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The political economy of banking regulation: interest groups and rational choice in the formation of the Swedish banking system 1822–1921

Anders Ögren

Department of Economic History, Lund University School of Economics and Management, Lund, Sweden.

ABSTRACT

We studied the implementation of banking regulation in Sweden from the origin of the commercial banking system until the important Banking Act of 1911. We also looked at the effects of these regulations. We found that regulations were often influenced by banker interests rather than by macroeconomic rationale, to the extent that banking legislation was an endogenous part of the banking business. Regulatory regimes that were rule-based (non-discretionary) and open for competition by providing clear and general benchmarks for establishments were more beneficial for financial and economic development than more protective and discretionary legislation. On the other hand, protective and discretionary legislation went hand in hand with bankers having greater influence on legislation.

KEYWORDS

Corporate governance; crises; note issuance; Parliamentary debates

JEL CODES:

N13; N23

Introduction

We know from the literature on finance and growth that regulations and enforcement are of the utmost importance for a well-functioning financial system (see for instance Rousseau & Wachtel, 1998; Rousseau & Sylla, 2003, 2005), and this was also the case for Sweden in the nineteenth century (Ögren, 2009). There will thus always be a need for financial and banking regulations. As highlighted by Rajan & Zingales (2004), some of these regulations are in fact necessary to counteract monopolies and lock-in effects that, in the interest of the dominating agents, may lead to less efficient financial and banking systems; however, this implies that active agents have incentives to affect financial regulations, which challenges the idea that regulations (legislation) are externally imposed upon the market agents by legislators as third parties. In the USA, bank owners were part of the legislative process, both directly as politicians and indirectly as a powerful interest group, allowing them to exploit competition over legislative influence between the federal and the state level of jurisdiction (White, 1982).

CONTACT Anders Ögren  anders.ogren@ekh.lu.se  Department of Economic History, Lund University School of Economics and Management, Lund, Sweden

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This leads to the question of the extent to which banking legislation is driven by an overall economic rationality versus the self-interest of various individual groups, and the effect of regulations on the organisation of the banking system, and as an extension on the economy in general. In this article we study the legislative process in Sweden during the period from the inception of the commercial banking system in the 1820s until the enactment of the important Banking Act 1911.

Sweden is an important case for study, as its commercial banking system was an integral part of economic modernisation and must in most respects be deemed to have been quite successful (see for instance Hansson & Jonung, 1997; Ögren, 2009). Sweden was one of Europe's latecomers in terms of economic development, but there are several important lessons to be learnt from the Swedish case, from both historical, and current issues of financial and economic development. The commercial banking system was built from domestic needs and did not involve foreign bankers or banks. The development of the banking system was not a linear process, however, nor was its success in any way given. We are thus interested in the kind of regulations that seemed to be more important for financial and economic development, and also how they came to be implemented. As in many countries, financial and economic development went hand in hand with increased representation (democratisation). Our objective is to know how the regulatory framework was built, why it changed and how it was related to the process of democratisation and economic development. We wish to find out if this banking development was indeed what the regulators had in mind to sustain financial and economic development, or if regulations were the offspring of struggles and compromises between different interest groups. Also how increased representation changed the influence of different interest groups. To do so we study charters, decrees, laws and regulations on banking as well as the parliamentary debates surrounding them. We also examine some broad measures of banking development to analyse the financial consequences of different legislations.

We have identified three distinct periods—or regulatory regimes—and one period of transition between two regulatory regimes. We found that when bankers were directly involved in the legislative process they would indeed create a banking system that benefited them, with high barriers to entry. Compromises were used when necessary, depending on the political power of the interest groups. Political power was manifested in the ability to set the agenda concerning regulations, and to decide which options were available. When political power shifted, so did the regulatory regimes. Each banking crisis was a window of opportunity for those opposing the regulatory regime to call for fundamental regulatory changes. The period when bankers had the least influence on banking regulations meant a less discretionary regulatory regime with transparent rules for bank establishment, and increased competition—this period coincided with strong financial and economic development.

Theoretical approach

One problem when studying regulatory processes involves the reason for their implementation. In the perfect world of economics it can be assumed that the most efficient regulations are established. In reality, however, inefficient regulations may well be established as a result of different groups' rent seeking behaviour. Analysing such unproductive, or even destructive,

business practices has become an important part of modern business history (Brownlow, 2015; de Jong, Higgins, & van Driel, 2015).

As a result of rent seeking the actual reasons for implementing regulations are often obfuscated by rhetoric, as the self-interests of the legislators are not accepted as legitimate arguments for the implementation of regulations. Our main issue is to understand the rationale behind the regulations, as part of an overall economic rationality or as part of the interest group's own rationality (self-interest). This makes it necessary to employ a rational choice approach to our study. More specifically, the methodology used is a formal logical reasoning along the lines of game theory, inspired by 'Analytical Narratives' (see Bates, Greif, Levi, Rosenthal, & Weingast, 1998, 2000, as well as Brownlow, 2015). We are thus adopting institutional theory and rational choice with bounded rationality as analytical tools, which is a useful way to study complex institutional processes.¹

As different interest groups often have opposing interests, we need to determine the forces behind the regulations. An interest group may also call for regulatory changes that seem to oppose their rationale, or are logically inconsistent. To understand why this happens, we need to understand the context. There are two main reasons why choices that may seem irrational and logically inconsistent are in fact rational in a given context:

First, there are different levels of influence of different interest groups. This involves the distribution of power. One tool used in their struggle to increase their pay-offs was the power of the actors to set the agenda. This power is of great importance in all collective decision making situations, and has received more attention in political science than in economics (see for instance Dahl, 1989). When analysing collective actions, which of course are crucial when dealing with regulations, the question cannot be limited to who stands to gain; it is also necessary to determine who has the power to establish an institution. Once rational choice is accepted, it no longer follows that institutional changes necessarily represent a quest for greater economic efficiency (as is often the case in institutional economics). Instead, those in control of the agenda are likely to establish parameters that will ensure that collective decisions do not deviate far from their own preferences. Less influential groups will be left to support their best available option, not what would provide them with the overall highest pay-off. In short, the division of power, and thus control over the agenda, deprives large groups from striving for their optimal choice. Utilising control over the agenda allows the actor to define the rules of the game, and hence to affect the pay-offs of all other actors. It is when the division of power between interest groups changes (for various reasons) that the ability to set the agenda shifts between interest groups. In relation to such shifts we see important regulatory changes that affect the regulatory framework for longer periods. Linked to the importance of setting the agenda is the idea of 'regulatory regimes', as each such regime is based on the overall political landscape at the time. The basic definition of a 'regulatory regime' is that the elements of regulations and supervision concerning the financial system points in a general direction (see Forsyth & Notermans, 1997; Larsson, 2010; White, 2009). Not surprisingly, these regulatory regimes are linked to the overall political landscape, as the parliament of the four estates according to the 1809 constitution affected power relations in one way for the first period, whereas the decision in 1862, and the following implementation of a two chamber parliament in 1866, changed these relations. The period between 1897 until 1911 was a period of transformation as a result of the consolidation of

the two state powers; the Crown (Government) and the Parliament, which eventually ended with the enactment of the 1911 law.

Second, agents may belong to several interest groups, where there may be conflicting interests. An obvious example is that Members of Parliament from the same Parliamentary group may not share the same views on financial regulations if they are bank owners or bank clients, or creditors or debtors. Agents can also be active in multiple arenas, and pushing for (or opposing) regulatory changes in one arena may affect the pay-offs in other arenas. In cases of multiple arenas, agents can be involved in a greater, overarching rule-determining, game. Such situations requiring rational choice involving multiple arenas are referred to in political science as 'nested games' (see Tsebelis 1988, 1990). The question of banking regulation has to be studied as a nested game which affected, and was affected by, such issues as the constitution, which for instance influenced the monetary authority (Bank of Sweden), and so on.

Setting the rules of the game

Originally, the two state authorities, the Crown (i.e. the government) and Parliament, were two separate agents (or interest groups) fighting over influence and often with rival interests. An example involves control over the national bank, the Bank of Sweden. From its establishment in 1668 until the end of the nineteenth century, the Bank of Sweden was owned and operated by Parliament, and was carefully insulated from any influence by the Crown. Its autonomy from the Crown was demonstrated during the political turbulence of 1809. On 12 March, King Gustav IV Adolf requested increased funding from the Bank of Sweden to pay his rioting troops. The Bank of Sweden, however, refused to provide the King with any funds in excess of those approved by Parliament. Before the day was over, the King had been forced to abdicate (Skogman, 1846:1, pp. 4–5).²

As the King had been forced to abdicate, a new constitution was launched in 1809. This was based on the formal division of power between the Crown and the Parliament. The Crown was vested with executive power, but financially the new constitution made it totally dependent on Parliament in accordance with Article 54, which gave Parliament the exclusive right to impose taxes. Article 72 endowed the Bank of Sweden and thus Parliament, with the sole right to issue legal tender bank notes, or in the words of the constitution: "notes that may be as coins admitted". The Crown's principal constitutional target was thus Article 72, as it guaranteed Parliament absolute control not only over the Bank of Sweden, but also over note issuance and credit facilities (Montgomery, 1934, pp. 13–15; Skogman, 1846:1, pp. 80–83). Article 89, which provided that the Crown could legislate on economic matters without parliamentary interference, seems to contradict these provisions, but its practical importance was unclear.

In addition to the rivalry between Parliament and the Crown, which was illustrated by the quest for control over the Bank of Sweden, the period up to 1866 Parliamentary representation was divided into four Estates: the burghers, the clergy, the nobility and the peasantry. According to the constitution of 1809, agreement among three of the four Estates was required to pass new legislation. The King could deny accepting the legislation when it was passed by Parliament, but this risked creating hostility in Parliament, and as Parliament could launch an act of impeachment against the King, this could be a risky strategy.

The 1809 constitution was heavily tilted in favour of the nobility to the extent that it is possible to talk about regulatory capture. Not only did votes of the nobility count twice in each Parliamentary committee responsible for preparing the legislative proposals, the chair was also a representative of the nobility. The peasantry, on the other hand, was not allowed to take part in such committees at all. Most Cabinet Ministers, representing the Crown as government, were also taken from the nobility. As can be expected after a King has been forced to abdicate, the new King Karl XIII (the uncle of Gustav IV Adolf) was chosen by Parliament (or more specifically by the nobility) and thus had little leverage on his own. The same was true for his successor, a certain Jean Baptiste Bernadotte who was brought from France by the nobility and adopted as heir by Karl XIII. He was later crowned in 1818 and given the name Karl XIV Johan.

In 1817, in relation to the recent Napoleonic war, the existing agents on the credit market—the ‘discount companies’ failed, virtually extinguishing the formal credit market. All that remained was the Bank of Sweden, with its single office in Stockholm. Since Parliament had complete control of the Bank, and thus of the formal credit market, it acted to increase its influence by instructing it to open offices in Gothenburg and Malmö. The lack of credit, especially in rural areas, also led to the right to establish local Savings banks, after the Scottish and English model of Parish banks. C. D. Skogman was a driving force, who had been given the mission to investigate the implementation of such savings banks in Sweden by Parliament. His report was published in 1819 and the first savings bank was established in Gothenburg in 1820. Even though the savings banks quickly multiplied in numbers, and in many cases acted more as commercial banks than as philanthropic saving institutions, Parliamentary debates about them were less intense than would become the case for the commercial banks. This may have been because there were fewer limitations on establishing savings banks, and due to the fact that savings banks did not have the right to issue notes—as became the case with the commercial banks. The importance of savings banks for Swedish financial and economic development should not be underestimated, however, and by the latter half of the nineteenth century, MPs who were in favour of freedom for commercial banks would at the same time start to argue for limiting the freedom of savings banks, out of fear of their competition (as seen below).

Political debates on commercial banking legislation

In 1822, the King appointed a committee to study the future of the Swedish monetary system and credit market. This action was justified by the unsatisfied demand for credit, but it was already clear at the outset that it was part of the struggle for influence over the credit and money market. The timing was not a coincidence, as it was made in relation to a quest to readopt the silver standard. The argument was that a return to the silver standard also required support from the Crown, why the Crown wanted to be given influence over the Bank of Sweden (BaU 1823 Vol No 20 pp. 243–289, KProp 1823 Vol 1 Bilaga, pp. 347–439).

The King’s proposal did not succeed, but two members of the nobility advocated the authorisation of private commercial banks in the same Parliament. The right to issue banknotes was presented in the proposal as a necessary requirement for funding banks. Even if this private right to issue bank notes was to become one of the issues around which most conflicts of banking regulation were centred, its inception was not controversial, and

debates on the issue were limited (PrAd 1823, Bilagor Vol. 2 pp. 198–204, Vol. 1 pp. 977–988). The generally positive attitude towards the establishment of private banks with the right to issue notes had its roots in the deplorable state of the credit market. As a result, the peasantry and the clergy were eager to support any measure that would increase the supply of rural credit. Wealthy individuals were also attracted by the prospect of investing in the emerging, if currently unstable, credit market. The only Estate where a number of members expressed opposition to the establishment of private banks issuing notes was that of the burghers, where the proposal nonetheless was adopted. The opponents represented the existing capital market as merchant houses, or private bankers who were involved in making private loans. Private banks, especially if they were allowed to issue notes, would be unwelcome competition for these lenders. The conflict over the right to issue notes and the Bank of Sweden's constitutionally protected exclusive right to issue notes was mentioned, but not taken further (PrAd 1823 Vol. 3 pp. 57–58, Vol. 6 pp. 1069–1073, Vol. 10 Part 1 p. 454, PrAd Bilagor 1823 Vol. 2 pp. 640–642, Vol. 3 pp. 5–16, Vol. 5–6 pp. 533–537, PrBd 1823 Vol. 5 p. 705, PrBg 1823 Vol. 4 pp. 18–21, Vol. 6 p. 443, PrP 1823 Vol. 5 p.8, Vol. 7 p. 344).

The nobility dominated the Standing Committee on Supply, which stated that the proposal did not in confer any new rights on the founders of private banks. Since the right to establish chartered companies already existed in civil law, no special legislation was required. The proposal thus became implemented as a Royal Proclamation in 1824 under Constitutional Article 89—that is as part of the Crown's responsibilities. The nobility allowed commercial banks to compete with the Bank of Sweden (although the nobility dominated the Board of the Bank as well) because to control commercial banks when there was an important deficit in credit supply was more beneficial than channelling credit through the Bank of Sweden, where ownership was divided between the Estates, and where 50% of the profit had to be handed over to the Government. This also explains why the nobility chose to put banking legislation in the hands of the Crown and not through Parliament. It would put the nobility in control of the charters, and it was more likely that the three other Estates would unite against the nobility than that the Crown plus three Estates would do so. In practice this solution thus allowed the nobility to set the agenda concerning banking legislation.

Because the banks were to be given a partial exemption from the usury law's limit of six percent interest by being allowed to deduct one year's interest in advance, it was argued that the Crown should issue charters for no longer than ten years and should approve the proposed company regulations. Like all other businesses, these banks would operate with unlimited owner liability (RdSkr 1823 No 346, StU 1823 Vol. 3 No 315).³

Discretion and regional banking monopolies, 1831–1841

As these unlimited liability commercial banks (ULBs) started to be established in the early 1830s, the question of the type of banking system that would best serve the public interest became the subject of extensive discussion in the parliamentary gatherings. There was a clear division between the nobility and the peasantry: the nobility advocated high barriers for entry but no restrictions on note issuance, nor any prescribed conditions for note redemption. The reason given for the high barriers to entry was that it was 'for the common good', by assuring the stability of the banks. The nobility thus proposed not only a high equity capital minimum but also a high minimum level for individual share holdings (PrAd 1834/35

Vol. 1 p. 256–258, vol. 2 pp. 79–82, Vol. 11 pp. 53–55, Vol. 12 p. 54, pp. 175–179, Vol. 16 pp. 268–314, Vol. 20 pp. 289–405, 445–502, Vol. 21 p. 8, Vol. 22 pp. 65–67, 174). ‘The logic was that without the high minimum level for individual share holding the principle of unlimited liability was useless, or, as one nobleman put it: ‘... if a hundred paupers united to establish a bank...’⁴ (PrAd 1834/35 Vol. 16 p. 269).

In contrast, the peasantry argued that an excessively high equity requirement would prevent a sufficient number of banks from being established. While agreeing that the right to issue bank notes was a prerequisite for successful bank operations, the peasantry supported a minimum note denomination. They argued that the proclamation of 1824 should be widened to deal with the basis of note issuance, to establish minimum denominations and to permit twenty-year granting charters instead of ten (PrBd 1834/35 Vol. 8 pp. 440–456, 477–480, Vol. 10 pp. 158–181, Vol. 11 p. 141). The peasantry also met the argument of the nobility with reference to ‘the common good’, claiming that if a bank is useful for a region with one million in equity capital, it is also useful with half that amount (PrBd 1834/35 Vol. 8 p. 451).

Most opponents of the private banks continued to be found among the burghers, as many of them were already running banking businesses (PrBg 1834/35 Vol. 7 pp. 221–304, Vol. 9 pp. 376–437, 462–465, 569–571, 636–706, Vol. 10 pp. 63–69, 252–260). In time, many burghers would also become owners of ULBs, which is why this Estate would become the most divided on these issues. The clergy, who, like the nobility were tax receivers, viewed the right of ULBs to issue notes in relation to the ability of the Bank of Sweden to maintain convertibility, as a depreciated currency would be costly for them (PrP 1834/35 Vol. 13 pp. 567–596, Vol. 14 pp. 31–79, Vol. 17 pp. 293–481, Vol. 19 pp. 124–126).

As an example of setting the agenda, the nobility, which dominated the Standing Committee on Banking, managed to make the four Estates agree on a proposal that largely resembled their own original proposal. That meant no limitations on note issuance but keeping both the barriers to entry and the ten-year charter period (BaU 1834/35 Part 2 No 2, No 4, No 7, RdSkr 1834/35 Part 1 No 348). All this was in line with the Nobility’s interest, as it would maintain their control over bank establishments. A prolonged charter period, as proposed by the peasantry, would be more beneficial for bank owners. Renewing a charter was complicated and costly, as the bank had to settle all its liabilities before applying for a new charter. On the other hand, allowing longer term charters increased independence from those granting the charters, who could otherwise deny new charters as unwanted competition.

The extensive debates delayed agreement until 19 May 1835. Proclaiming that the bill was delivered too late, the King rejected it, even if he approved laws settled by Parliament on 20 May (Kprop 1834/35 Part 2 No 8, Montgomery (1934, p. 30), Skogman (1846, p. 2, pp. 26–34, 36). In the closing speech of Parliament the King expressed his wish that it should be more supportive of the ULBs (Kprop 1834/35 Part 2 No 9). New bank charters were approved in 1836 and 1837, increasing the number of ULBs from two to six.

As the number of ULBs grew so did the debates on their regulation, as the rural population carried most of the costs of their note issuance. In the following 1840/41 parliament, members of the peasant estate argued that individuals holding only ULB notes had been fined by the tax authorities for not being able to pay their tax in the required, but unavailable, Bank of Sweden notes. The peasantry still did not question the right of ULBs to issue notes,

but wanted the notes to be accepted for tax payments (PrBd 1840/41 Vol. 1 pp. 244–246, 516–518, Vol. 7 pp. 225–246, Vol. 10 pp. 401–430, Vol. 12 pp. 110–112).⁵

The nobility did not support the acceptance of private bank notes for tax payments, however (PrAd 1840/41 Vol. 1 pp. 314–315, vol. 3 pp. 193–206, Vol. 4 pp. 333–345, Vol. 12 pp. 225–263, Vol. 20 pp. 396–437, 458).⁶ Given their enthusiasm for such note issuance, and since accepting them for tax purposes would increase the value of, and demand for these notes, this stand seems inconsistent, but as part of a ‘nested game’ where the outcome in one arena affected outcomes in other arenas, the response was rational: as recipients of tax payments the nobility insisted on payment in the generally accepted and convertible Bank of Sweden notes.

The members of the clergy were closely attuned to rural problems, which meant that they saw ULBs as good, since they challenged the monopoly of the ‘Capital City’s money aristocracy’.⁷ On the other hand, as the ULBs often seemed unable to redeem their notes, the best solution would be a Bank of Sweden takeover. Such a course of action would also have the benefit of redirecting the profits of banking to the state through the Bank of Sweden (PrP 1840/41 Vol. 7 pp. 94–139, Vol. 12 pp. 411–418). Once again, the burghers were divided between those who argued that the creation of ULBs violated the constitution, and those who maintained that the private banks had helped alleviate the shortage of credit and means of payment, and every detail in the proposed banking legislation had to be voted on separately (PrBg 1840/41 Bilagor pp. 287–288, Vol. 1 pp. 566–575, Vol. 4 pp. 402–420, Vol. 6 pp. 229–241).

As had been the case in 1834/35, in 1841 all four Estates agreed on legislation concerning private note issuing banks (RdSkr 1840/41 No 358). The proposed banking law of 1841 was presented to the King, but once again it was rejected for being delivered too late (KKS, Kprop 1840/41 Part 2 No2, RdSkr 1840/41 No 6).

As these legislations included clauses that decreased the freedom of the bankers, such as minimum denominations, it is likely that the nobility used its influence over the Crown to deny the legislation. In this way the nobility could use its influence over two arenas; the government and parliament. The Crown could also maintain some leverage in the struggle for influence over the parliamentary-owned Bank of Sweden.

Towards a state-controlled banking system: Credible and non-credible threats 1842–1855

Debates on note issuance grew to be very harsh. Not only had the King repeatedly refused to sanction bank legislation passed by Parliament, large groups of MPs had been unhappy with the note issuance of the ULBs, as well as with their large profits. The opponents of ULBs considered the Crown’s granting of charters to be an unconstitutional and inequitable distribution of valuable monopoly privileges.

The confrontational strategy pursued by the Crown by refusing to sanction the law proposals caused Parliament to pass an act of impeachment (*Riksrättsåtal*) against the government (Nilsson, 1981, p. 26). As a ‘nested game’ there was a perceived possibility of altering the institutional design and thereby affecting the agents’ pay-offs. The original stake, control of the credit market, was expanded to include the overall power of the King.

Thanks to support from the nobility, the prosecution failed, but it is evident that the threat of losing power was seen as credible by the King. Instead of continuing to lean on the influence

of the nobility, the King backed off and compromised with the opponents of private banks. As a result of this, the Crown and Parliament (with the exception of the nobility) were in agreement about the creation of a largely state-controlled banking system for a few years. At an 1842 Cabinet meeting, the King presented a memorandum concerning private banking. His vision was to replace the ULBs with banks only partly privately owned and dependent on the Bank of Sweden. These Bank of Sweden branches would have a maximum of 50% private ownership, and would operate with credit from the Bank of Sweden. The obvious time to introduce this new system would be when the existing ULB charters expired in 1847 (KKS pp. 10–15).

The future looked rather gloomy for the supporters of the ULBs, but the plan proposed by the King was never put into practice. External circumstances dramatically altered the situation, as King Carl XIV Johan died in 1844 and was replaced by Oscar I—who did not view dethronement as a credible threat. Instead, at Parliament in 1844/45, the nobility proposed the Banking Law of 1846 through its control over the Standing Committee on Banking, and it was accepted by the Crown. The Crown completely ignored the legal proposal that was agreed upon by the other Estates, and extended the Crown's exclusive right to act with regard to private banks. It also, with the official argument that banking business should be 'of use for the Country', maintained the regulatory strategy of combining discretion and heavy barriers on entry, with important freedoms to run a banking business once a charter was received. At the end of the debate within the nobility, an MP dryly remarked: 'I would like to take the liberty to point out that the liveliness in the vocal voting probably emanates from those with an interest in private banks.'⁸ (PrAd 1844/45 Vol. 10 p. 590)

Apart from the nobility, parliamentary criticism of the ULBs note issuance and large monopoly profits remained. The burghers wanted to sharply increase the minimum denomination of private bank notes, while the clergy and peasantry wanted to put an end to the ULBs altogether. The peasantry presented a series of apparently contradictory proposals, as the very same motion suggested that ULB notes should be accepted for tax payments and that the ULBs should be eliminated (PrBd 1844/45 Vol. 3 pp. 220–222, 425–460, PrBg 1844/45 Bilagor pp. 60, 241–242, PrP 1844/45 Vol. 1, pp. 377–398).

The 1846 law was more or less a summary of the pre-existing bank charters. The main focus of the law was the backing of the ULBs' note issuance (for more details see Ögren, 2006). The law however ended such practices as owner's promissory notes, and the bank's own or other ULB notes as backing for note issuance (Post & Inrikes Tidning 1835–1847, for instance 21 March, 29 April 1835, 9 March, 26 April 1836, 2 February, 9 May 1843).

Discretion and the rise and fall of the filial branch banks, 1855 - 1863

The changing policy of the Crown was not well met by large groups within Parliament, who maintained the goal of eliminating the ULBs. Two possibilities for replacing ULB notes in circulation were presented. The first was to simply let the Bank of Sweden increase its note issue, but the silver standard limited this possibility. The other was to establish private banks relying on Bank of Sweden credit, inspired by the original proposition by the King in 1842 (BaU 1850/51 Part 1 No 43, No 65). As a result, the right to form a new kind of commercial bank, the *Filial Bank* which would operate on Bank of Sweden credit as a kind of privately owned Bank of Sweden branch bank, was pushed through, despite the nobility's complaint that they were guaranteed subsidised loans from the Bank of Sweden and thus received state support (PrAd 1850/51 Vol. 8 pp. 153–167, Vol. 9 pp. 82–83, PrBd 1850/51 Vol. 2 p. 63, PrP 1850/51 Vol. 8 p. 125, PrAd 1856/58 Vol. 4, p. 147).⁹

The Crown could not stop the proposal for the filial banks without provoking large parts of Parliament. Instead the Crown seized the power over the issuance of Filial Bank charters as well, and this was exploited to further limit their competitiveness by reducing the grants decided on by Parliament. The Crown also prevented them from engaging in deposit financing with the conspicuous reasoning that it was impossible for them to compete for deposits due to the already high interest rates. With reference to the destabilising nature of competition, charters for filial banks were not to be issued for cities where a ULB was already in operation (Nilsson, 1981, pp. 72–73).

Initial funding in Bank of Sweden credit was allocated for the establishment of three such banks, but within a few months eight applications had been received, all competing for the same pot of funds (Brisman, 1934, pp. 113–119; Montgomery, 1934, p. 34). Over a period of eight years, a total of nineteen *filial banks* were established despite very limited funds (12 ULBs issued four times as much in notes as the Bank of Sweden credit that was allocated to these 19 filial banks (Ögren, 2003, pp. 285–287, Sveriges Riksbank, 1931, pp. 21–23). The unanticipatedly large number of filial bank applications is the best evidence that the banking market was by no means over-established. Against the intent of Parliament, but as a result of their limited funding and probably in line with the Crown's preferences for the ULBs, the filial banks came to function as important distributors of ULB notes (Montgomery, 1934, p. 33; Nilsson, 1981, p. 56; RdSkr 1850/51 Part 2 §§ 25–29).

In 1857 an international financial crisis hit Sweden, which came to be a window of opportunity for pushing for legislative changes. During the crisis, the Bank of Sweden supported the credit market by acting as a lender of last resort which brought it to the brink of abandoning convertibility. Facing a run for note redemption, the largest bank of the time, *Skånes Enskilda Bank*, had to be saved from bankruptcy by state intervention (Ögren, 2007).

In Parliament, opposition to the rescue operation was centred among the peasantry, now citing the legal rule that no private bank could expect help from the state. The financial crisis of 1857 may not have been sufficient to force the supporters of the ULBs to agree to revisit the legislation on banking, but the crisis in conjunction with the increasing pressure for a reform in Parliament that would increase the representation of groups that tended to be ULB opponents changed the potential for the ULB supporters to confront these groups (PrAd 1856/58 Vol. 2 p. 326, Vol. 4 pp. 143–157, PrBd 1856/58 Vol. 1 pp. 233–239, 253, 345–346, 386, PrBg 1856/58 Bilaga pp. 252–259, 277, RdSkr 1858/60 Part 1 Vol. 2 No 260). The 1862 Parliament also voted to adopt a new constitution from 1866. This constitution ended representation in relation to the Estates and introduced a two-chamber parliament (Nilsson, 1969). The new election process for the second chamber had the effect of decreasing the representation of the groups that traditionally had the privilege of taxation (the clergy and the nobility) and instead increasing it for those who paid taxes (burghers and especially the peasants). Thus the nobility faced the end of their strong regulatory influence and the new constitution forced the ULB supporters to become more open to compromises.

Rule-based banking and banking expansion, 1863–1897

In the same Parliament of 1862/63 which decided on the representative reform, a new law concerning ULBs, which included many features previously demanded by the peasantry was passed and sanctioned by the Crown (SFS 1864:31). It stated that ULB notes should be

exchangeable for Bank of Sweden notes or specie at their main office. Although they were given the option of delaying such an exchange for six months, such an action would result in an interest penalty of six percent per annum. These rules were incorporated as a way of forcing the banks to redeem their notes on demand—prior to this there was no official rule that protected the note holders (SFS 1864:31 §§27–28).¹⁰ The opponents of private bank notes also succeeded in imposing a 0.2% tax on the issuance of ULB notes.

Most important were the changes concerning the barriers to entry for the ULBs, since they ended the discretionary practices associated with granting bank charters. The previous, costly process of renewing the charters of existing banks now became a mere formality, as long as the basic requirements were fulfilled (Davidson, 1931, pp. 147–150; Montgomery, 1934, pp. 36–37; SFS 1861:34 §15). The regulations had now changed to make bank establishment easier, but included more regulations about the way the banks could conduct their business.

The defenders of the ULBs and opponents of the filial banks were not left empty handed; it was decided that no further Bank of Sweden credit was to be extended to these banks in line with the nobility's interest. As a consequence the filial banks disappeared as their charters ended, and quite ironically most of them were reformed into, or acquired by, ULBs. The law on usury that had hampered the ULB's business was also effectively abandoned from 1864.

The Crown continued to keep some control over banking legislation. In 1863 the Crown issued a proclamation accepting the charter of the first Limited Liability Bank (hereafter LLB) to be established in Gothenburg in 1864 (SFS 1863:59). A second LLB was formed in Stockholm in 1871, and a total of ten were established by 1875. The LLBs were not allowed to issue notes but they did have the right to issue bonds to fund their business. Given the earlier debates on the ULBs, this move by the Crown probably went unnoticed because it did not include note issuance.

Although important bankers also became MPs, they were less influential in Parliament than had been the case before the representative reform, with the result that banking issues were not debated to the same extent and not nearly as intensely. New legislation concerning the ULBs was enacted in connection with the change from the silver to the gold standard in 1873 (SFS 1874:44). This was largely a matter of adapting the law of 1864 to the gold standard by officially forcing the banks to hold gold instead of Bank of Sweden notes—a change which had no effect in practice (Ögren, 2006). This shift in banking legislation did not spark much debate in Parliament, not even the decision to prepare for an ending of the ULB's smallest denomination notes of 5 and 10 SEK, which emphasises the small influence the proponents of ULB notes had in Parliament (RdSkr 1879 No 52, SFS 1874:44).

Late in 1878 a banking crisis hit Sweden. As had been the case with the crisis in 1857, the 1878/79 crisis again provided a window of opportunity to attack the ULBs and especially their right to issue notes. It was the important Stockholm Enskilda Bank that had to be saved by state funds, paradoxically because it to a very limited extent issued notes. The difficulties of the bank resulted in a run on deposits instead of a run on note redemption (Ögren, 2007). What this crisis actually demonstrated was that the banks that issued notes were no more vulnerable to runs than the banks relying exclusively on deposits. The Special Committee on Banking of 1883, which was instigated by the Crown as a result of the crisis, nevertheless again recommended that the Crown should have some degree of influence over the Bank

of Sweden in return for a monopoly on the issuance of notes (Bankkomitén 1883 p. III, BaU 1881 Part 2 No 1, RdSkr 1881 No 50). No such agreement was reached, as Parliament was not prepared to hand over influence over the Bank of Sweden to the Crown. It is clear that opposition to the ULBs' note issuance remained, however, as Parliament continued to successively increase the tax on private bank note issuance from the original 0.2% to 0.3% in 1887, 0.5% in 1892 and finally to 1.0% in 1893 (RdSkr 1887 No 49, 1892 No 98, 1893 No 45, SFS 1861:34 §15).

Another decision taken during the 1879 crisis year was to force through the ending of the issuance of the 5 SEK notes, to be effective on 1 January 1880. The Bank of Sweden would ease this change by making credit available for the ULBs. At this point in time the ULBs circulated approximately 14 MSEK in 5 SEK notes—to be compared with the Bank of Sweden's total note issuance of 31.6 MSEK. As a result the Bank of Sweden was given increased note issuing rights (Ögren 1995, pp. 38–40). The timing was questionable from an economic point of view, but it again illustrates the strength of pressure in Parliament against ULB note issuance.

As they were under attack, the owners of the 24 ULBs met in November 1879, and decided to launch the Syndicate of the ULBs (today the Swedish Bankers' Association). The association was formed in 1880 and this meant that the owners of the ULBs saw that it was necessary to create an arena outside of Parliament that could coordinate and push for their interests.¹¹

In 1886, the Crown again proposed alternative legislation concerning both commercial banking and the Bank of Sweden, in case private note issuance was to cease—again based on the Crown acquiring influence over the Bank of Sweden (BaU 1886 Part 2 No 1, No 2, No 4, Kprop 1886 Part 1 Vol. 2 No 27, No 28). One offspring of the legislative debate concerning ULBs was the enactment of a law concerning LLBs. Until 1886 the establishment of LLBs had been based on individual charters that were granted by royal proclamations. The 1886 law on LLBs summarised the charters of these banks, as had been the case for the ULBs in the 1846 law (SFS 1886:84). The lack of debates surrounding the LLBs may have been because these banks were still in a minority, but it may also have been because they lacked the right to issue notes and thus did not openly conflict with the interest of parliamentary owned Bank of Sweden. The enactment of an LLB law did not change the basis for establishing such banks, and did not lead to an imminent surge in the establishment of LLBs (see [Figure 1](#)). Instead the quick increase in LLBs in the mid-1890s was again caused by regulatory changes as the ability of savings banks to invest their funds was largely limited by law in 1892 (Larsson, 2010, p.178; Lilja, 2010, pp. 52, 56). Commercial bank-owning MPs, who actively worked for the freedom of the ULBs, just as actively worked to limit the freedom of the savings banks. Many savings banks thus chose to re-form as so-called Folkbanker, a form of local LLB that more closely resembled savings banks but that were categorised under LLBs.

In 1896, the Crown again proposed an end to private bank note issuance, together with joint control of the Bank of Sweden. This time Parliament agreed to amend Article 72 to permit a Crown appointee to serve as chairman of the seven member Bank of Sweden board (SFS 1897:27). With this change, the opponents of the ULBs' right to issue notes finally succeeded in eliminating this right, and the Crown, which had supported the ULBs' right to issue notes but had been blocked by the Bank of Sweden, finally managed to gain influence over the Bank of Sweden. This compromise is a clear illustration of the consolidation of the two state powers that took place in the nineteenth century.

The consolidated state and bankers' special interests, 1897–1911

Removing the Crown's quest to gain influence over the Bank of Sweden, changed the game for influence over banking legislation. The two main parties were now the legislators (policy makers) and the legislated (the bankers), but by joining the legislators, the bankers again gained influence over the legislative process.

The Banking Act of 1897 revoked the right of the ULB banks to issue notes from 1903, and required their notes to be totally out of circulation by 1906. In practice this meant that ULBs and LLBs were now only different as far as the forms of ownership were concerned. As a result, a new banking act was enacted in 1903 that targeted both LLBs and ULBs. One feature of the law of 1903 was that it allowed two different levels of required equity capital, whereas banks with smaller businesses only needed equity capital as small as one-fifth of the requirements for bigger banks. On the other hand, capital requirements benefited larger banks (Håkansson, 2009, p. 49; Larsson, 2010, p. 175, SFS, 1903:101).

The 1907 crisis fitted into the pattern that crises were a window of opportunity for regulatory change. A temporary parliamentary committee was instigated to solve the problem. Several leading bankers were part of the committee that resulted in the extensive Banking law of 1911. The focus was to ensure a stable banking system, where stability and size went hand in hand. Many features of the first law in 1846, as well as prior charters, were present in the law of 1911. First and foremost, the use of bank charters regulating the banks' businesses was again implemented, as was the original mandate that the banking business should officially 'be of use to the Country'.

As the quest for larger banks limited the potential for future competition, the Swedish Bankers' Association supported this suggestion. Together with the bankers on the committee, they also successfully promoted the idea of the commercial banks' right to trade with shares in relation to the revision of the banking legislation in 1911. If the bank in addition held six times the required equity capital of one million SEK (approximately 54,500 GBP), they were allowed to trade with shares (Larsson, 2010, pp. 174–176). It should, however, be noted that the basic equity requirement was quite modest, including 90% of all banks.

The minimum equity capital for small, local banks was also raised from one-fifth to half the requirements for all commercial banks. The number of commercial banks, which had already started to decrease due to the 1907 crises, started to fall even more rapidly following the change in regulation, although the size of the commercial banking sector in terms of turnover, lending and public liabilities rose (see [Figure 3](#)).

The 1911 law further stipulated that banks should hold funds that covered at least 20% of all deposits. Seventy-five percent of those could be in the form of bonds and at least 25% should consist of legal tender cash reserves. In reality this meant that deposits should be covered to five percent by legal tender, but the Banking Act of 1911 did not prevent bankers from altering regulations when it started to limit their business opportunities. When the continuing boom during WWI, along with inflation, stretched the commercial banks' abilities to cover their deposits to the extent the law required, the law was amended in 1917 so that banks holding five million SEK (five times the required equity capital) did not have to comply with the deposit limits (Håkansson, 2009, pp. 49–53). It was also the bankers who pushed through their design for the toxic asset fund that was adopted in relation to the crisis in 1921/22 (Ögren, 2017). It is clear that the policies and their

amendments favoured big banks, and given the obvious political influence of the active group of bankers behind these policies, it seems as if their interest really was taken as ‘being of use to the Country’.

The legislative effect on the Swedish commercial banking system

Most important for the development of banking until the 1860s were the limitations on entry along with the freedom that the (few existing) banks had in how they could conduct their business. As seen in [Figure 1](#), the banking system had a slow start. This has been interpreted as showing that demand for bank credit was low (Flux, 1910). This was not at all the case: instead there were political and regulatory reasons behind the slow development. The filial banks that existed for a short period are in themselves evidence of the under-established banking system and their acknowledged ‘failure’ was also due to political reasons and over-regulation which affected their ability to fund their business.

The LLBs that emerged in the mid-1860s were few but important, and operated mainly in the cities. These did not have the right to issue notes. The rapid increase in LLBs from the mid-1890s was again caused by regulatory changes favouring the establishment of smaller LLB banks. The 1892 law turned many savings banks into small local LLBs (Folkbanker). As a result the number of commercial banks almost doubled between 1895 and 1906 (from 44 to 84); bank assets and lending followed suit. The decision to revoke the ULBs’ right to issue notes in 1897 (effective from 1903) was important, as the note-issuing ULBs were the dominant form of commercial banks, measured both in number and in total assets.

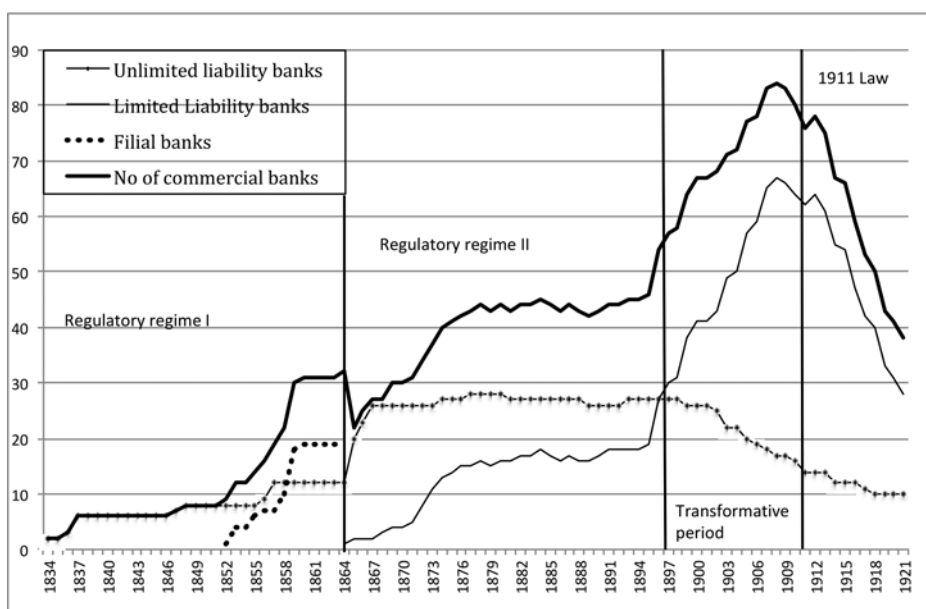


Figure 1. No. of Unlimited Liability, Limited Liability, and Filial Banks, 1834–1921.

Sources: Brisman (1924), p. 245, Brisman (1934), pp. 219–221, *Ekonomisk Tidskrift* 1899–1933, *Sammandrag af Bankernas Uppgifter, 1871–1911*, Sveriges Riksbank (1931), pp. 172–185.

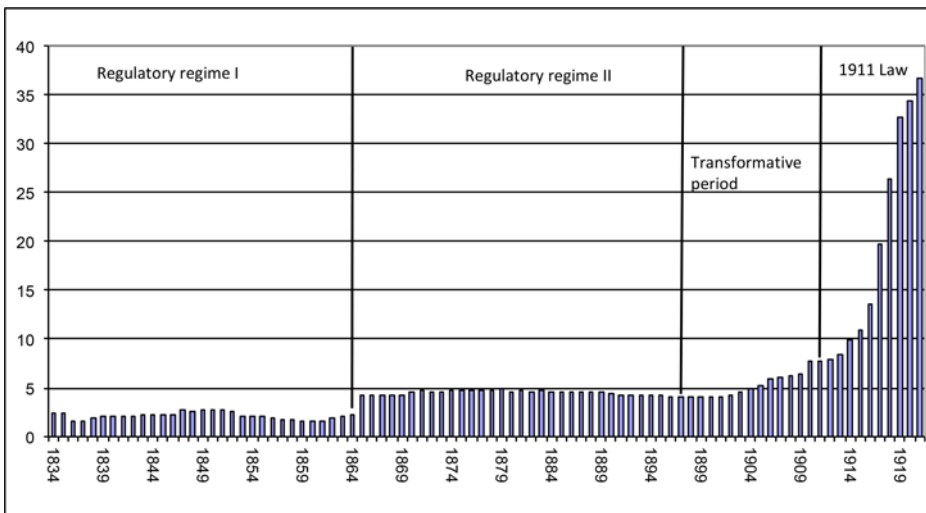


Figure 2. *Branches per Commercial Bank, 1834–1921.*

Sources: Brisman, (1924), p. 245, Brisman (1934), pp. 219–221, *Ekonomisk Tidskrift 1899–1933*, Lilja, (2010), p. 46, *Sammandrag af Bankernas Uppgifter, 1871–1911*, Sveriges Riksbank (1931), pp. 172–185.

One important part of a developed banking system is the use of branch banking. Branch banking has important effects as it allows banks to diversify their investments as well as their liabilities. Despite this, branch banking has been considered unsound and, especially in the history of commercial banks in the US, was subject to extensive regulation (White, 1982). In the Swedish case we can see (Figure 2) how the idea that banks should operate in their own territory, a kind of regional monopoly, was expressed, at least until the early-twentieth century. Before this branches consisted mainly of exchange agents whose sole purpose was to redeem the ULB notes for Bank of Sweden notes (Ögren, 2006).

The average of more than four branch offices per bank from 1870 and onwards may indicate a more positive attitude towards branch banking. The reason for the leap is surely the ending of the filial banks, which either chose to reform as independent ULBs or to merge with existing ULBs. There was a huge increase in branch banking in the late 1910s, along with a decline in the number of commercial banks. This was a result of the extensive merger and acquisition (M&A) movement that took place within commercial banking during the 1910s and early 1920s. This M&A movement was an effect of the economic trends in conjunction with the new banking law of 1911, which increased the influence of the main banks (Jungerhem & Larsson, 2013).

As seen in Figure 3 below, the development of the commercial banking system took off in the mid-1860s. Its growth continued until it halted and dipped during the late 1880s. A new wave of banking establishment took place in the mid-1890s (as seen in Figure 1), which rapidly increased the size of the commercial banking sector. Lending to, and deposits from, the general public followed suit in the expansion until the late 1880s. From then on a larger portion of the commercial banks' lending began to be funded by means other than the issuance of public liabilities, such as retained earnings or loans from other sources. This gap between lending and deposits was around 50% in the early 1910s.

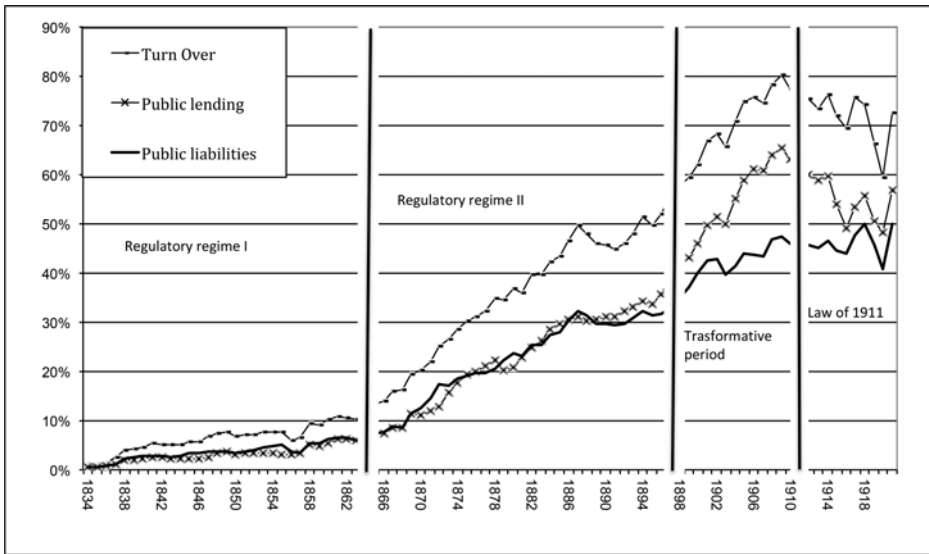


Figure 3. Public Lending, Public Liabilities and Turn Over in Commercial Banks, 1834–1921 in Percentage of GDP (Market Prices).

Sources: Brisman (1934), pp. 219–221, Ekonomisk Tidskrift 1899–1933, Krantz and Schön, (2012), Lilja, (2010) p.46, Post & Inrikes tidning 1835–1871, Sammandrag af Bankernas Uppgifter, 1871–1911, Sveriges Riksbank (1931), pp. 172–185.

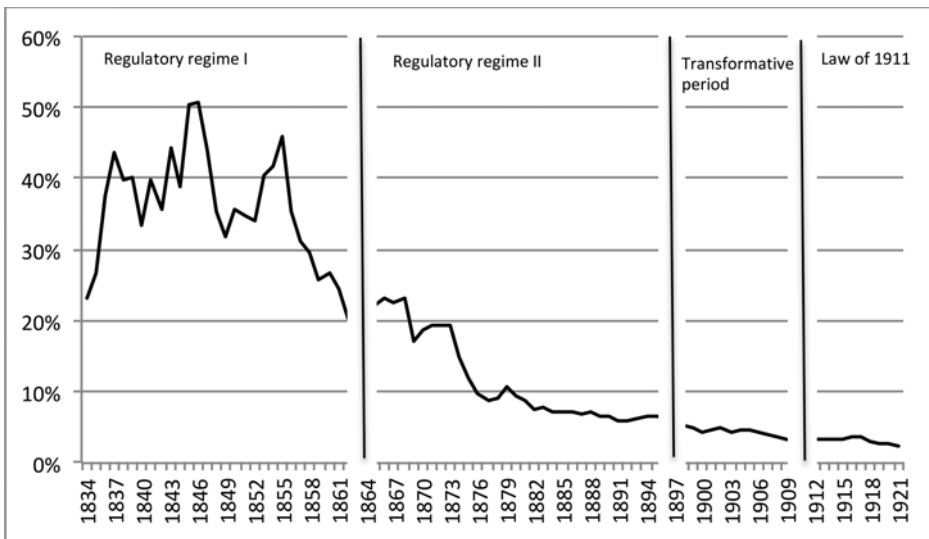


Figure 4. Legal Tender Cash Reserves in Percentage of Public Liabilities (Deposits and Notes), 1834–1921

Sources: Ögren (2003), pp. 282–287, Ekonomisk Tidskrift 1899–1921, Post & Inrikes tidning 1835–1871, Sammandrag af Bankernas Uppgifter, 1871–1911, Sveriges Riksbank (1931), pp. 172–185.

If we look at the riskiness of the banking system in terms of legal tender cash reserves in relation to public liabilities (notes and deposits) (Figure 4) we can see that reserve holdings were most important during the first period, which contained fewer banks. This was because charters from the beginning, and the later laws (1846, 1864, 1874), all stipulated the same

legal tender reserve backing for note issuance, whereas deposits were never subject to such regulations. Consequently, the more the ULBs substituted deposits for notes, the fewer reserves they needed to hold. The capital requirements that were implemented with the law of 1911 did little to increase holdings of legal tender reserves. By the end of the period, however, banks held cash reserves at a level of around two to four percent of public demand liabilities (notes and deposits).

Conclusions

The period 1831–1922 can be divided into three distinctive regulatory regimes directly related to the division of power between different interest groups. This was manifested in the possibility for strong groups to set the agenda concerning banking regulation. The first period, 1824 to 1863, was when the nobility dominated parliament, as well as the cabinet of the Crown. Through their constitutional control over the agenda they implemented a regulatory regime where they could control the banking establishment, which meant high barriers to entry, complicated charter rules (including for their renewals), discretionary rules, local monopolies, and few responsibilities for the way the banks managed their business. This regulatory regime combined high profits for those who managed to establish banks, with high costs for bank clients and the holders of bank liabilities (notes). Despite important opposition to this regulatory regime and its economic and financial consequences, it was not changed until parliamentary representation was about to change, dramatically decreasing the influence of the nobility.

Increased representation by the groups in parliament who carried the costs of the commercial banks' monopoly privileges, in conjunction with the fact that the largest bank had to be bailed out in the 1857 crisis, drove a change in the regulatory regime. 1864 was a hallmark year in the move to a developed commercial banking system. Bank establishment became a matter of following certain specific non-discretionary criteria and the prolongation of bank charters was formalised in a way that ended their disruptive character. The commercial banking system grew steadily in the 1864 to 1900 period. Criticism of the ULB's note issuing made Parliament both limit note issuing rights and tax note issuance, showing that the ULB opponents were setting the agenda. The interest of commercial bankers was no longer coordinated in Parliament, and as a result the bankers organised themselves outside Parliament with the outspoken aim of defending their interest and affecting legislation.

Throughout the period the Crown's control over the charters of the ULBs was used as leverage to gain influence over Parliamentary-controlled Bank of Sweden. It took, however, until the adoption of the law of 1897 before the Crown gained access to the Bank of Sweden by being granted the right to appoint the chairman of its board. This law also revoked the right of the ULBs to issue notes. It is unlikely that this compromise could have been reached if the ULB supporters still dominated the political arena. This change illustrates the consolidation of the state, ending the competition between the Crown and Parliament.

The crisis of 1907 again called for a revision of banking regulation. The regulatory package in 1911 was a trade-off between the state and the representatives of the major banks, who had been present in the law committee. The upside for the bankers was that competition was curbed, as the bank establishment (again) became subject to charters under the fuzzy statement that banks had to serve 'the use of the Country', and that they received the right to trade in shares. The disadvantage was that capital requirements were implemented, but

banking interests were strong in their influence over not only the regulations themselves, but also their interpretation and enforcement to their advantage.

Notes

1. 'Our use of rational choice and game theory transforms the narratives into analytical narratives.' (Bates, 1998, p. 12).
2. This started a rumour that the King had tried to gain control over the Bank of Sweden.
3. Thus, the decision to give note-issuing banks unlimited liability had nothing to do with their right to issue notes, as has been proposed (Jonung, 1989).
4. '... om 100 trashankar förena sig om att inrätta en bank ...'
5. When voting on the legislation, the majority of the Estate supported the right for private banks to issue notes, with 82 for and 14 opposed (PrBd 1840/41 Vol. 421). The peasantry again stressed the necessity of note issuance for private banking in such a poor country as Sweden.
6. Regarding the possibility of paying taxes with private bank notes, the nobility dominated the Standing Committee on Supply and argued that private bank notes were to be considered as IOUs issued by any company, and thus could not be viewed as legal tender (StU 1840/41 Part 2 No 143).
7. Clearly this barb was directed at the merchant lenders among the Stockholm burghers.
8. 'Jag vill ta mig friheten att nämna, att lifligheten i ropen torde komma ifrån privat-banks-intresset.'
9. The system of filial banks was close to the original suggestion made by the King in 1842, and the suggestion made in Parliament as a response on how to solve the question of a banking system if private note issuing banks were to end in 1844/45. Most of the members of the peasantry had also approved this suggestion (KKS, PrBd 1844/45 Vol. 3 pp. 434–449).
10. Thus, these features were not implemented to protect the gold holdings of the Enskild banks as a result of the banking law of 1874, as has been suggested (Flux, 1910, pp. 61–63; Jonung, 1984, pp. 371–372).
11. The Swedish Bankers' Association is still actively involved in legislative debates.

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 PrFK – Första Kammarens Protokoll (1866). – 1898. [Minutes of the First Chamber].
 PrP – Presteståndets Protokoll (1823). – 1865. [Minutes of the Clergy]
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