**Workings of a Nineteenth Century Indigenous Banking System:
A Case in support of Free Banking**

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<u>Abstract:</u> Free Banking theory predicts that banks working under competitive conditions with minimum or no government regulation will regulate themselves efficiently and not be necessarily prone to crisis. This paper puts forth a case of a banking system in nineteenth century India that evolved and functioned without any government regulation. The Chettiars, indigenous bankers from South India comprised a banking system that provided banking and credit in many countries in South-East Asia. This paper describes their banking system and mechanisms of self-regulation such as interest rate setting, clearinghouses and informal deposit insurance. In general, it finds that their banking system was stable and functioned smoothly, thus adding to the literature in favor of free banking.
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1. Introduction

Most economists agree that a government run central bank is essential to the workings of a monetary economy. A minority view (Hayek 1976, Dowd 1994, Selgin 1988, White 1989) holds that free banking or banking without government involvement would fare better than the government-regulated system. The theoretical literature on free banking explains how these banks would handle the problems of note-issue, lender of last resort and other regulatory mechanisms. Complimentary to this literature is the study of various episodes of free banking or near-free banking through history. These historical episodes come close to resembling laboratory experiments and allow economists the chance to 'test' or verify their theories against concrete data.

This paper contributes a new historical case of free banking to the literature. The Chettiars were a nineteenth century banking caste from the South Indian state of Tamil Nadu. They formed an entire banking system that spread along side the expanding British Empire from South India to several countries in South-East Asia. Although existing case studies within this literature have exhibited varying degrees of government regulation (Dowd 1992), this case offers a look into a completely 'indigenous' banking system, with no government involvement in its inception or its functioning. This paper provides a description of their regulatory mechanisms such as clearinghouses, interest rate setting, insurance mechanisms and note-issue. In general, it finds that the banking system of the Chettiars was stable and functioned smoothly, thereby adding to the existing historical cases in favor of free banking

One particular characteristic that stands out is the lack of competitive note-issue in the Chettiar banking system. This can be attributed to their 'notes' or deposit receipts never gaining in circulation as money substitutes. They did allow for the drawing of bills of exchange or 'hundis', but these always came back to be redeemed quickly. Thus they relied mainly on the extension of credit and interest rate differentials for their business. Their case, however, seems to strongly support Dowd's (1994) notion of voluntary 'banker's clubs', clubs that would serve key regulatory purposes but not regulate as extensively as central banks do. The Chettiars provided for the communal setting of deposit rates that in turn created an informal deposit insurance mechanism as well as other key regulatory services like information sharing and clearinghouse mechanisms. Beyond these key club goods, things such as branching decisions, reserve ratio requirements or even risk taking were left completely up to the discretion of the proprietors of firms and thus ultimately to competitive forces to regulate.

Section 2 of the paper reviews the existing historical literature on free banking and shows where this case study fits in. Section 3 provides the historical details of the Chettiar banking system and their regulatory mechanisms. Section 4 highlights the main implications and contributions to the literature. Section 5 provides conclusions.

2. Literature Review

The theoretical argument for free banking rests on the idea that competition in banking and note issue would work just as it does in other sectors of the economy. White (1984,1989), Selgin (1987,1988) and Dowd (1989,1991,1994) have stressed the ability of competition among banks to regulate themselves, keep excessive note-issue and risk taking in check, as well as provide information sharing mechanisms. The implication is that banking stability does not inherently require the presence of a government central bank to regulate or provide mechanisms such as clearinghouses. As a corollary, these economists maintain that much government regulation of the banking sector is most often the result of previous government regulation, not a response to an inherent market failure.

This simple thesis, if true, should hold up to historical analysis wherever its conditions are present. There have been several free banking case studies brought to light where banks had more or less a great degree of self-regulatory power. Prominent among them are free banking in Scotland, Canada, France, Australia and the United States. Some others are free banking in China, Switzerland, Ireland and Sweden (Dowd 1992). Within this historical literature, the main focus has been the study of competitive note issue and co-operation among banks for clearing purposes.

Structurally, the first feature common to all existing cases is the presence of some amount of government regulation of banking, however small, with Scotland often cited as the freest (Selgin 1992, Dowd 1992). The main features of the banking system in Scotland were freedom of entry, no branching restrictions and the ability to issue notes privately from 1695 to 1844. During this period, several banks competed in the market, issued notes, voluntarily participated in a note-exchange system and no major banking crises occurred.

Another feature common to the existing cases is involvement of government in the setting up or creation of the banks, and then allowing them to regulate themselves over time. This process took place in two patterns. The first was prominent in Britain and its colonies where the government let banks regulate note issue themselves from the beginning (Schuler 1992). The second was prominent in the Americas where government note issue preceded private note issue (Schuler 1992).

The case study presented in this paper provides a look into an Indian banking system with no government involvement either in its inception or its functioning. Thus, it provides a look at a more pure case of totally free banking in a different geographical area, offering the opportunity of rendering the literature more robust.

3. Chettiars and their banking system

This section lays out the historical details of the Chettiar banking system. It begins by providing a general historical setting and description of the system, before going over the particular regulatory mechanisms. It draws from a few primary and several secondary sources. The primary sources are government reports of banking enquiries undertaken in 1929. Specifically, the Madras Provincial Banking Enquiry Committee Report, 1930 (MPBEC 1930 henceforth) and the Burma Banking Enquiry Committee Report, 1930 (BBEC 1930 henceforth) are used. The main secondary sources used are Rudner (1994), Weerasooria (1973), Krishnan (1959), Tun Wai (1953), Jain (1929), Menon (1985) and Mahadevan (1978a & 1978b) for historical and anthropological details.[1]

[1] The main secondary sources of information are the works of anthropologists and historians writing regional economic history, since officially chartered bank histories do not exist. Anthropologist David Rudner (1994) provides the most comprehensive study of the Chettiars and their banking system and serves as the main source for this section. Other supporting works that are not mentioned above are also utilized and cited explicitly when used.

3.1 Institutional Setting and Market Structure

The Chettiars[2], native to the South Indian state of Tamil Nadu, started out as salt traders and money lenders in the seventeenth century and evolved into a full-fledged banking system by the nineteenth century (Rudner 1994). At its peak, their banking system extended from South India to Burma, Malaya, Ceylon (now Sri Lanka) and parts of China. It resulted from the exploitation of new business opportunities created by the British conquest of these countries in the early nineteenth century (Rudner 1994). It lasted till around 1930, leading to large-scale withdrawal from foreign stations and disinvestment from banking and finance. This decline was not due to inherent instability within the banking system. Rather it was a combination of various *external* factors such as the Great Depression, increasingly hostile business environments in foreign business stations as well as the opening up of alternative investment opportunities in India (Rudner 1994:55, Menon 1985, Mahadevan 1978b, Weerasooria 1973). This decline of the Chettiar banking system is dealt with in more detail below. They were an important source of credit in the countries where they did business and are widely acknowledged as having been instrumental to the economic development of various industries (Tun Wai 1953, Weerasooria 1973, Mahadevan 1978a & 1978b, Rudner 1994, Baker 1984).

Known as 'indigenous' bankers, their growth and functioning took place *outside* of the formal government-backed banking sphere. One encounters some inconsistency and difficulty in the various definitions of 'indigenous banker'. All writers, including government reports, recognize their true intermediary nature of

[2] Alternative names for the Chettiars are Nattukottai Chettiars, Nagarathars and Nakarattars. Rudner (1994) uses Nakarattar. While these other names are somewhat technically more accurate, here 'Chettiar' is used for brevity.

taking deposits and making loans as opposed to moneylenders who only make loans. One way of defining them is as bankers who are *not* organised along western banking practises or joint-stock banking (BBEC 1930). This however does not get to the heart of the matter. Jain (1929:1) comes closer when he writes about such bankers as “not required to register themselves as such under any law of the realm”. A crucial point that is not emphasised enough explicitly is the fact that such bankers or systems of banking were also naturally free from any government regulation or involvement and this makes them relevant to the literature on free banking.

The formal banking sphere at that time consisted of the three government-backed Presidency Banks meant to handle domestic credit requirements, the ‘Exchange Banks’ chartered to handle foreign exchange and tribute remittance to England as well as some private joint-stock banks (Bagchi 2003:22, Chandavarkar 2008:775). Despite this formal sphere, the Chettiars and other indigenous bankers like them remained an important vehicle of banking and credit throughout the country. Jain (1929) provides one explanation for this, in his study on indigenous banking in India. He writes (Jain 1929:25):

> Each system had a distinct and separate existence, because each had its own particular function. The indigenous banker concerned himself with the granting of credit to the agriculturists and the artisans and the financing of the internal trade of the country, while the early European banks confined their activities almost entirely to the three Presidency capitals, providing remittance and deposit facilities, chiefly made use of by Europeans, and financing the external trade.

Indigenous bankers had been providing banking and monetary services much longer, several centuries in some cases and this contributed to their continued relevance in the credit market as well (Jain 1929, Krishnan 1959). The Chettiars, too, catered to a niche market of local businessmen and agricultural labor whose credit needs were not met by government banks in India and abroad (Rudner 1994). They competed with other banking castes such as the Multani and Marwari bankers, local Burmese and Chinese moneylenders and with each other within this loan market (Tun Wai 1953, Krishnan 1959, BBEC 1930). For attracting deposits, they even competed with government banks in addition to any other bankers offering deposit services (MPBEC 1930, BBEC 1930)

As mentioned earlier, there existed no systematic regulation of their banking through the time that they were at their peak. The Indian government set up a national committee to study the nature of banking in the country in 1929, with a view to regulate it. The report of the Madras Provincial Banking Enquiry Committee (MPBEC 1930) is relevant here.

> These proposals were in general agreed to and a press communiqué was issued on 12th June 1929 stating that *the objects of the enquiry were the investigation of existing conditions of banking and the consideration of what steps, if any, are feasible and desirable* under the following headings:-
> a) The regulation of banking with a view to protecting the interests of the public;
> b) The development of banking in the sense of the expansion of both indigenous and joint-stock banking with reference to the needs of agriculture, commerce and industry.
> …*The indigenous bankers in this Presidency must include the* banking communities of Marwaris, Multanis, *Nattukottai Chettiyars* and Kallidaikuruchi Brahmans. They grant loans primarily on personal credit generally at higher rates of interest than large joint-stock banks and at the same time take larger risks relying more on personal knowledge of their clients and their clients' business than on pledged securities for trade loans. *They deal in hundis*[3] *to a very large extent and finance a great deal of the internal movement of goods.* (MPBEC 1930:2,emphasis mine)

Though they were sporadically impacted by legislation pertaining to business practises in general (Weerasooria 1973, Krishnan 1959), the government did not exercise any significant regulatory control until after 1930.

The decline of the Chettiar banking system that is usually dated to 1930 was the result of several complex external and socio-political factors. The early twentieth century saw the rise of nationalism in India as the forbearer of the coming freedom

[3] A 'hundi' is a bill of exchange.

movement against the British. With this rise, several ‘indigenous’ or informal business elite got increasingly involved in political movements and faced the choice of entering the more legitimate formal business sphere or remaining informal (Roy 2010). This was true of the Chettiars as well; several elite members withdrew from the informal banking sphere to set up joint-stock banks in the formal sphere.[4] This led to a growing polarization in the community since smaller non-elite bankers could not afford to set up joint stock banks (Mahadevan 1978b, Rudner 1994). However, as is explained below, the Chettiar business in its heyday was not very vast in India. It was most extensive in Burma followed by Malaya, Sri Lanka and China. Within these countries, it is the Great Depression of 1930 and the sudden fall in prices that dealt the first blow to Chettiar business. Mainly involved in financing agriculture as they were, a sharp fall in agricultural prices led to many debtors defaulting on their loans, which either led several smaller Chettiar banks to go bankrupt or to acquire the land pledged as collateral for the loan. For example, in Burma, total Chettiar land holdings went from 570,000 acres in 1929 representing 6 % of total cultivated area in the major rice growing districts to 2,393,000 acres by 1936 or 25 % of total cultivated rice growing area (Mahadevan 1978b). Again, rising nationalist movements and hostile business environments within those countries led to massive Chettiar withdrawals back to India, often having had to relinquish ownership of the land they had acquired due to the Depression (Mahadevan 1978a & 1978b, Menon 1985, Rudner 1994). Back in India to a changing socio-political and business environment, many Chettiars were forced either into poverty or reinvestment of resources into other avenues (Rudner 1994). Thus, the Chettiar banking system that had flourished through the nineteenth century changed form dramatically and declined definitively post 1930.

[4] Some of these joint stock banks exist to this day.

Officially, India was on a monometallic silver standard from 1835 to 1893, after which it shifted to a gold exchange standard from 1893 until 1916 with a period of transition in between (Chandavarkar 2008). The government monopolised the issue of bank notes after the passage of the Paper Currency Act of 1861, prior to which the three Presidency banks had the right to issue notes (Chandavarkar 2008: 777).

3.2 System of Banking

The Chettiars represented an entire banking *system*, one formed by hundreds of interdependent family firms or banks. Each extended family would accept deposits, issue bills of exchange and grant loans, rendering it a separate bank. The main proprietor would live in his homeland village in South India, while hired agents from within the caste or extended family would carry out day-to-day operations of the business in India or abroad. This system of agency was well developed whereby agents and proprietors kept close contact with each other via telegram and each agent was hired for a period of three years, after which his contract could be renewed or would lapse (Rudner 1994:118). Proprietors, on the other hand kept abreast of the latest business news and information from each other while in the homeland. Rudner (1994:90) describes the banking system:

> Nakarattars built their commercial empire out of a complex network of interdependent family business firms. Each firm was involved in commodities trading, money lending, domestic and overseas banking operations, or industrial investment. Beyond this specialization—making possible every other commercial venture in which it engaged—each family firm operated as a commercial bank: taking money on deposit and drafting bills and other financial instruments for use in the transfer of lendable capital to branch offices and to other banks. As a result, every Nakarattar firm was tied together with all of the others to form a unified banking system.

Estimates of their working capital in 1930 range from 795 million rupees to 1200 million rupees, which translates to 3.71 billion and 5.6 billion in 2008 dollars respectively.[5] While Rudner (1994:70) attributes these discrepancies to the biased nature of government reports,[6] even the smallest estimate points to a sizable business. There were 243 firms or bankers doing business locally in South India in 1930 (Rudner 1994:72), while 1650 firms were operating in Burma in 1929 (Mahadevan 1978b). There were 700 firms operating in Ceylon in 1916 (Rudner 1994: 76). This picture is confirmed by a regional break-up of working capital provided below, which shows that Chettiar business was least prominent in India and most prominent in Burma.[7]

As a banking system, the Chettiars were an important source of credit to one another (Mahadevan 1978a & 1978b, Rudner 1994, Weerasooria 1973). Rudner (1994:103) estimates that for any bank, deposits from fellow Chettiars (bankers and non-banking caste members) comprised between 60 to 80 per cent of all deposits, while proprietors' own capital invested in the business generally constituted 10 to 20 per cent. Non-Chettiar deposits would make up the difference. This is a crucial feature that is not apparent based on the aggregated values present in the table below. However, one finds support for it in all works describing Chettiar banking in addition to Rudner's (1994) estimations, which are based on his study of their account books and oral evidence.[8]

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[5] Conversions have been made using the following calculation. In 1930, 1 USD = 2.77 Rupees, thus 795 million rupees was the rough equivalent of 287 million dollars. In 2008 dollars, that would be 287*12.95 = 3.71 billion dollars.
Source for exchange rates: www.measuringworth.com

[6] Rudner (1994:77) writes: "In the depressed economic environment of that time and in the atmosphere of emergent nationalism and populist politics that characterized public debate in the 1930s, most of the evidence obtained in a public "enquiry" on any topic was highly biased and prejudicial..On one hand, the vast majority of relevant testimony was collected from Nakarattar debtors, who painted a predictably black picture of their creditors. On the other hand, testimony by Nakarattar bankers can hardly be accepted as an unbiased alternative. Such as it is, however, Nakarattar evidence provides the only picture we have of the extent of Nakarattar business operations."

[7] Rudner (1994) and Mahadevan (1978b) explain that the working capital in Madras Presidency is most certainly underestimated due to underreporting of income in tax returns.

[8] Rudner (1994: 101) writes: "it is clear from information contained in Nakarattar account books and from interviews with surviving Nakarattar bankers that there are major differences between aggregate

Table 1. Break up of three estimates of working capital in 1930, (1 crore = 10 million)

A. REPORT OF THE BURMA PROVINCIAL BANKING ENQUIRY COMMITTEE	
Location of Working Capital	Amount (crores)
Burma	75
Federated Malay States	25
Ceylon	14
Cochin China	5
Madras Presidency	1
Total	120
Source : Krishnan (1954: 36).	
B. ORAL EVIDENCE OF KARAIKUDI ARUNACHALAM CHETTIAR	
Type of Investment	Amount (crores)
Money lending employed in business (own capital)	36
Investment in houses and jewels	10
Chettiars in Pudukottah State, many of whom do business in British India (own capital)	14
Their houses and jewels	4.5
Investments in land, estates, etc. in India, Federated Malay States, etc.	15
Total	79.5
Source : Madras Provincial Banking Enquiry Committee (1930 IV: 252).	
C. WRITTEN EVIDENCE OF RAJA SIR MUTHIA CHETTIAR, NAKARATTAR REPRESENTATIVE TO THE MPBEC	
Type of Investment	Amount (crores)
Cash	80–90
Houses and other property	15–20
Jewels	5
Non-Chettiar capital (borrowed)	15
Total	115–130
Source : Madras Provincial Banking Enquiry Committee (1930 1: 186).	

Source: Rudner (1994: 71)

The Chettiars offered checking or demand deposits as well as time deposits to their customers and caste members. As noted above, deposits from non-caste members made up a small percentage of total deposits. Depositors would receive either a deposit receipt or a passbook containing the particulars of the transaction when the deposit was made, depending on which one they preferred. All deposits, including the checkable ones, paid interest[9] (BBEC 1930, Rudner 1994). Chettiars made a clear distinction in their account books of deposits (time and on

classifications of Nakarattar assets provided to banking enquiry committees and the nonaggregated classifications of liabilities that Nakarattars employed in their own account books. One of the most significant differences reflects precisely the importance of different kinds of deposits just among Nakarattars themselves."

[9] This points to the keeping of fractional reserves. This is elaborated on in the conclusion as matter for further research.

demand) received from fellow caste members and those received from outsiders. The interest rates paid on the two were also different. Interest paid on Chettiar time deposits was lower than non-Chettiar time deposits, allowing them cheaper access to stable capital from within the caste (Rudner 1994: 91). Deposits were the basis for the drawing of bills of exchange or 'hundis'. Clients had to maintain a deposit account with the banker, in order to be able to draw a hundi. Hundis worked much in the way checks do, serving the purpose of transferring funds across place and time without moving physical money. Checkable deposits, in turn, could be drawn on by 'at sight' or 'darshan' hundis, resembling demand drafts. Time deposits could only be drawn on by interest-bearing hundis with fixed maturity dates, resembling present day certificates of deposit. Deposit interest rates were set communally and this feature is dealt with below.

Loans of various kinds, on the other hand were granted against promissory notes and other kinds of collateral such as land or jewellery. The interest rate varied depending on the banker's knowledge of the borrower and quality of collateral offered. Loans issued only on promissory note charged higher interest than loans issued on promissory note and collateral. Chettiars competed with each other and other bankers in the loan market. Thus, there was no one standardized loan rate that was used by all Chettiars. It depended on local knowledge, trust, bank's location and strength of collateral offered. Loans were issued by actually giving out physical money and not by the creation of a checkable account that could then be operated on by checks or hundis (BBEC 1930). This is attributable to the limited extent to which the Chettiars' notes were able to circulate as money. In other words, customers were unwilling to use Chettiar issued notes or deposit receipts as money substitutes and thus also demanded actual or 'outside money' for loan transactions. On repayment of principal and interest, the borrower would receive the promissory note with a stamp of repayment by the banker.

3.3. Mechanisms of Regulation

This section provides a description of the self-regulation mechanisms used by the Chettiars. The three main mechanisms of interest rate setting, parent bankers and informal deposit insurance are described.

3.3.1. Parent Bankers as Clearinghouses

The natural elite among the Chettiars played an important role in the banking business, that of clearinghouses for the smaller firms. The main differentiating factor between parent or ‘adathi’ bankers and non ‘adathi’ bankers was the size and scope of their business. ‘Adathi’ bankers owned an extensive network of banking branches, and comprised 5 to 10 per cent of the caste population (Rudner 1994: 123). This widespread network of banking branches allowed smaller Chettiar firms to transmit funds over wider distances. Every small or mid-sized Chettiar firm would maintain an account with an adathi banker and this in turn led them to function as clearinghouses for the banking system as a whole in a *defacto* way. It allowed for the efficient clearing of debits and credits among dispersed Chettiar bankers. Adathi bankers also had a larger say in the monthly setting of interest rates (Rudner 1994:124), and this helped regulate as well as standardize interest rate levels across business stations. Hundis issued by adathi bankers had a greater value than those issued by non-adathi banks and were often kept uncashed by caste members as security for a time when liquidity was required (Rudner 1994).

Further, British banks would lend to some adathis from a pre-approved list, who in turn would further lend out the funds at a higher rate to fellows and thereby earn an interest rate differential. This higher status within the banking system was not granted on the basis of a one-time agreement among members. It was the result of greater respect and trust given to those bankers who had done very well in business, and thus represents an organically evolved institution resulting from repeated interaction among caste members.

3.3.2. Communal setting of interest rates

Interest rates were set communally in common houses or temples, on a fixed day of every month, in every Chettiar business station. The focal point of the monthly meeting was the setting of the checking deposit rate or 'nadappu' rate that was then used as a benchmark to set other rates. This rate was paid to other Chettiars for their checking deposits. Time deposits between Chettiars paid the 'nadappu' rate at compound interest, while time deposits from non-Chettiars added a mark-up to the 'nadappu' rate.[10] This practice meant that the Chettiars could borrow from one another at a cheaper rate than borrowing from non-Chettiars. A second point is that although they did not compete with each other in the setting of the 'nadappu' rate, they could possibly compete in attracting non-Chettiar clients since there was no standardization on the level of the mark up that was paid to the outsiders.

The Report of the Burma Provincial Banking Enquiry Committee (1930) cited in Rudner (1994: 91) describes this process of setting of interest rates in Burma's capital Rangoon.

> '[The *nadappu* rate] is fixed in the evening of the 16th of every Tamil month at a meeting held at 9 p.m. in the Nakarattar temple at Rangoon, and it holds good for all the current Nakarattar month including the sixteen days already passed.... The meeting discusses the general financial situation, and fixes the current [*nadappu*] rate for the current month with this, taking into account the current pitch and

[10] At this point, it is not clear whether this 'nadappu' rate was paid on outsider demand deposits as well. Hopefully, further inspection of the primary materials will clear this up.

> tendency of the thavanai rate, the rates current amongst the Marwaris, Multanis, and Gujeratis [other Indian banking castes] and the rates for advances by the joint-stock banks to Nakarattars. As every firm has both income and expenses determined largely by this rate, great care is taken to fix the rate according to the needs of the situation…'

Thus cooperation and keeping watch on competitors' rates were key to the formation of interest rates.

3.3.3. Caste ties as Deposit Insurance

The communal setting of deposit rates was closely tied to a sort of informal deposit insurance. If a trusted Chettiar was in sudden need of liquidity, he could count on his fellows to lend to him easily and at a lower rate than he could secure from outside (Rudner 1994: 124). As a result, the reputation of fellow Chettiars was under consistent scrutiny and formed an important part of the information exchange that took place at collective events at common houses or temples (Rudner 1994). Rudner (1994: 125) describes this activity:

> As clearinghouses for information about each other and about business opportunities generally, these collective events effected investment decisions, including decisions about the optimum allocation of investment funds and the amount of credit to extend to a fellow Nakarattar. In other words, *vitutis*[11] provided Nakarattars with access to information about each other's business. They provided opportunities to scout out investment opportunities and arrange for loans by fellow Nakarattars looking for investments. *At the same time, the information they provided served as checks against incautious business behaviour and unreasonable requests for credit.* (Emphasis mine)

Thus, although the Chettiars did not have a formal lender of last resort, they did have an informal insurance mechanism that any Chettiar could call on in time of trouble. This informal insurance, however, was rooted in cautious judging of the particular situation at hand by the lender since it was his own money and capital at risk. This helped hedge against excessive risk-taking since the costs of doing so would have to

[11] A 'vituti' is a common house.

be borne by the lenders themselves. As a community, then, the Chettiars were incentivized to reduce asymmetric information by providing for the smooth exchange of information. This exchange would take place at the weekly and monthly meetings for the setting of interest rates as well as by maintaining blacklists of bad or risky debtors that were circulated throughout the community of bankers (BBEC 1930).

There is one recorded instance of a ‘crisis’ leading to the closing down of some Chettiar firms in Ceylon (Weerasooria 1973). This took place in 1925 when a prominent Chettiar bank collapsed leading others to follow suit. Weerasooria (1973:15) writes:

> The firm was heavily in debt both in Madras and in Ceylon and the liquidation and winding-up proceedings of the firm disclosed a number of malpractices freely indulged in by it..The result was what came to be known as the “Chetty Crisis” of 1925. A number of Nattukottai Chettiar firms had to suspend business operations. Others had to close down permanently.

Rudner (1994:78) writes of the first firm’s bankruptcy, “the High Court of Madras estimated the firm's Indian assets at Rs. 800 thousand and Indian liabilities at Rs. 3.7 million; its Ceylon assets at Rs. 150 thousand and its Ceylon liabilities at Rs. 1.7 million”. The reason for this crisis was ascribed to the “unholy alliance” between British banks lending to a few large Chettiar firms coupled with the easy inter-firm lending practices among the Chettiars (Weerasooria 1973:15, Rudner 1994:78). A witness’ testimony in the Report of the Ceylon Banking Commission (1934) cited in Rudner (1994: 78) alludes to this alliance between the British banks and Chettiar firms as causing the crisis:

> As the due dates of the loans vary in the different banks, the Chettiars used to borrow from one bank to pay off their dues to others so that a Chettiar firm which is financially embarrassed can easily tide over its difficulties and if it is actually insolvent the heaviest loss is entailed upon the bank to which the loan is repayable last in order of time…Thus the Chettiars through the age-old practice of being their own mutual lenders of last resort, were able to use loans from banks, sometimes from the same bank, to meet the maturing bank loans. To the

> extent this happened, it was the banks' own money which enabled the Chettiars to keep their loan contracts with the banks with striking promptness.

However, this crisis did not lead to the downfall of the entire banking system, let alone within Ceylon. Though the exact number of firms that went bankrupt is unknown, there were still 556 Chettiar firms operating in Ceylon as of 1934 (Weerasooria 1973:22), down from 700 reported in 1916 (Rudner 1994:76)[12]. This is an indication that inter-firm lending or informal deposit insurance itself was not the problem, it was the particular risky practises of a few firms at a particular time. The implication is that Chettiar banking system was stable in the majority of cases, with informal deposit insurance adding to that stability.

The next section goes over some implications or contributions that the historical case of the Chettiar banking system makes to the literature.

4. Implications

Dowd (1994) provides the concept of a 'banker's club', a voluntary association among member banks that would regulate and provide clearinghouse services. He sharply differentiates between this concept and the services of a government central bank in an economy. In a free market, banks would have the incentives to voluntarily come together and form a club that would then regulate certain key aspects of banking. Dowd (1994) lists three possible benefits to such an association: the benefits of reducing monitoring and transactions costs, benefits of help against bank contagion and the benefits of external reserves. The club would most likely be in the form of a clearinghouse, where member banks would pay a fee and partake of the services and regulatory structure. Regulation would only pertain to key

[12] The Report of the Ceylon Banking Commission ,1934 is unavailable to me at this point. It is hoped that once I am able to access it, the precise details of the 'Chetty Crisis' will become much clearer.

features such as organizing clearing of notes and checks against counterfeiting (Dowd 1994). A central bank, in contrast, is not a voluntary institution but an imposed one and has historically regulated banks in a more extensive way, contra Gorton and Mullineux (1987) who argue that the extensive banking regulation that exists today arose as a spontaneous response to the problems of asymmetric information inherent in banking. Their contention is that the extensive amount of regulation of banks by ways of capital requirements, reserve requirements, accounting standards, exposure restrictions would all exist even in the case of voluntary clearinghouse clubs.

The Chettiar banking system seems to provide strong support for this notion of a banker's club. Their self-regulatory systems provided for clearinghouses, interest rate setting and informal deposit insurance. Beyond that, other banking decisions related to matters such as account keeping, risk-taking or adequate reserves were left to the judgement of the owners themselves. This pattern validates Dowd's (1994) prediction of voluntary associations regulating on key matters only as opposed to the extensive regulation of banking undertaken by central banks.

Economists interested in free banking have extensively studied the problem of note-issue or money supply under competition. The Chettiar banking system provides little to no evidence of note-issue being prominent. Deposit receipts issued in return for deposits made never circulated and thus never became money substitutes. While their bills of exchange were widely used for financing trade and transferring money across places, there is no evidence of them circulating beyond the realm of traders, merchants and bankers who were familiar with them. There is some scant evidence of hundis issued by parent bankers being held by some Chettiars, uncashed as substitutes for liquidity, hence performing a monetary function (Rudner 1994). However, the focus of banking in the Chettiars' case was the provision of credit, not note-issue.

5. Conclusion

This paper presents the case of a self-regulated banking system operating in nineteenth century India. It was shown that ‘indigenous’ banking in the Indian context is also banking free from any government regulation. The Chettiars are but one of many indigenous banking communities that evolved and existed for several decades before the rise of the regulatory State in the twentieth century. Thus, studying their banking practises offers a look into a purer instance of ‘free-banking’ and sets it apart from other historical cases of free banking (Dowd 1992), where government was involved in some way or the other.

Their regulatory mechanisms of interest rate setting, clearinghouses, information sharing and informal deposit insurance resemble closely the services of a ‘banker’s club’. These crucial services allowed for the smooth functioning of the banking system and added to its stability. It was also pointed out that the Chettiar banking system does not give evidence of competitive note-issue, the primary reason being that their ‘notes’ never gained the status of money substitutes. Thus, one is not able to offer new evidence for stability under note-issue. Whether or not and to what extent the Chettiars kept fractional reserves is an interesting question that comes up since interest was paid on all deposits including checkable ones. Preliminary investigation of the primary sources suggests that they did and also suggests a completely voluntary setting. How the keeping of fractional reserves interacted with the inability to create new money (substitutes) is also an interesting question, all subject matter for further research.

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