History: Banks are at the heart of capitalism

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Two years after the credit crisis overwhelmed the markets and shook the world's confidence in the banking system, the debate over the social utility of financial institutions and their services still rages. Yet while the events of 2008-09 were in many ways unprecedented, today's bank critics and defenders have in some ways simply inherited the same arguments first posed centuries earlier.

Two hundred years before the invention of the credit default swap, when the city of Basel, Switzerland, was known more as the place to sign peace treaties than set capital requirements, the rhetoric over banks' contributions to society was no less passionate.

Thomas Jefferson, the founding father of the US and author of the Declaration of Independence once called lenders "more dangerous than standing armies" and opposed vehemently the creation of a US central bank. Not surprisingly his political rival, Alexander Hamilton, had a different view.

"Most commercial nations have found it necessary to institute banks and they have proved to be the happiest engines that ever were invented for advancing trade," Mr Hamilton, the first US Treasury secretary and founder of the Bank of New York, wrote in 1781. "Venice, Genoa, Hamburg, Holland and England are examples of their utility."

Hamilton was arguing for the creation of a national bank, but his words – as well as those of his rival, Jefferson – could easily apply to the role of commercial and investment banks in creating the modern business world.

In the 19th century, as agrarian economies gave way to the industrial revolution, corporations sprang to life with the help of banks. Companies and individuals no longer relied on barter to conduct business. Cash, so the cliché goes, became king.

"By 1900, there were dozens of industrial corporations," says John Steele Gordon, a business historian and author of *An Empire of Wealth: The Epic History of American Economic Power*. "It was a whole new world. These companies needed huge amounts of capital."

The bankers came of age, too. John Pierpont Morgan and Jacob Schiff, the dominant financiers of the era, provided the capital for Western Union, General Electric, Carnegie Steel and many other industrial heavyweights.

By the early 20th century, stock markets would emerge as significant sources of capital, giving rise to a new class of corporate owners.

"You had more stakeholders involved than ever before," says Charles Geisst, professor of finance at Manhattan College and the author of several books on Wall Street.

Family-run businesses went public and hired professional managers, Mr Geisst said.

When the markets grew overheated and panic ensued in 1907, it was the Morgans and the Schiffs – the US Congress had not yet created the Federal Reserve – who stepped in with capital to shore up the banking system.

The private banks filled that void, but the truth is they had to," Mr Geisst says. "There was not one else to do it."

While the formation of a US central bank would forever change the industry's response to crises, banks continued to play pivotal roles in developing the world's economies.

Depression-era regulations would separate Wall Street – the issuance and trading of securities – from commercial banking – taking deposits and making loans. Until those rules were rewritten decades later, financial institutions from each side of the divide would flourish on their own.

Walter Wriston, who ran Citibank from 1967 to 1984, would help bring automated teller machines to almost hundreds of thousands of street corners. Millions of consumers would come to own credit cards and certificates of deposits.

Epitomised by Lazard's Felix Rohatyn, investment bankers helped corporate chieftains expand dramatically through mergers and acquisitions, creating a new generation of conglomerates that would diversify into markets with little or no connection to their core businesses.

From seeding a burgeoning technology sector and creating a junk-bond market that would finance leveraged buyouts (and corporate raiders), to the development of the debt-securitisation markets that would create a massive mortgage bubble, banks have been at or near the epicentre of every economic boom or bust of the past century.

Occasionally, bankers did play a more direct role in society, as they did in the 1970s in helping the city of New York restructure its debt to avoid bankruptcy after the US president, Gerald Ford, famously declined to offer federal aid. The cause – one their critics would argue was not entirely selfless – would help burnish Wall Street's reputation in its hometown.

“There was great hostility toward New York,” says Mr Rohatyn, who led the effort as chairman of the Municipal Assistance Corporation. “Bailing out New York City became a symbol. If the city went bankrupt, that would show that liberalism was a sham.”

Bailing out the banks themselves, as the world’s governments did in the most recent crisis, was symbolic, too. Whether one believes they are deadlier than hostile forces or “happy engines” of economic growth, few now doubt the financial services industry’s importance to the economy.

“The banking industry is the circulatory system of the economy,” Mr Gordon says. “It’s analogous to the heart. Breaking your arm is unpleasant – it takes awhile to recover but eventually you’re as good as new. If your heart fails, you’re in trouble.”