The emergence of the loanable funds (credit) market in Europe and its impacts on war and growth.

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The Netherlands is one of the richest and least unequal countries in the world. The Dutch born today can expect to live 82 years. But the Netherlands became a country (the Dutch Republic) almost accidentallyby accident, when its 17 separate regions were united by a single overlord, the Habsburg Charles V, in the 1550s (C't Hart et al, 1997). From 1400 to 1700, the Dutch growth of income per capita was the fastest in Europe, and from 1600 to the 1820s its level was the highest (OECD, 2018). At the turn of the seventeenth century, the Dutch Republic emerged as Europe's leading economy (Gelderblom and Jonker, 2004). The Netherlands was one of the first modern states, with relatively free markets for most goods, and institutions that moved away from absolutism, allowing for the expansion of commerce in all its forms. Of course, there is not a single explanation for the relative success of the Dutch Republic, with factors ranging from geography to the Protestant work ethic all contributing to some degree.

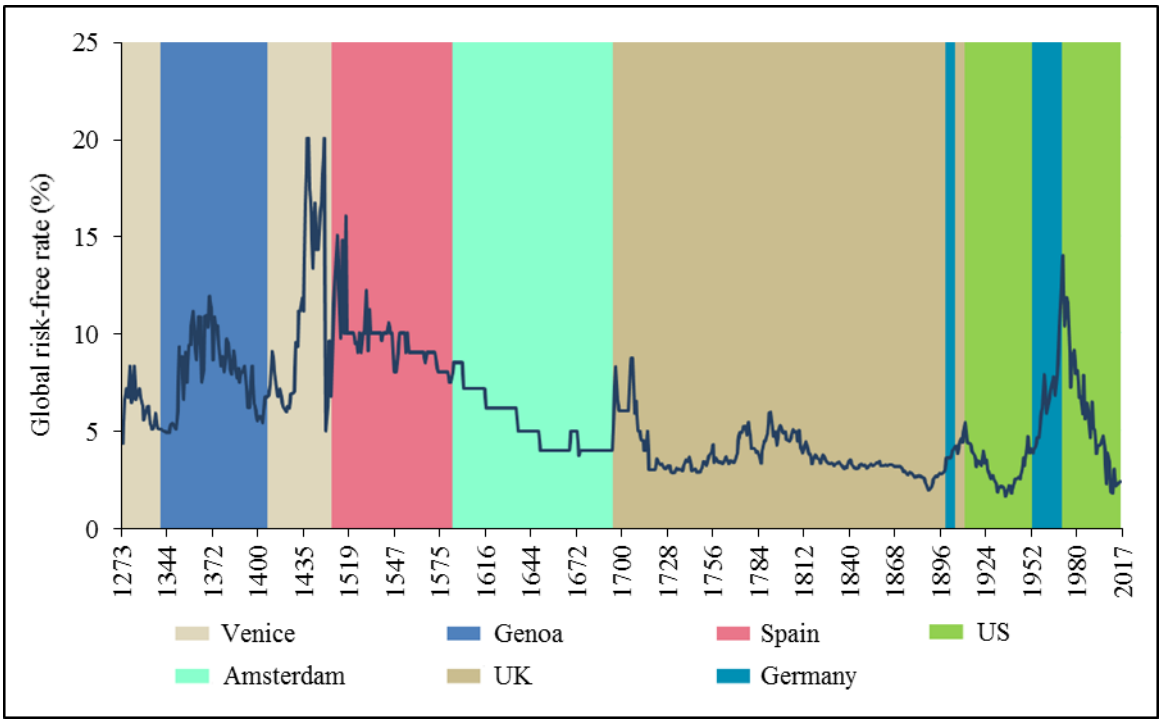
One important factor was the financial revolution that started in the 1570s. The development of financial markets complemented other institutional innovations. William Petty's pioneering work on Political Arithmetick, written in 1676 and published in 1690, showed the importance of institutions for long-term growth, using as an example the comparison between France and the Dutch Republic. From the OECD (2018): "The population of France was more than ten times that of the United Provinces, but the estimated the Dutch merchant fleet to be nine times as big as the French, its foreign trade four times as big, its interest rate about half the French level, its foreign assets large, those of France negligible. The Dutch economy was highly specialized, importing a large part of its food, hiring mercenaries to fight its wars, and concentrating its labor force in high productivity sectors."

The financial revolution consisted mostly of the development of the loanable funds market, both for private and public debt. Credit relies on trust and collateral, both of which were in short supply in the world at the time. In most absolutist states in Europe, the monarchs could not rely on public debt to finance the increased public spending. Some had tried, but a history of defaults eroded whatever little trust they had. For instance, Spain under Phillip II defaulted in 1557, 1559, 1574, and 1596 (Jeon, 2014.)

In the Dutch Republic, funding options for long-distance trade were not really different from those today: merchants use retained earnings; credit, for instance by drawing bills, bonds; or equity raised by seeking fresh partners or issuing shares. Long term capital for expeditions to Asia came from the precursor of stock markets (Gelderblom and Jonker, 2004). On the public front, the republic could finance spending through the issuance of long-term bonds.

The history of public debt in Europe starts with Venice and Genoa, the earliest issuers of marketable long-term sovereign debt in the early Renaissance (Schmelzing, 2017). Historians can trace public debt to a forced loan by Venice on its wealthy citizens in 1171 (Homer and Sylla, 1996). Schmelzing (2017) builds a graph in which the global (in fact, it should be named European for most of its period) nominal risk free rate is the interest rate paid by public debt of the region that is considered to be the "safest" in that particular year.

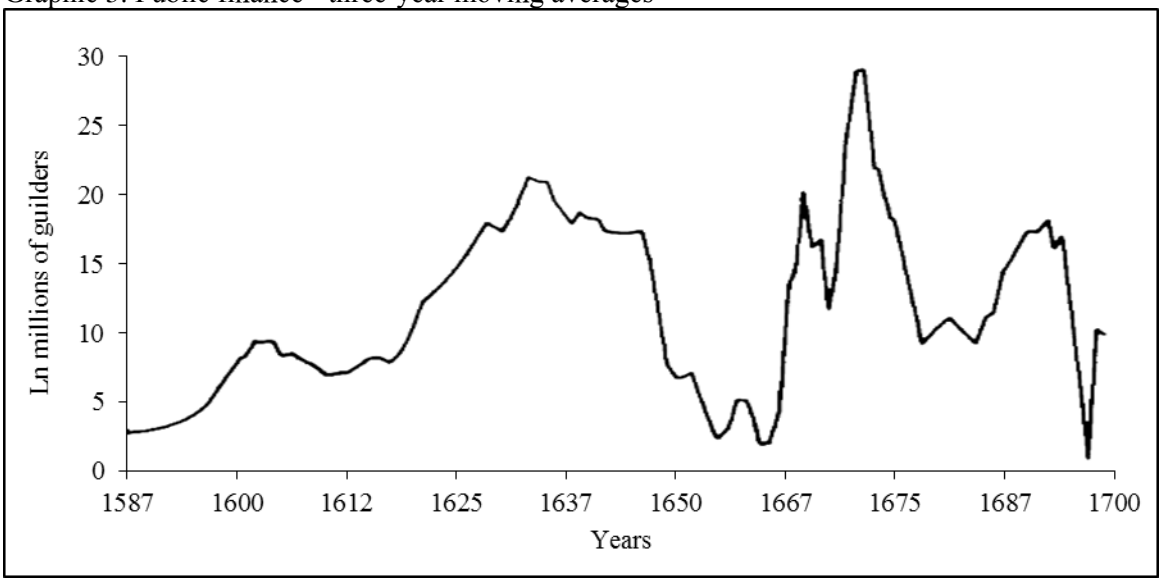
Graphic 2. Global nominal risk free rate and asset composition.



Source: Schmelzing (2017)

For the 17th-century, the most credible and important issuer was the Netherlands. We can also see that the risk-free interest falls sharply and its volatility is much lower than in previous centuries. The financial revolution helps explain the military superiority of the Netherlands throughout the 17th century. The country, without any major colonies and no steady supply of gold and silver, managed to sustain military campaigns against global powers such as Spain and France. Most of the Dutch Republic's spending had a cyclical component in which it rose during military campaigns and fell in times of peace.

Graphic 3. Public finance - three-year moving averages



Source: C't Hart et al (1997).

Around 1641, 90% of government spending was directly related to war (C't Hart et al, 1997). Of course, long-term public debt markets did not spring to life fully formed. At first, most loans were short term, with agents demanding repayment as quickly as possible. As the Republic developed, it started to issue long-term bonds. In 1596, total federal debt was 92,300 guilders, increasing to 14 million guilders in 1650 (C't Hart et al, 1997).

We know that there is a link between financial markets and economic development. The Dutch case illustrates this in a historical context. The financial revolution was one of the most important factors that made the Dutch Republic the major economic power in Europe in the 17th century. Today, many poor countries lack sophisticated credit markets. This is an obstacle to their economic development. History lessons are not easily learned, especially when the necessary condition for stable credit markets is the credibility of public authorities.

Questions for discussion:

1) Research one emerging country and try to find comparative data or analysis of the evolution of its loanable funds market. Is the country hindered by the current state of its credit markets? Does it suffer from perennially high or volatile interest rates or lack of access to credit by small and medium enterprises?

2) The hegemonic powers today are the US, China and, to a lesser extent, Japan and Germany. Do you think that the political clout of these countries can be traced back to the development of their credit markets?

3) Identify the relationship between the loanable funds market (chapter 6) and the Solow Model (chapter 3) by establishing which variables of long-term growth are related to the sophistication of credit markets.

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