcement mechanisms at work in the case of the socially diverse participants of the London and Amsterdam stock exchanges, the Chettiars leveraged their social and religious homogeneity to adjudicate as well as enforce business contracts.

The use of religious or ethnic homogeneity to enforce contracts is also found in the work of Landa (1981, 1994), Bernstein (1992) and Greif (1989, 1993). Landa (1981, 1994) documents how Chinese middlemen groups used their ethnic homogeneity and resulting trust as a substitute for contract law in their dealings between socially diverse buyers and sellers. Bernstein (1992) presents the case of orthodox Jews comprising most of the New York Diamond Dealers Club who use religious homogeneity to settle disputes and enforce contracts pertaining to the diamond business. Greif (1989, 1993) documents the 11th century Maghribi traders that formed a coalition and used a multilateral reputation mechanism to facilitate trade across a wide trading network in the Mediterranean. The common mechanism of enforcement in these cases is the leveraging of trust created out of repeated interactions within a socially homogenous group. The Chettiars, too, were able to reap the benefits of such repeated interactions and social homogeneity that manifested itself through institutions such as trust, shared customs and beliefs.

On the other hand, the Chettiars also reaped the benefits of allowing marriage only within caste-members. This marriage rule had evolved and existed many decades and possibly centuries prior to their banking system. Thus, marriage was used not only to further business bonds and networks between families; it also formed the core of how caste adjudicators enforced their decisions, essentially through restricting marriage with the non-abiding disputant and his family. An instance where the threat of restricting marriage enforces decisions made by judges has so far not been documented in this literature.

1.2. Recasting caste

Caste as a social institution has been an important area of study for sociologists and anthropologists alike (Berreman, 1960; Dumont, 1980; Thurston, 1909; Weber, 1958). Few economists, however, have scrutinized caste from an explicitly economic perspective. Akerlof (1976, 1980) and Scoville (1996, 2003) focus on caste as effectively creating barriers to competition in the labor market while trying to explain the persistence of caste in India. Implicit in their analysis is the view of caste as harmful to growth and development.

Akerlof (1976, 1980) is one of the few economists who has attempted to model the workings of a labor market in a caste economy, with specific reference to India. He shows how the sanctions imposed by a caste system would be effective in thwarting the normal functioning of a competitive labor market. Labor market participants in search of the highest remuneration would find the costs of defecting from their caste too high, or in his words, defectors do "not gain the profits of the successful arbitrageur but instead suffer the stigma of the outcaste" (Akerlof, 1976, p. 610).

Scoville (1996, 2003) provides a more realistic and dynamic model of the labor market in a caste economy, again in reference to the Indian caste system. He does this by incorporating certain realistic aspects of caste that Akerlof (1976) ignores, namely that caste occupations are hereditary, compulsory and endogamous. This leads him to conclude that it is these very features that lead to insurmountable transaction costs and have thus resulted in the persistence of the caste system in India. Put another way, these are the very reasons that the Coase theorem fails or why people do not cross caste boundaries to indulge in profit generating trades.

This paper proceeds by looking at the working of one particular caste that also embodies the characteristics Scoville (1996) identifies, but through the lens of rational choice. By interpreting caste members as rational self-interested agents engaged in