The Disappearance of Deposit Banks: An Explanation

Carolyn Sissoko

First Draft: 7/30/04

This Draft: 6/5/07

Abstract

This paper asks why deposit banks thrived in the late middle ages, but had virtually dis-

appeared by 1600 and studies banking in Venice in order to answer the question. A model is

developed that shows that a partial reserve banking system is an e¢ cient means of allocating

investment funds only if the returns from long-term investment are su¢ cient both to compen-

sate the banker for the costs of running a bank and to o§er depositors a return over what they

can receive through market allocation. Thus the collapse of deposit banking in Venice can be

explained by the fact that in the 16th c. the costs of operating deposit banks remained high,

while the returns from long term investment declined

argue that the beneÖts of banking outweighed its

costs only when the investments available to bankers who held partial reserves paid high returns.

During the 16th century Venice lost its hegemony in the trade between East and West, and the

returns from investment in the Venetian economy fell. It is this drop in investment returns that

meant that the unstable form of banking practiced in Venice was no longer viable

he next section of the paper discusses the position of

Venice in the late Medieval European economy. Section two describes the Venetian banking system,

detailing the penalties bankers who defaulted could face and the instability of the environment in

which bankers operated. Sections three and four take an analytic approach, using a variant of

Diamond and Dybvigís model of banking to make the theoretic point that a high-cost banking

system is only viable in an environment with high investment returns. The Öfth section concludes

1 The Setting: 16th Century Venice

Recall for a moment the role that Venice played in the European economy of the 14th and 15th

centuries. German and Hungarian silver was Önancing the purchase of ìsilks and spicesîñwhich

included a great deal of raw cotton and cotton textiles ñfrom the East. Venice, just over the

Alps from the silver mines, was a convenient outlet for the central Europeans and, as a maritime

power, had easy access to the ports of the Black Sea, the Levant and Egypt. While in the 14th

century Genoa challenged Venetian supremacy in the Eastern Mediterranean, through much of the

15th century Venice lacked maritime rivals on the Eastern trade routes. Venice was an exemplar

of the medieval tradition of cities that act as a corporation of mercantile interests: she carefully

negotiated in each Eastern port a monopoly on trade for her merchants. Access to the silver that

was in such demand in these foreign ports was an important bargaining point in these negotiations,

as was the strict regulation of Venetian merchant convoys that helped establish annual markets in

eASTERN ports.

t is no surprise then that Venetians were earning exceptionally high rates of return in this

period. According to Peter Spu§ord, ìthe Öfteenth century Venetians ... could commonly reckon on

a proÖt of 40% merely on bringing spices half the length of the Mediterranean.î

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As a consequence

of hegemony over the Eastern Mediterranean, through the 15th century Venice developed into a

city-state of extraordinary wealth and power.

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