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CHAPTER 10: EPILOGUE

The hong merchants have long had a reputation as wealthy men. In the late 1600s, the poet Chu Dajun wrote of silver “piling up” in the thirteen hong. Customs taxes collected from their trade were a key part of the revenues of the imperial Court in Beijing, representing 38% on average of the so-called “surplus quota” taxes that were directed to the Imperial Household Department (*neiwufu*) during the period 1796 to 1821. The Department viewed Canton as a “rich” post, and sent indebted officials there as an opportunity to restore their fortunes and pay off debts to the state. The hong merchants lived well. Some supported large extended families, had magnificent houses and gardens, and collected books and art,¹ practices which caused foreign creditors to sputter. Summarizing the Canton scene, a French trader stated that “The Mandarins wanted tranquility in their nation and the [hong] merchants opulence in their homes.”²

The hong merchant of the port of Canton, China was one of the first great international brands. That brand was marketed both as an image and as a reputation for value and creditworthiness. The image is familiar today, in the form of the august portraits of Chinese businessmen that were brought home by or were sent to trading partners worldwide, and in anecdotal accounts of the munificence of hong merchants. Through the years 1780 to 1842, the trend in hong merchant portraiture is toward grandeur. The austere style of earlier portraits gives way to a more magnificent, colorful and Western presentation. The actual trend of hong merchant fortunes in this period was instead one of decline, with the notable exception of Howqua II, who was growing more wealthy. The trend in portraiture runs contrary to economic reality. The portraits are somewhat misleading -- or perhaps the appropriate word is aspirational. They present grand images of hong merchants in the success they hoped they would attain, but largely did not.

To Western traders in the eighteenth and nineteenth centuries, these painted images were of almost no consequence. Hong merchants built up their high standing with trading partners through commercial reliability and daily practices which assured that value was delivered to the customer. The Canton trade functioned efficiently, as a whole, and on those rare occasions when teas turned out to be bad on delivery in the West, hong merchant sellers gave full credit to foreign buyers, even years after the original sale. The collective guaranty by the entire hong merchant body of the foreign debts of its members, in particular, was important to the Western trading community. It meant that for many years any hong merchant's promise to pay was rock solid. The commitment of a hong merchant could be relied upon anywhere. As Joshua Forman stated in 1829, “the bond [i.e. the promise to pay] of a Hong merchant has acquired a credit over the whole world, not exceeded by that of any other security.” For all the value the foreign traders found in the collective guaranty, it was not a promotional feature that the hong merchant guild either sought or desired. It was imposed, and strictly enforced, by the Chinese government as part of a regulatory system that sought to maintain security in and tax revenue flow from an enormous foreign trade upon which China had become dependent. The Canton Guaranty System assured that the licensed hong merchants



Figure 12. A hong merchant.
Oil portrait by Spoilum, painted ca. 1800. (Private collection. Photograph by
courtesy of the Martyn Gregory Gallery, London.)

of Canton paid their foreign debts in full and made good for any problems in trade.

The Canton Guaranty System yielded significant benefits for the parties involved. The collective guaranty raised foreign confidence in the ability of the hong merchants to perform their commitments. This served both Chinese and foreign interests in stabilizing the foreign trade from Canton. In modern times, similarly, the public good is seen as advanced by bank deposit insurance, which discourages citizens from keeping money in mattresses, and also by automobile insurance guaranty funds, which decrease uninsured driving.

In daily practice, the Canton program was understood to mean that the financial commitments of guild members would be fulfilled. This contributed to an international brand image of equal strength – and honor – among all of the hong merchants. For the Chinese state, and for foreign creditors, it minimized the amount of effort that had to be devoted to debt collection disputes and thus made the trade the more efficient. As designed, it advanced the Confucian ideal of maintaining harmony in trade. It may have accomplished this objective in some cases in the short term, but over time the growing amount of undischarged debt damaged many surviving firms and yielded a final bounty of disharmony. The system had a funding mechanism – the *hangyong* tax – that might have covered creditor claims had the Chinese state abstained from taking these tax revenues from the Consoo Fund. Without independent existence, or interested local parties able and willing to defend it, the fund proved powerless to protect its assets from the needs of the state and of the guild members who ran the fund. By helping the most frail perform their imprudent contracts, and fostering a global image of equal creditworthiness (“not exceeded by that of any other security”), the collective guaranty contributed to a misleading appearance of hong merchant wealth. The hong merchants had good commercial reasons to join in building that image, as the appearance of strength gave them status in the marketplace and attracted foreign customers. Opulent lifestyles, plus grand images in portraits sent to the West, supported a gilded image. Unfortunately, in many cases the image of wealth was founded on little more than the equation of (a) being able to pay large expense bills on a regular basis with (b) being rich.

The economic reality of hong merchant existence was utterly different. In his study of hong insolvencies, Kuo-tung Ch'en concludes that most of the hong merchants “labored under incessant financial difficulties.”³ Their situation was “particularly bad” between 1760 and 1843. As he states,

“During that period, thirty-seven Hong merchants closed business. . . . Of that thirty-seven, only two retired with substantial fortunes. Four disappeared from all accounts without notice. Eight were closed down by the local authorities on account of their incompetence or infringement of laws. Three stopped business upon their death. The remaining twenty merchants were publicly declared bankrupt. These bankrupts were always heavily indebted to the foreign traders, the government, as well as to their own countrymen who either provided merchandise for them or lent them money.”⁴

Hong merchant insolvency was “not only common but also perennial.”⁵ Ch'en set out to find its causes, examining, among other things, the profitability,

capitalization, borrowing and expenses of hong firms. During the nineteenth century, by Ch'en's estimate based on British EIC records, the total import and export business of the entire hong merchant body averaged more than ten million taels (\$13,888,889) annually, or roughly one million taels (\$1,388,889) per hong.⁶ His examination of each of the principal lines of hong merchant business -- their trades in tea, woolens and cotton -- indicated basic profitability in these areas,⁷ but also a nagging problem of capitalization.⁸

Few of the hong merchant firms had the money they needed to do business on the scale in which they were engaged. They took high interest rate loans from foreigners, or found other precarious ways to raise funds, out of necessity because credit was not available from domestic sources.⁹ Ch'en finds that, on average, the hong merchants carried heavy expenses in running their businesses, in making the deposits for tea purchases required by inland suppliers, in supporting extended families, in high living, in paying the debts of failed hong merchants, and in paying frequent demands for money by the Canton officials.¹⁰ While these averaged expenses largely consumed the merchants' averaged profits, Ch'en found exactions by the Canton officials to have been particularly harmful.¹¹

Continual *ad hoc* demands by Chinese governmental bodies and officials for the payment of discretionary fees, known as *kejuan dashui*, are familiar throughout Chinese history. These exactions have attained recent prominence as part of an answer to a question posed by William C. Kirby in 1995 -- Why have mainland Chinese been so reluctant to do business in the form of a corporation with statutory limited liability?¹² In their solution to the "Kirby Puzzle," J. Ray Bowen II and David C. Rose pointed to government exactions as the primary cause. As they explain,

"the practice of *kejuan zashui* has the effect of making the government, and not the firm owner, the residual claimant on any private firm's income. This makes public trading of privately owned shares too risky, effectively depriving PPCs [privately owned, publicly traded corporations] of their principal advantage over other firm governance structures in China. As a result, all significant economic activity is driven into either state-affiliated enterprises or highly secretive family firms."¹³

A climate in which exactions by government were uncertain, or, worse yet, increased when the firm seemed to be doing well, trained generations of Chinese business owners to be cautious when dealing with government. Scholarship has related these demands to an "obsession with secrecy" in the Chinese family firm, to business activity tending to be coordinated by relationships rather than by contracts which might require government involvement, and to a preference for business operation in family form.¹⁴ The record shows that the hong merchants were frequently required to pay discretionary fees, in the nature of *kejuan dashui*, and also that there was little trade information that they could keep secret from the government. To the extent they engaged in legitimate trade, for example in allotted shares of the tea contracts of the British EIC, the Canton officials could easily track their business, and officials were able to adjust their "expectations" to the conditions of the moment.¹⁵

At Canton, the expenses analyzed by Ch'en outstripped the operating profits and capital of most of the hong. While records indicating the original capital of the hong are rare, such records as have been found indicate that such capital tended to be meagre.¹⁶ Once a hong merchant found himself in need of money, as Ch'en explains, he

“was in fact thrown into a vicious cycle, in which he was constantly compelled to raise funds with all kinds of methods detrimental to his own interest. When his indebtedness increased and his imminent need grew, he was obliged to engage in the detrimental practices in a much more extensive way than before. The insolvency of a Hong merchant then became chronic.”¹⁷

The ultimate causes of the many hong merchant insolvencies, according to Ch'en, were a lack of sufficient capital, poor financial management and official exactions. This toxic mix destroyed many of the hong and discouraged new merchants from joining the guild. The hong merchants became “a group of reluctant people whose capital and ability were always insufficient to carry on the enormous volume of their business. Their insolvency and ultimate failure, no doubt, was but a matter of course.”¹⁸

This insolvency analysis is incomplete, as Kuo-tung Ch'en admits. It is primarily based on British EIC records. These are only part of a commercial whole, of which the remaining records are largely missing. While Ch'en carefully probes various categories of hong revenues and expenses, his study necessarily relies on selected data. Business skill, experience, and luck varied considerably from merchant to merchant, and from year to year. Furthermore, trading results during the period 1780 through 1842 often depended on wars and international economic downturns over which the hong merchants had no control and of which they typically had little or no warning. Under these conditions, average data can be misleading. Just as the British EIC did two centuries earlier, Ch'en faults the hong merchants for poor management, but he fails to identify any corrective measures which, if taken, would have saved any number of hong from insolvency. The “incessant financial difficulties” under which the hong merchants labored from 1760 through 1842 indicate problems of a systemic character. Solving these problems -- within the rules of the Canton System -- exceeded the skills of virtually all of the hong merchants. These were experienced traders and some had considerable business talent. Accomplishing the revival of a financially troubled hong firm, within this system (including the scarcity and high cost of credit), would represent a challenge even to a modern business school graduate or turnaround management consultant.

Kuo-tung Ch'en identifies lack of capital as a chronic problem among the hong merchants, and there is abundant evidence that he is correct. Inadequate business capital was a problem from the early days of the hong merchant system through to its final years, in which several merchants found that they had no working capital left as of the first day they did business.¹⁹ In analyzing the financial plight of the hong, however, Ch'en does not factor in the repayment expectations of domestic sources of capital. This might follow from the fact that records of original or later investments in hong businesses are scant, but a paucity of investment evidence is not good cause to omit consideration of repayment. As Ch'en discusses,²⁰ and as Paul Van Dyke details in his new study of the eighteenth century hong merchants,

family alliances, joint ventures and partnerships were in common use among the hong merchants to conduct their growing trade with the West. While the details of such arrangements in the early nineteenth century remain unclear, there is no doubt that they existed. They may have been common. Whether characterized as equity or debt, or viewed as some hybrid of the two, or if the combination involved jointly held lineage property, the person or persons who advanced assets to a hong expected a financial return. To the extent such capital came from family or kinship sources, these demands weighed heavily on the affected merchants. If there was indeed no net income left after expenses, these hong merchants were in grave trouble already, for there were never going to be funds to provide a return on investment for sources of capital, let alone cash to set aside to save the business in an hour of need.

The Ch'en analysis avoids singling out particular culprits for the hong merchant insolvencies. He calculates profit on average, tallies up the various expenses of the hong on average, and concludes that little if anything remained after expenses in the average case. This analysis is accurate as far as it goes. It is certainly in accord with the limited available evidence. The Xingtai hong merchant Yan Qixiang thus explained, after the 1836 failure of his firm, that "In 1830, I began business with a limited capital; after deducting expenses of hanging out my signboard, beginning business, and buying packing houses and furniture, not a *cash* remained to me. In that year on account of the English ladies coming up to Canton, I was confined to prison for more than a month and found myself minus a lac of dollars [\$100,000]."²¹ The hong opened for business with no capital, and then, as if by a snap of the fingers, its net worth was transformed into negative \$100,000. So it was with the weakened hong of the later years. For these marginal firms, any material expense could become the straw that broke the proverbial camel's back. The problem, therefore, seems to lie on the expense side of the ledger.

With but one exception, the categories of hong firm expenses Ch'en reviewed and averaged are current expenses. Business operating cost, household expenses, and even ostentatious living, were all expenses that were paid in the year in which they were incurred. Taxes assessed by government, exactions demanded from individual hong by the Canton officials, and advances as security for future purchases of tea, were all, for the most part,²² payments of current year charges. Payments by hong merchants as their collective responsibility for the debts of failed hong, alone, represented the current payment of debts which had been incurred in the past. The fact that they were channeled through the Consoo Fund, and currently paid to foreign creditors from that source, does not alter the status of these payments as the weight of the past. Ch'en averages the total cost to the guild of collective responsibility for foreign debt at about 150,000 taels (\$208,333) annually.²³ This figure understates the true guaranty burden as the guild was also forced to pay the tax debts of failed hong to the state, much of which are unknown.²⁴ See Chapter Seven, Table One (list of debt assumptions including the amounts of unpaid taxes also required to be assumed, where known). In this instance the use of an annual average becomes truly misleading, for, as is detailed in Chapters Four through Seven above, the average annual burden of collective liability for foreign debt had increased steadily during the period 1780 to 1842. The initial average foreign debt assumption burden of the years 1780 to 1799 was 81,050 taels (\$112,569) annually. That average rose to 113,733 taels (\$157,963) annually between 1800 and

1814 (a 40% increase), to 123,214 taels (\$171,130) annually in 1815-1828 (an 8% increase), and then soared to 186,266 taels (\$258,703) annually in the *derniers jours* of 1829-1842 (another 40% increase). This increase trend is shown as a bar chart in Chapter Seven, Table Two.

The dead weight burden of the old foreign debt and tax obligations of failed hong steadily increased precisely as the overall financial health of the hong merchant body gradually declined. It may well be that thin capitalization and inadequate access to credit were ultimate causes of many hong merchant insolvencies, but it was the mounting burden of collective liability that pushed these firms over the edge. Ch'en fingers official exactions as an accelerant,²⁵ and rightly so, but it was the steady growth of the guaranty burden that undid the barely profitable economics of the hong merchant order. The old debts became combustible. The cash required to feed this mounting fire deprived the hong merchants of the money they needed to operate in the present and fund the future. The collective guaranty carried the debt conflagration into the surviving hong and many of them were consumed by it in their own turn.

Chapter One introduced the Canton Guaranty System in the context of the parallel financial crises of the year 1829. In that year, a collective liability regulation that was applied locally among the hong merchant guild at Canton became the inspiration for bank guaranty fund legislation that was enacted in the State of New York. The idea had been transplanted before, within China into the regulated salt and ginseng trades, and even in the thirteenth century from China into Russia. It was then transplanted again, from New York State to Washington, D.C., where it inspired national deposit insurance in the United States, and in turn from the United States across the world as large numbers of nations followed and adapted this 'American' innovation to meet local conditions.

The remarkable journey of this legal idea conforms with the model introduced by Alan Watson in 1974 in *Legal Transplants*. Watson states that "foreign law can be influential even when it is totally misunderstood."²⁶ In this case, the basic Chinese rule was understood, but its record in China was totally misunderstood. The New York legislature knew nothing of the troubled history of the Canton Guaranty System. As Joshua Forman states, the structure of the Chinese system was "modified and adapted" for use in New York. In other words, he found parts of the Chinese system unsatisfactory. This also conforms with Watson's model. "[A] time of transplant is often a moment when reforms can be introduced," as happened in New York. Watson quotes Jeremy Bentham:

"I would venture to lay down the following propositions: 1st, That the English law is a great part of it of such a nature, as to be bad everywhere: 2nd, But that it would not only be, but appear worse in Bengal than in England: 3rd, That a system might be devised, which, while it would be better for Bengal, would also be better, even for England."²⁷

Each stage of the reception of this venerable idea has proven to be, and has been taken as, the occasion for reform and adaptation to its new purpose. Watson also posits that "reception is possible and still easy when the receiving society is much less advanced materially and culturally."²⁸ New York State was a raw growing commercial power in the United States in 1829. Joshua Forman himself was a

developer, and his banking reforms were motivated in large part by development concerns. It may be argued that Canton was less advanced in 1780. However that may be, the conditions that existed in the Chinese ginseng business in 1739 (less than a century after the Manchu conquest) were certainly primitive. At every stage, as Watson teaches, the adoption of a legal transplant was eased because it was shown to have come from an authoritative source.²⁹ In 1829, the banking reform was based on a practice that was said to have achieved seventy years of success in imperial China and worldwide. The innovation was significant, involving the reception of an idea that sought to impose liability on a collective basis by a society that was already recognized as highly individualistic. As of 1933, it had been tested in numerous American states, and wanted only, so it was said, national implementation and a few more adjustments to operate with complete success. Since 1933, the idea of deposit insurance has been adopted in large numbers of countries, due, for the most part, to years of success enjoyed by the system in other nations. At each stage, the system was validated by its association with perceived success (or near success) in a context respected by the adopting society. At its source, collective responsibility for debt among the hong merchants of Canton was terminated in 1842, and its demise was mourned by no Chinese and by few if any foreigners. A century and a half later, a far more advanced system of risk sharing that grew out of this idea -- bank deposit insurance -- is thriving in transplanted and adapted form in many countries worldwide.

Three questions were posed in Chapter One about the idea that first inspired bank deposit insurance in the United States. First, was the Chinese idea of collective legal responsibility for debt accurately transmitted to the New York legislature in 1829? Second, was the actual experience of the Canton Guaranty System accurately transmitted to the New York legislature in 1829? Third, do either the Chinese idea of collective legal responsibility for debt or the experience of the Canton Guaranty System offer any lessons for contemporary bank deposit insurance? It was also asked, who won under the Canton Guaranty System, who lost, and why?

As noted above, question one is answered in the affirmative. The Chinese idea of collective legal responsibility for debt was accurately transmitted to the New York legislature. Joshua Forman provided a correct description of the basic practice of collective financial responsibility at Canton. His three sentence description is incomplete, but the missing details had no bearing on the idea that served as Forman's model. The security and tax collection duties of the hong merchants were omitted, but these components had no part in the Safety Fund Forman proposed. It is also possible, as Forman suggests, that his educated audience already knew the basic structure of the Canton System.

Question two is answered in the negative. The actual experience of the Canton Guaranty System for hong merchant creditors was not accurately transmitted to the New York legislature in 1829. It was certainly the view of some foreign creditors, in 1829, that the Canton Guaranty System was then a success -- that it had stood the test of experience for many years, and that under it "the bond [i.e. promise to pay] of a Hong merchant has acquired a credit over the whole world, not exceeded by that of any other security." Forman's bright view of the Canton Guaranty System contained two errors, one technical, the second profound. First, the Chinese system was not even fifty years old, as opposed to the seventy year pedigree Forman gave

it.³⁰ Second and more fundamentally, Forman failed to report the terrible financial condition of the hong merchants to the New York legislature in 1829. It is likely that he did not know of the crisis of that year, and newspaper evidence indicates that this news did not reach the general American public. There was considerable newspaper coverage of hong failures, and of payments of hong debts under the collective guaranty, but only a *creditor's* lesson was drawn from this news. The other hong merchants were paying old debts under the guaranty, and, by inference, all was well on the Canton waterfront. Joshua Forman was unaware of the degree to which the Canton Guaranty System contributed to the hong firm failures. This is an excusable oversight. Information on hong merchant finances was closely guarded in his time. The understanding we now have of the negative effects of the collective guaranty of debts is the fruit of modern scholarship, using source material which was largely confidential when these events occurred.

The third question is answered in the affirmative. Many of the tribulations experienced under the Canton Guaranty System are immediately familiar today. While the parallels to present day regulatory experience are imperfect, they can be telling:

(A) At Canton, the state-enforced collective guaranty system failed to anticipate, reserve for, or tax adequately to cover the foreign debt default risk that it was supposed to cover. For its part, modern bank deposit insurance has been criticized since its inception as not representing "true" insurance at all. This charge is based both on the fact that premiums are not assessed in actuarial relation to the risks involved and because collected premiums have proven inadequate to cover losses incurred.

(B) At Canton, a reserve fund -- the Consoo Fund -- was created but it was soon depleted and was then regularly drawn on by government for other purposes with the result that funds were not available to cover losses when hong failures occurred. While modern bank deposit insurance has not, to date, accumulated reserve balances in amounts large enough to attract the notice of government, these funds have often been depleted by losses, as in the Savings and Loan crisis in the United States, with the result that governments have had to advance additional monies to prevent deposit insurance funds themselves becoming insolvent.

(C) In China, as discussed in Chapter Three above (pages 55-56 above), strict protective laws were enacted in order to prevent loan losses that would have to be paid from the Consoo Fund under the collective guaranty. It was illegal for foreigners to make and for hong merchants to accept foreign loans. These protective laws were not enforced. Today, it is a popular if controversial view that many insured bank losses have resulted from illegal conduct. Prosecutions for violations of law that led to losses suffered in the financial crisis of 2007-8, for example, have been few.

(D) At Canton, as analyzed in Chapter Three above (pages 56-57 above), systemic disincentives existed which discouraged official enforcement of the existing protective laws. In modern times, disincentives to the enforcement of protective laws are more subtle, such as the existence of the "revolving door,"

whereby key persons are influenced by the prospect of subsequent employment by financial institutions, consulting firms, or even governments.

(E) Two centuries ago, as reviewed in Chapters Four through Seven above, foreign lenders made risky and imprudent loans to Chinese hong merchants, confident that the collective guaranty would protect them from the consequences. For their part, hong debtors repeatedly took desperate risks in the vain hope of returning to profitability. Today, such conduct may be recognized as examples of “moral hazard,” i.e., excessive risks taken when insurance coverage shields parties from the economic consequences of their actions.³¹ Contemporary examples of moral hazard include the imprudent behavior of some weak banks, which have attracted deposits by offering abnormally high interest rates or have made high interest rate loans to dubious borrowers, and also the laxity of bank customers when their deposits are fully insured.

(F) At Canton, when losses loomed, attempts were made to dodge the guaranty system. Such evasions, as in the Gnewqua II and Ponqua receivership of 1810, invariably ended badly. The Canton Guaranty System ended up bearing heavier losses accrued through the time of exposure. Some critics see attempts to evade bank capital requirements and national guaranty schemes in certain of the increasingly complex structures used in modern international banking. If that is true, such evasions ended badly in the financial crisis of 2007-8.

(G) Furthermore, something in the nature of a “too big to fail” policy was observed at Canton during the period 1780 to 1842. Its objective, as under the modern doctrine, was the protection of key firms whose continued operation was believed to be vital to the economy and to society. The Qing government, however, did not bail out firms that it believed were vital to the economy. To the contrary, “too big to fail” status (the modern term was not used) protected fortunate key hong firms from excessive exactions by government (*kejuan dashui*). The existence of a well recognized limit on how much money the state or its officials could extract from the hong is evidenced, for example, by the deferral from 1819 through 1839 on imperial approval of large amounts of taxes that were due to Beijing from the hong merchants. The government could easily have demanded payment of these taxes in full from the senior hong firms, but it avoided doing so out of concern that they would fail, and the entire Canton System with them.

In sum, a number of parallels exist between the experiences of the Canton Guaranty System and those of the modern bank deposit insurance programs.

The context is certainly very different between the foreign trade that was conducted at Canton in the eighteenth and nineteenth centuries and that of the operations of insured banks in the present day. Nonetheless, some problems experienced under the Canton Guaranty System anticipate, to a remarkable degree, problems of bank deposit insurance systems today. While the Canton system experienced heavy losses, and those losses are instructive, at least two factors that restrained risk taking in the 1700s and 1800s are largely absent today. First, debts under the Canton Guaranty System were incurred and were largely paid in the form of silver coin. Currency was valuable metal, not printed paper founded on public

credit and subject to added production in accordance with state needs. Hard currency could not be easily multiplied. Second, with the exception of the British East India Company, none of the parties who were involved in transactions covered by the Canton Guaranty System were limited liability entities. Almost all of the parties involved were individuals or partnerships subject to unlimited personal risk. Unlimited exposure restrained risk taking (in most cases). In the modern era, transactions that are covered by bank deposit insurance are often made among entities organized as one of any number of types of limited liability entities, often organized under the law of remote foreign jurisdictions. These barriers further separate the parties taking economic risk from the consequences of that risk. The Canton Guaranty System operated in a radically different environment.³²

Despite all of these differences, the historical record of the Canton experience offers valuable lessons to the modern world. These include: (1) that the tax that supports a deposit insurance fund must be based on an assessment of the risk of loss that the fund has undertaken to pay; (2) that the fund and its insureds must be subject to strong independent supervision; (3) that laws enacted to avoid risk contingencies must be enforced, with care taken to avoid any disincentives to enforcement of those laws; and (4) that both corruption and the diversion of premium revenues intended for the fund must be strictly prohibited. None of these controls were observed at Canton between 1780 and 1842. Perhaps most important, (5) bank deposit insurance funds must avoid the unlimited commitment to pay losses that was made under the Canton system. Unlimited coverage impaired the economic incentives for insureds to protect themselves. The mounting burden of unlimited liability for losses incurred brought the Canton Guaranty System and those exposed under it to the edge of ruin.

With respect to the last question posed at the outset of this study, it is easiest to identify losers. The hong merchants lost, weakest to strongest, from bottom to the top. The weight of old debt, undischarged and demanding full payment, was rolled forward by the guaranty and contributed to the failure of many surviving hong. There can be no doubt that various factors, such as official exactions, contributed to the large number of hong merchant insolvencies, but the ever increasing burden of collective liability for debt stands out as a leading cause of failure. It is difficult to conceive even of the "too big to fail" hong as winners, for at the end they were tapped to pay hong debts and other obligations after the Opium War. The details of how these funds were raised are unclear, but it is doubtful for example that the \$3 million that was paid to the British on 23 July 1843 was held as ready cash at that time. The asset liquidations that were necessary to raise these funds must have been painful even for the "successful" firm that was forced to raise cash at this difficult point in time.

It might be said that foreign creditor firms, the guarantee beneficiaries, were the clear winners under the Canton Guaranty System. With respect to the imprudent creditors, that is certainly the case. Some foreign creditors courted enormous losses and were spared from ruin by the collective guaranty. It seems remarkable enough that William Jardine exposed over \$2 million of assets of his own firm and its constituents in credit extended to the frail young Xingtai Hong. Yet more remarkable is the note of calm with which Jardine assured his London partner that this enormous sum would be paid under the collective guaranty.³³ Jardine was

absolutely right, and his claims were paid in full. As for the other foreign firms at Canton, including those firms which were more prudent extending credit, the answer whether they were “winners” is less clear. The British EIC had understood, from the dawn of the Canton Guaranty System, that a guaranty is never free. To the extent that creditor claims would be paid, payment necessarily came out of the trade, driving up costs, potentially narrowing profits, and increasing the ultimate cost to consumers in the West. Furthermore, capital that might have been profitably used elsewhere was locked up during the time period over which hong debts were repaid, without interest. These were not reasons to fail to take advantage of the system when it existed, to file and to demand full payment of claims, but they narrowed the creditor’s advantage at the end of the day.

In the 1930s, banker opponents feared that the adoption of deposit insurance in the United States would result in the entire banking industry being dragged down by careless practices. Shortly after the National Banking Act of 1933 became law, Professor Edwin W. Kemmerer of Princeton University warned of its consequences. In the new era,

“The bank with the loose credit policy gets the business and the bank with the careful, cautious credit policy loses it. The slack banker dances and the conservative banker pays the fiddler. If the conservative banker protests, the slack one invites him to go to a warmer climate. Soon all are dancing and the fiddler, if paid at all, must collect from the depositors or from the taxpayers.”³⁴

Kemmerer’s words were prescient in substance and in metaphor. The professor anticipated a now infamous statement by an American banker, made as the crisis of 2007-2008 set in. Citigroup was going to stay in the market for United States subprime loans. It intended to dance on. Chuck Prince, chief executive of Citigroup, stated in July 2007 that “When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you’ve got to get up and dance. We’re still dancing.”³⁵

The quotation from Kemmerer also provides a fitting epitaph for the hong merchants under the Canton Guaranty System. They failed in droves. Collective responsibility cast the debts of failed merchants onto survivors, many of whom failed in turn. The end of the China monopoly of the British EIC triggered a crisis of confidence in 1834, with foreign and domestic creditors wondering alike how the fiddler could ever be paid. Foreign eyes turned to the Chinese government, which had enforced the system of collective guaranty since 1780, to pay the massive sum the Consoo Fund and the hong merchants seemed unable to pay. The Opium War followed soon thereafter, an unpleasant echo of the British gunboat diplomacy that caused the Canton Guaranty System to be adopted in 1780, resulting in payment in full of all outstanding hong debts in July 1843. The metaphorical fiddler was paid by the Chinese state, which drew heavily from firms that had been considered, until this point, too big to fail.

Loss can be painful, as can be the recognition of loss. An unlimited guaranty can be painful as well, and its ramifications potentially disastrous. An unlimited guaranty delays or prevents the recognition of loss. More fundamentally, it delays or prevents the education -- the market discipline -- that should follow from every

instance of loss. Where undischarged, debt accrues interest and grows. Where an unlimited guaranty exists, that ever increasing burden is shifted to the guarantor. President Franklin Roosevelt expressed concern in 1932, at the dawn of bank deposit insurance, that the unlimited guaranty of bank deposits might prove "an impossible drain" on the national treasury. In the too big to fail era, unlimited guarantees of debt threaten to drag down banks, guaranty funds, and even national treasuries, the prudent with the imprudent. Professor Kemmerer saw the fiddler being paid, "if paid at all," ultimately by depositors or taxpayers. This has begun to occur. If private parties are not made to bear some material part of the burden of losses arising from their own insured transactions, then this process will continue. It is right to be concerned that at some future point, as unrecognized losses continue to be passed through to governments and taxpayers under state commitments of unlimited guaranty, that this burden will test mathematical possibility.

1 Ch'en, *Insolvency*, pp. 107-111.

2 " Les Mandarins veulent la tranquillité dans leur pays, et les marchands l'opulence dans leurs maisons." Letter from Michel à Rothe dated 31 December 1760, quoted in Dermigny, *La Chine et L'Occident*, Vol. 2, p. 835 n.2.

3 Ch'en, *Insolvency*, p. 251.

4 Ch'en, *Insolvency*, pp. 36-8 and Table 1.4.

5 Ch'en, *Insolvency*, p. 41.

6 Ch'en, *Insolvency*, p. 152.

7 Ch'en, *Insolvency*, pp. 43-88, 102-3 and 251.

8 Ch'en, *Insolvency*, p. 152.

9 Ch'en, *Insolvency*, pp. 162-177.

10 Ch'en, *Insolvency*, pp. 103-150.

11 Ch'en, *Insolvency*, pp. 136, 138 ("In the dissipation of the Hong merchants' profit, the rapacious demand of officials in fact played a more important part."), 139 and 251-2.

12 Kirby, "China Unincorporated," pp. 57-9.

13 Ray J. Bowen II and David C. Rose, "On the Absence of Privately Owned, Publicly Traded Corporations in China: The Kirby Puzzle," *Journal of Asian Studies*, Vol. 57, pp. 442-52 (1998), p. 450.

14 Bowen and Rose, "The Kirby Puzzle," pp. 445-6.

15 Cheong, *Hong Merchants*, p. 228 (discussing how the increased profits of the decade of the 1780s resulted in a "steep increase" in official exactions).

16 Ch'en, *Insolvency*, pp. 153 and 157; Van Dyke, *Merchants of Canton and Macao*, p. 177 (while "Chinese merchants kept detailed records of all their transactions, just like the foreigners, . . . none of the Chinese records have survived.").

17 Ch'en, *Insolvency*, p. 177.

18 Ch'en, *Insolvency*, p. 258.

19 See examples at pages 161-162 above.

20 Ch'en, *Insolvency*, pp. 160-2.

21 Greenberg, *British Trade*, pp. 66-7; Ch'en, *Insolvency*, p. 159.

22 Payment of substantial sums due to the Chinese government was deferred, starting in 1819, on Imperial approval, due to hong merchant inability to pay. The total arrearage owed to the state by the hong merchant body stood at 1,464,282.732 taels (\$2,033,726) as of 29 April 1839. Tsiang, "Government and the Co-Hong of Canton, 1839."

23 Ch'en, *Insolvency*, p. 147.

24 Ch'en, *Insolvency*, p. 95 ("the precise figures are rarely available").

25 Ch'en, *Insolvency*, p. 138.

26 Watson, *Legal Transplants* (2d ed.), p. 99.

27 Watson, *Legal Transplants* (2d ed.), p. 35.

28 Watson, *Legal Transplants* (2d ed.), pp. 51 (importance of "the lack of a strong native law and the absence of system.") and 99.

29 Watson, *Legal Transplants* (2d ed.), pp. 88 and 99.

30 Comprehensive regulations of the Canton trade were introduced in 1760, but collective responsibility for debt among the hong merchants only began in 1780.

31 "In the insurance literature where the term has its roots, moral hazard is defined as a situation where the provision of insurance increases the probability of the event being insured against, due to diminished incentives for the insured party to take preventive actions." Jun Il Kim, "Unconditional IMF Financial Support and Investor Moral Hazard," IMF [International Monetary Fund] Working Paper No. WP/07/104 (May 2007), p. 3.

32 See James Grant, "Requiem for the Dollar," *Wall Street Journal*, 5 December 2009 (discussing both of the factors discussed at the end of this paragraph), available at:

<http://online.wsj.com/article/SB10001424052748704342404574575761660481996.html>

33 Greenberg, *British Trade*, p. 70.

34 Flood, "Great Deposit Insurance Debate," p. 60.

35 Michiyo Nakamoto and David Wighton, "Citigroup chief stays bullish on buy-outs," *Financial Times*, 9 July 2007, available at:

<http://www.ft.com/intl/cms/s/0/80e2987a-2e50-11dc-821c-0000779fd2ac.html#axzz278Oae11X>