

VVY ondergheschreven van weghen de Camere der Oost-Indische
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Actum den .8. Decembris anno .1606.

Jan van Goyenkamp
Maer f. Courte
1606

A Museum of Finance:

By Richard Sylla

Earliest share certificate, 1606.

The Power of Finance: Evident, But Underappreciated

IT IS SAID THAT imitation is the sincerest form of flattery. As the Museum of American Finance observes its 25th anniversary, those of us connected with it are pleased that its model is being emulated in other countries. China has several finance-related museums, all of recent vintage. Italy recently opened one. Plans for one in France are well along, and people in Poland and the UK are interested in forming one. The Museum of American Finance inspired some of these ventures. Others started independently and then were encouraged by discovery of the Museum's model.

What accounts for this burgeoning interest in the past and present—and of course, the future—of finance? The worldwide financial crises of 2007–2009 and their aftershocks have contributed. They showed many people unfamiliar with the long history of financial crises that when financial systems go off the rails, the economic consequences can be serious indeed.

and securities markets grew faster than those without them. Moreover, sophisticated statistical analyses indicated that financial development caused economic growth rather than the other way around. The related findings of economic historians are discussed below.

The other root of the growing interest in financial development is the realization that most people are not aware of the power of finance, either in history or now. In fact, although most people use some part of the financial system daily, many of them, sad to say, are unaware of all that it offers or have but a limited understanding of the various options.

Financial illiteracy is a real problem. If the power of finance is to be more fully realized, the solution to this problem is financial education. Museums of finance are logical places to illustrate and teach about financial history, and to stimulate people to become more aware of the power that finance can have in their own lives.

At the start of the 17th century, the Dutch Republic, to help win its independence from Spain, developed the first fully-articulated modern financial system. It featured a public debt market, a stable currency, the Bank of Amsterdam and other banks, the Amsterdam Bourse and corporations such as the Dutch East and West India Companies. These two companies, as it happened, were involved in founding New Amsterdam/New York. Powered by modern financial arrangements, the Dutch Republic could borrow more money at a lower cost than could far larger Spain to put armies in the field and fleets on the seas. They won their independence. With modern finance, the Dutch went on during the 17th century to have their Golden Age and what historian Simon Schama termed “the Embarrassment of Riches.” They became the first modern economy.

The English, in the Glorious Revolution of 1688, invited the Dutch leader Willem of Orange to become King William III of



Bond issued to, and signed by, President George Washington, 1792.

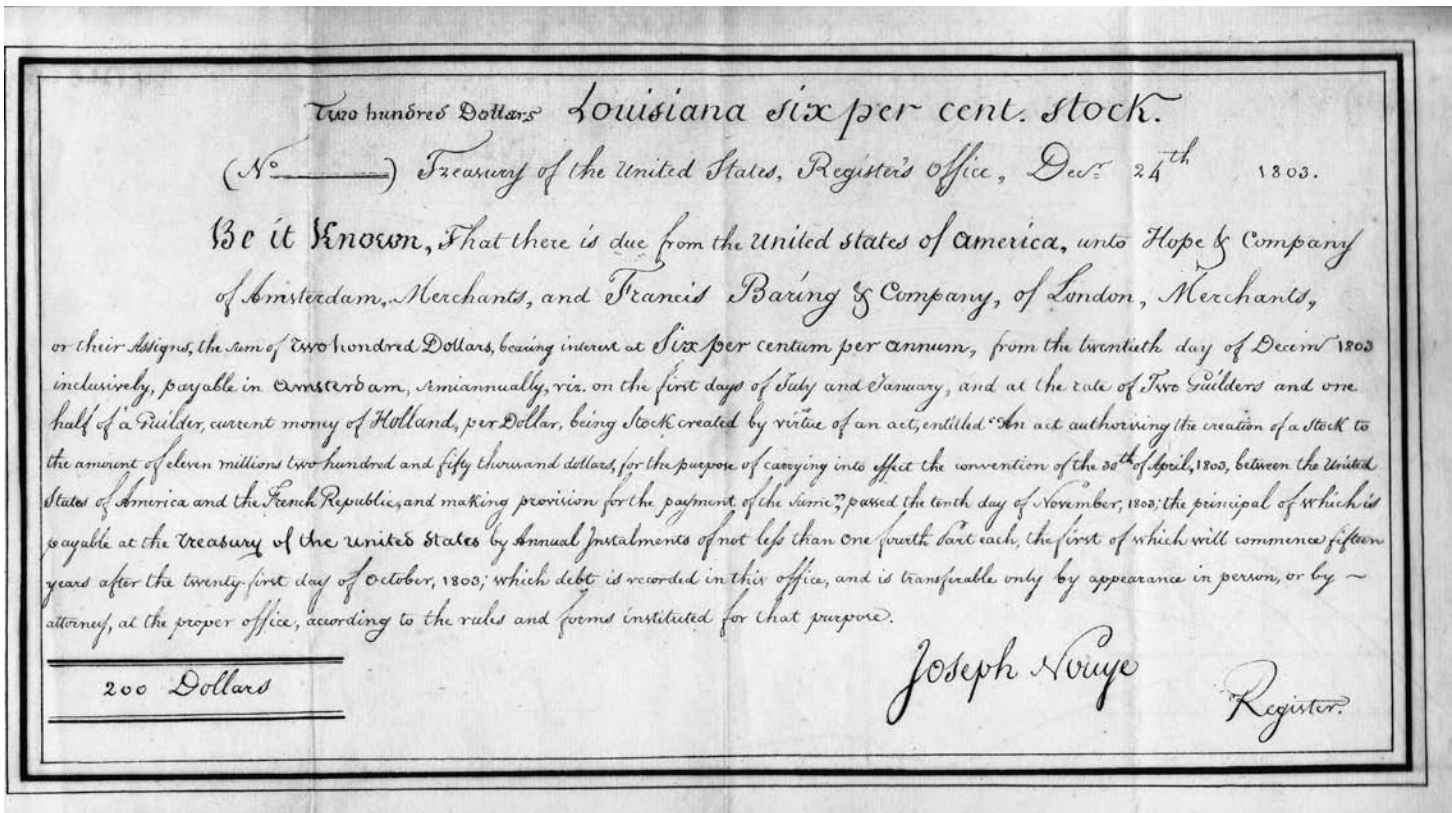
Why?

These recent developments, however, have only amplified an interest that was increasing before they occurred. Before the recent crises, the growing interest in finance and its history developed two deeper roots. One derived from the work of scholars—economists and economic historians—that demonstrated what for short can be termed “the power of finance.” Economists, using the wealth of data on financial development and economic growth for most of the world's nations during the past half century, showed that countries with more highly-developed banking systems

The Power of Finance in History

Financial historians, myself included, were not surprised by the findings of the economists on finance-led economic growth. History offers even stronger confirmation of it. The medieval Italian city states, for example, invented modern banking and public debt markets before the Renaissance... and then had the Renaissance. But one example cannot establish a cause-effect relationship. Fortunately there are more.

England. William brought Dutch financiers with him, and England shortly had a modern public debt market, a stable currency, the Bank of England (1694), a banking system, many companies and a stock market. In a reprise of the Dutch-Spanish story, there followed a string of English military victories over much larger France, as well as the first industrial revolution and a worldwide empire on which the sun never set.



6% Louisiana Purchase bond, 1803.

North America was a part of that empire, but 13 of its colonies opted out in 1776 to form the United States of America. Alexander Hamilton, one of the key founding fathers, absorbed the lessons of Italian, Dutch and English financial history, and quickly brought the power of finance to the US by emulating and improving on the earlier models.

When Hamilton became the first Secretary of the Treasury in 1789, the US had

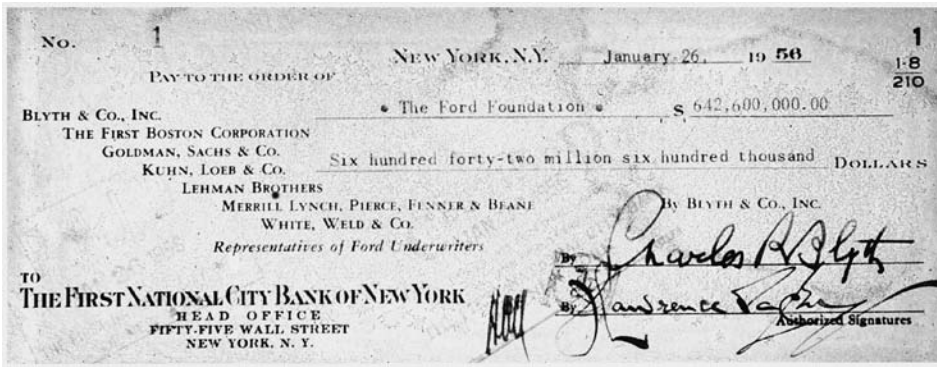
none of the key components of modern financial systems. By the time he stepped down in 1795, it had all of them: strong public finances and national debt management, a stable dollar, a central Bank of the United States, a banking system, securities markets (the NYSE, for example, originated in 1792) and a growing number of corporations that quickly eclipsed the numbers existing in the old European countries. The US was off and running on

modern economic growth. It became the most successful emerging market of the past two centuries. Is it any wonder that Hamilton is the Museum's patron saint?

Japan is my favorite historical case to illustrate the power of finance and how it leads to growth. The country was almost totally isolated from the rest of the world for two and a half centuries before the 1850s, when US Commodore Perry's black ships arrived to "open" it. There followed a struggle between Japan's traditionalists and its modernizers, which the modernizers won by 1868. Like Hamilton before them, the modernizers studied the institutions of the leading European and American countries, and quickly realized the power of finance. They stabilized public finances and issued modern debt instruments, a new currency and a central bank (the Bank of Japan, 1882). In 1878, stock exchanges were founded in Tokyo and Osaka. The Japanese government reformed the banking system and promoted modern corporations. Powered by finance, Japan's economic growth accelerated. By the early 20th century, the country was a major world power. After



\$5 US greenback, 1863.



Check for \$642,600,000 issued to the Ford Foundation after investment bankers sold a large block of the Foundation's stock in the Ford Motor Company to the public, 1956.

World War II, Japan became the first non-western country to equal the developed western nations in virtually every respect.

From Whence the Power of Finance?

Despite the work of economists and economic historians, to most people the power of finance is hardly self-evident. Even people working on Wall Street can miss it. A foreign currency trader there once told me he could not understand why he was earning 10 times as much as his mother, a teacher, when in his view his mother was doing far more important work. What can explain the power of finance?

A century ago, the noted Austrian (later American) economist Joseph Schumpeter (1883–1950) provided the best short analysis. In his *Theory of Economic Development*, Schumpeter identified the entrepreneur, the innovator of new products, markets, processes, sources of supply, etc., as a driving force in economic progress. Thanks to Schumpeter, we cherish entrepreneurship.

But—and this is often forgotten in accounts of Schumpeter's analysis—besides the entrepreneur, there is an equally important driving force, the banker. The banker is important because the entrepreneur cannot implement his innovative ideas without credit and capital, which is what the banker can supply. There are many would-be entrepreneurs, but far fewer good ones. A part of the banker's job is to identify and back the good ones; one will recognize modern venture capital activities as an example of this. When bankers do their work successfully, good ideas get implemented, economies grow and the world has more goods and services.

There are, of course, some losers in the development process. Those who do things the old way and fail to innovate are driven to the wall. Schumpeter called it “creative destruction.” Think, for example, of what Jeff Bezos and Amazon have done to traditional booksellers and other traditional retailers.

More generally, Schumpeter's concept of the banker can be regarded as the entire financial system, which is a vast network of governments financing themselves; banks lending and facilitating payments; financial markets making assets liquid and tradable; and a variety of financial and non-financial corporations that issue stocks and bonds, lend and borrow and provide most of our goods and services.

This vast financial network, working properly, allocates scarce capital to its best uses. It also provides ways of managing risks by offering insurance, diversification and hedging. The network has what economists call network externalities. When they are positive, the whole is greater than the sum of the parts, and we experience prosperity and economic growth. When something goes wrong in a part of the network, the externalities can become negative. The result is a financial crisis in which financing is crippled or dries up, economic growth slows or stops and unemployment rises.

Economic and business historians at NYU's Stern School of Business, where I teach, have created what is in essence a more historically-attuned model of development than Schumpeter's simple one of entrepreneur and banker. We call it “the diamond of sustainable growth,” which like a baseball diamond has four corners or bases. Countries that cover all of the bases

well tend to prosper; those that don't tend not to prosper or prosper less.

The first corner of the diamond is an *enabling government and political system*, one committed to economic growth and development. Often this involves representative institutions and governments. Harking back to history, it was not a coincidence that the financially-innovative Italian city states of the Renaissance were republics, as later in time were the Dutch and the American nation states. Or that Britain and Japan were constitutional monarchies. A representative government with constitutional constraints on its powers is more likely to care about the general welfare than about the welfare merely of those who happen at the time to exercise governmental powers.

The second corner of the diamond is a *dynamic financial system*. It is second because it depends on the rule of law, property rights and the enforcement of contracts. These are provided by enabling governments and political systems.

Corner three of the diamond is *vibrant entrepreneurship*. Entrepreneurs likely will thrive when government is on their side and a financial system is in place to provide them with the credit and capital they need to implement their creative (and creatively destructive) ideas.

Finally, corner four is *effective managerial capabilities*. With good governments and dynamic financial systems in place, successful entrepreneurs are likely to create enterprises so large and complex that a single entrepreneur or family cannot effectively manage them. Professional managers are needed, and they have to be trained. It was no accident that the first business schools began to appear in the US during the late 19th and early 20th centuries, the very time when large corporations in transportation and manufacturing arose and came to dominate the American economy. Business schools addressed the need for trained managers.

The diamond of sustainable growth teaches us that the power of finance is not absolute. Rather, it is contingent on good government and the rule of law. We in America often take good government and a dynamic financial system for granted. A glance back at history and around our world today ought to cure us of taking such things for granted. For much of modern history only a few of the world's nations » *continued on page 46*

A Museum of Finance

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had both, and even now they are lacking in many countries.

The Role of Finance Museums

The power of finance is clear to those of us who study it, both historically and in today's world. Yet many people are unaware of it or don't fully understand it. This provides the rationale for a museum of finance. Through artifacts brought to life with written and oral explanations, a museum can use visual stimulation to arouse curiosity and teach important historical lessons. Some examples may illustrate the point.

In 2009, the Museum had an exhibit featuring the world's oldest extant share of stock of a publicly-traded company, the Dutch East India Company. It was lent by its Dutch owners. The company was founded in 1602, and the share dated to that decade. The company sponsored Henry Hudson's "discovery" of New York harbor and the river subsequently named after him. For New Yorkers and others, it was a great way to relate the city's history to financial developments in Europe long ago.

The Museum's permanent exhibits feature two early US government bonds. One dates to 1792 and is registered in the name of George Washington, whose signature appears on it. It was "assumed debt," meaning that Washington had turned in some Virginia state debt he owned for US government debt as a part of Alexander Hamilton's plan for the assumption of state debts by the federal government in 1791. This is an entry for teaching about Hamilton's financial innovations at the beginning of US history, which spurred both economic growth and our two-party system when Thomas Jefferson and James Madison organized a political party to resist Hamilton's innovations.

The other early bond is a Louisiana 6% of 1803. Almost every American knows of the Louisiana Purchase of that year. But how was the Purchase actually made? The US government issued \$11.25 million of bonds maturing some 15 years later, of which the one on display is an example. The bonds were taken to Europe by

Barings, London investment bankers, and sold by them and other banking houses to European investors. The proceeds were paid to France so that the French emperor, Napoleon Bonaparte, had more money to wage his wars in Europe. The transaction, the largest such international financial transaction in history to that time, doubled the geographical size of the US. Our country had been a bankrupt nation in 1788, but by 1803, thanks to Hamilton, it had one of the best credit ratings in the world. That is why France was to be paid in US bonds. The bonds were easily marketable to European investors, illustrating the power of finance.

Perhaps you have heard the phrase, "Not worth a Continental." It refers to the paper money issued to such an extent by Congress during the War of Independence that it lost almost all of its value. You can see one and learn the story in the Museum's permanent "Money: A History" exhibit. Have you heard of the greenbacks that were similarly issued by Abraham Lincoln's Union government during the Civil War, and similarly lost value? You can see greenbacks and learn their story at the Museum.

Did you ever see a check for \$642,600,000? Investment bankers wrote such a check to the Ford Foundation in 1956, after they had sold a large block of the Foundation's stock in the Ford Motor Company to the public. Henry Ford ran a private company, and when he died in 1947, he left most of his stock to the Ford Foundation. By selling the block of stock in 1956, the Foundation diversified its assets and increased its philanthropic activities, while the Ford Motor Company became a public company in which anyone could invest. You can see that check at the Museum. A number of stories about the power of finance can be conveyed on the basis of it.

But one shouldn't have to come to New York to view these artifacts of financial history and learn the stories that they tell. Modern information technologies can allow us to put these and other treasures, and their stories, online. Then anyone in the world with access to the Internet can see and learn from them. It means more, of

course, to see the real thing up close. When I was young, I saw many images of the Mona Lisa and the Venus de Milo, but they meant much more when I later viewed the actual masterpieces at the Louvre in Paris. So our online plans when realized will not be a substitute for a visit to 48 Wall Street, as much as an invitation to make that visit.

Using artifacts from financial history and exhibits based on them to increase the public's understanding of the power of finance is just one aspect of the Museum's mission. Financial education broadly construed is just as important. The Museum does that for adults with its evening lecture series featuring prominent speakers from the financial and academic worlds. Its "Lunch and Learn" midday events give authors of recent books on finance and financial history an opportunity to explain their work. The Museum Finance Academy uses the Museum's own and Wall Street's resources to educate high school students about the power of finance and to increase their personal financial literacy.

In 1987, in the wake of the stock market crash of October 19 that year, Wall Street and the US financial system were under a cloud. Some feared it was 1929 all over again and expected a depression to follow. In those dark days, stockbroker John Herzog, knowing of the power of finance, decided to dedicate his fine collection of historical artifacts, documents and financial instruments to teaching others about it.

It was a splendid vision, one that resulted in the Museum of American Finance. Thanks to John Herzog's vision, the power of finance is more appreciated now, a quarter century later, than it was then. But much remains to be done to make more people aware of it. As it looks back, the Museum looks forward to meeting this challenge. \$

Dr. Richard Sylla, Chairman of the Museum of American Finance, is the Henry Kaufman Professor of the History of Financial Institutions and Markets and a professor of economics, entrepreneurship and innovation at the New York University Stern School of Business.