CIVILIZING CAPITALISM? THE BEGINNINGS OF CREDIT RATING IN THE UNITED STATES AND GERMANY

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Capitalism is intrinsically tied to risk and recurrent cycles of boom and bust. Despite this obvious and almost trivial observation, many people were surprised when the current financial crisis broke out in 2007. Capitalism has never been stable. On the contrary, it stands for dynamic change, “creative destruction,” and a never-ending series of bull and bear markets. The all-important question is how to deal with this Janus-faced system. The enormous dynamism of modern capitalism poses a fundamental dilemma: How can stability be imposed on an economic system that, by its very nature, destroys equilibrium and order? A look at the beginning of modern industrial society can be very helpful in searching for answers to this question.

This article deals with insecurity and distrust in anonymous markets and with ways to overcome these obstacles to economic growth. More specifically, it concentrates on the early history of credit rating and demonstrates how useful this new service was during the industrialization and globalization of the nineteenth century, although it entailed problems and dangers right from the beginning. This historical overview will focus mainly on the United States but will also draw a brief comparison to the German Empire, where credit rating played a much smaller role. The reasons for this striking discrepancy will be discussed. At the end, I will briefly address the question of why the rating agencies failed so blatantly in identifying the risks that brought about the post-2007 financial crisis. At the outset, an account of the challenges facing industrializing countries like the United States in the nineteenth century is called for in order to understand the institutional response that credit rating represented.1

I. Causes and Effects of Industrialization and Globalization

Industrialization unleashed productivity gains that changed Western societies beyond recognition. Six major factors contributed to the turbulent change.

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1 This essay, for the most part, maintains its original form as a lecture, and therefore dispenses with extensive citation of sources. I would like to thank Casey Sutcliffe and David Lazar for their help in polishing my English.
1. A revolution in logistics made for quantum leaps in connecting the nation and the world. Steam power substantially cut transport times. Railways reduced the cost of transporting heavy goods over land by some 95 percent and added greater speed and reliability. The once isolated regional markets for most products became parts of a huge unified system. A fast-growing national and international market emerged. This unprecedented integration brought forth the challenge of dealing with the increasing anonymity of exchange.

2. A revolution in communications took place. Historians long focused on the impact of the telegraph but have recently begun to place greater emphasis on the advances brought about by railroads and steamboats. In 1820, it took some 32 days for messages to cross the Atlantic from New York to London. By 1860, steam-powered ships had reduced that time to 13 days — before the telegraph succeeded in reducing it to two days and later to a few minutes. Compared to these drastic reductions, the changes effected by the Internet in relation to letters or faxes have been relatively modest.

3. An explosive growth in world trade occurred. Preindustrial trade tended to concentrate on luxury products with favorable weight-to-value ratios such as silk and spices. These constraints were shed after 1820 as ever larger ships carried grain, coal, minerals, textiles, and later machines and finished products that could be transported long distances at economically viable rates for the first time. Industrialization led both the supply and demand for tradable goods to grow. More people survived to an advanced age. In Germany, the average life expectancy for men rose from 27 to 45 years, and, despite mass migration, the population tripled. Meanwhile, people’s real income increased, particularly toward the end of the century. And on the supply side, the number of products grew continuously while prices sharply declined.

4. Capital markets became global. The large discrepancies in development between countries created lucrative investment opportunities for European surplus capital, particularly in the development of enormous tracts of hitherto uninhabited land. Because there were few restrictions, the international flow of capital swelled to previously unimaginable dimensions, increasing by 49 times from 1825 to 1913.

5. Labor markets became more international. Not only capital but also people were highly mobile. Relatively open borders made it easy
for millions to escape the poverty of their homelands. Migration reached inconceivable dimensions, with about 70 million people emigrating worldwide between 1850 and 1915. The lion’s share of this mass movement consisted in transatlantic migration from Europe to North and South America.

6. Deregulation of the economy. Generally speaking, industrialization and globalization went hand in hand with deregulation. Old rules were abandoned, or new technologies and market structures outgrew existing regulatory regimes. Liberalism emerged as the dominant ideology in Europe, which, likewise, spurred the removal of constraints on trade and production. People, capital, and goods were freely exchanged in this relatively open world, despite the reappearance of modest protectionism after 1880.

What were the consequences of this sea change? By and large, there was an increased division of labor and a growth in complexity. Both created a myriad of new uncertainties. The number of geographically distant people who had to cooperate with one another increased exponentially. For the most part, they lacked the shared values and regulatory systems that craftsmen in guilds or “honorable merchants” had relied on. Industrialization and globalization made business partners out of people who would never personally meet.

II. Trust as a Key Socioeconomic Category

For all these reasons, more and more businesspeople had neither good names to uphold nor any stake in the traditional rules and practices of preindustrial wholesale. What resulted was, essentially, a crisis of trust, as deceptions, breaches of contract, and failed shipments proliferated. Without trust a market economy cannot work.2 The word “credit” originates from Latin credere, which means to believe and to trust. Without it, economic activity simply grinds to a halt.

Sociologists have long understood the significance of trust. For Georg Simmel, it was a prerequisite of cooperation. Complex modern societies require a multitude of promises whose fulfillment is uncertain. In every exchange of goods, one party always makes itself vulnerable through advance action. The key question following every delivery is if and when the bill will be settled. The same goes for bank credits. Niklas Luhmann defined trust as a mechanism to reduce complexity

\[2 \text{ See Hartmut Berghoff}, \]
\[\text{“Die Zähmung des entfesselten Prometheus? Die Generierung von Vertrauenskapital und die Konstruktion des Marktes im Industrialisierungs- und Globalisierungsprozeß,” in Hartmut Berghoff and Jakob Vogel, eds., Wirtschaftsgeschichte als Kulturge-}
\[\text{schichte: Dimensionen eines Perspektivenwechsels (Frankfurt/M., 2004), 143-68.}\]
and to stabilize uncertain expectations. Trust makes the contingencies of modern society bearable and cooperation possible. The neglect of trust in mainstream economics results from the preponderance of neo-classical theory, which holds that the well-informed, rational *homo oeconomicus* does not need trust because he has perfect information at his disposal. This is theory at its worst: Real people in real economies always act with incomplete information.

As economists began to search for more realistic assumptions, trust received more attention. In his classic study *The Limits of Organization*, nobel laureate Kenneth Arrow referred to trust as a “lubricant of a social system”:

> It is extremely efficient; it saves a lot of trouble to have a fair degree of reliance on other people's word. Unfortunately this is not a commodity which can be bought very easily ... Trust and similar values ... are examples of what the economist would call 'externalities.' They ... have real, practical, economic value; they increase the efficiency of the system ...\(^4\)

The field of New Institutional Economics stresses the importance of trust even more strongly. It searches for institutional designs that help overcome distrust. According to the anthropological assumptions of this school of thought, human beings are prone to opportunism, i.e., to lying, malice, deceit, and the manipulation of information, as well as to free-riding. That is why Institutional Economics looks for efficient incentive structures that encourage desirable behavior without excessive transaction costs.\(^5\) Trust in individuals but also in complex systems might be the result.

Experimental economics also ascribes considerable significance to trust. In his multi-period games, Robert Axelrod asked “how cooperation among egoists can take place without a central mediating power.”\(^6\) The answer he came up with was tit for tat, or, in more technical terms, reciprocity. The individuals who performed best were those who responded constructively to offers of cooperation but broke off relationships when they encountered unfriendliness. The profits to be had through cooperation, however, were greater than any advantages that might accrue to the lone wolf in a world of general suspicion. In short, trust pays. Unjustified, blind trust, on the other hand, can cause substantial damage. Trust has to be justified. Otherwise, the consequences may be disastrous.

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The insights gained from these experiments were not unknown to the people who had to respond to the challenges of industrialization and globalization in the nineteenth century. I personally find it fascinating that it took many years of research for twentieth-century sociologists and economists to discover what practitioners more than 100 years ago already regarded as general knowledge. Take this undated meditation of a mercantile Hamlet:

To sell or not to sell?
That is the question
Whether it is better to send the goods
And take the risk of doubtful payment,
Or to make sure of what is in possession
And, by declining, hold them.
To sell; to ship; perchance to lose—
Aye, there’s the rub!
For when the goods are gone,
what charm can win them back
From slippery debtors?
Will bills be paid when due?
Or, will the time stretch out till crack of doom?

Today a warning might read: Advance action like shipping goods to insolvent companies or depositing money with hedge funds can damage your wealth. With their world becoming more complex and riskier by the day, how could nineteenth-century businessmen know where to place their trust? How were they able to play Axelrod games or, in the words of the poem, “to send the goods/And take the risk of doubtful payment?”

III. National and International Regulation and the Power of Sociocultural Networks

There were very different responses to these challenges. According to Max Weber, the modern state’s monopoly on the legitimate use of force, as well as its administrative machinery, enabled public authorities to solve these problems. The rule of law curbed insecurity and created trust in general regulations. Legal codification and the consolidation of the judicial and executive branches of government contributed to the tremendous progress of the rule of law in the nineteenth century. At the international level, there were intensive and at least partly successful efforts to harmonize national laws. 1883 saw the establishment of an International Union for the Protection of

7 Undated poem quoted in Peter R. Earling, Whom to Trust: A Practical Treatise on Mercantile Credits (Chicago/New York, 1890), 200.
8 See Craig N. Murphy, International Organization and Industrial Change: Global Governance since 1850 (Cambridge, UK, 1994).
Industrial Property, which secured patents and trademarks. Efforts were also made to standardize the laws on bills of exchange, trade, and insurance. International Chamber of Commerce congresses and trade associations exchanged information and attempted to harmonize laws touching on commerce. Despite the rise of what we might call institutionally based trust on the national and international level, many gray zones and large areas outside the range of trust-creating measures remained. Especially in grappling with our mundane question of whether “to ship or not to ship,” merchants had to look elsewhere for confidence.

They found sources of trust in areas that many contemporary intellectuals perceived as doomed to disappear. In their theories, industrialization seemed to destroy premodern communal forms and replace them with a pure cash nexus. According to Marx and Engels, there was “no tie between humans other than ... cold-hearted cash payment.” For sociologist Ferdinand Tönnies, the social relationships of modern Gesellschaft, in which “everyone is a merchant,” were structured along lines of self-interest, and individuals were isolated units in the market. But, in fact, traditional social relationships did survive and helped businesses safeguard their activities. Businessmen systematically placed family, ethnic, and religious loyalties in the service of their commercial interests, securing national and global transactions with non-market links. If such ties were lacking, they could be established through strategic marriages or social networks. Churches served as networks for the business transactions of their members. It was hoped that the faithful would adhere to the fundamental norms they espoused. Moreover, concern for one’s reputation played a crucial role, and the fear of hell might also have helped to assure honesty.

Immigrant networks created solidarity as well. The success of many “ethnic businesses” to this day is based on the interlocking dynamic of outside pressure and internal cohesion. Many transactions such as credit allocation can be settled with lower transaction costs between members of an ethnic community than between strangers. The phenomenal success of Jewish entrepreneurs and other minorities, above all in the financial sector, is due to this close culture of trust that grew from their marginality. Comparative advantages sprang from the outside world’s discrimination – discrimination that maintained minorities’ awareness of their identity. On account of their uniquely high degree of cohesion, diasporas were able to develop greater levels of trust than members of other

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ethnicities. In the nineteenth century, Indians organized long-distance trade in the eastern and southern parts of Africa; Armenian merchants had very broad networks stretching from the Middle East to England; Greek merchants dominated the Black Sea region for a time; and European entrepreneurial families operated not just in Europe, but all over the world, especially in North and South America, cultivating networks that functioned very well. Such socially and culturally based networks were and are self-coordinating and “self-regulating.”

They use specific sanctions and gratification mechanisms such as exclusion from their community or allotment of symbolic capital. Of course, these patterns, which had kept international trade going for centuries, also had clear limits. In the nineteenth century, not every business transaction could be secured by such sociocultural relationships.

IV. Commercial Risk Management: Credit Rating in the United States

The crisis of trust created by market expansion was eased by the market itself, by commercial risk management. The challenge of rapidly growing anonymous markets was met by the professional transformation of uncertainty into risk, in other words, by turning trust into a commodity. The economist Frank Knight famously argued that a distinction should be drawn between uncertainty, in the sense of pure contingency, and risk, which is calculable and therefore manageable. Uncertainty, according to Knight, can be transformed into risk in two ways: first, by evaluating relevant data, and second, by establishing expert systems. This idea was taken up by Anthony Giddens, who defined expert systems as “embedding mechanisms.”

In the nineteenth century, the number of such mechanisms grew in response to increasing uncertainty. Here we will focus on credit markets alone. These had to cope with the problems of adverse selection and information asymmetries. Lenders do not normally have all the information on potential borrowers that they need to adequately evaluate risk – considerable scope for deceit and misjudgment exists on both sides. To be sure, banks were specialists in transforming vague uncertainties into manageable risks, although the nineteenth century is littered with bank failures. As most of these failures have been well researched, concentrating on less-known institutions might be a more rewarding endeavor. What’s more, banks were not optimal institutions for all kinds of credit, especially not for small loans.


12 Frank H. Knight, Risk, Uncertainty & Profit (New York, 1921); and Anthony Giddens, The Consequences of Modernity (Stanford, 1991), 20.
Therefore, I shall now turn to an expert system to which historians have paid little attention: credit-rating agencies.13 These “guardians of trust” emerged in the United States in the early nineteenth century.

The pioneering role of the United States in the development of these agencies reflected the comparatively high demand for financial information that this land of immigrants generated. Businessmen with different ethnic and cultural backgrounds who did not know each other and had just arrived had to advance trust to one another, and existing legal and administrative structures were deficient in many ways. Around 1850, U.S. retailers sold up to three-quarters of their stock on credit and, thus, were dependent on credit from their suppliers. Accounts were settled once a year, usually after the harvest, when the cash registers were ringing. As long as markets remained local, problems associated with credit could easily be worked out. But as interregional markets expanded and business transactions became more anonymous, defaults on debts became rampant.

In 1890, a merchant looked back somewhat nostalgically on the more personal nature of business transactions in the past:

Most of us can remember when it was the custom of merchants, from all parts of the country, to repair to the metropolis once a year, at least, for the two-fold purpose of settling up and buying new stock. This custom brought the New York merchant into personal contact with his customers, both old and new, and developed in him a faculty for determining character and judging men and human nature, that has been largely lost.14

In reaction to this loss of face-to-face contact, Lewis Tappan founded the Mercantile Agency in New York in 1841. He began to sell credit information at the very moment when the railroads were creating interregional, anonymous markets. Tappan had two motives: First, he had had some bad experiences himself; his creditors had almost driven him into bankruptcy. Second, he was a strict Congregationalist and thought that credit was basically evil. In 1843 he wrote: “How much wisdom there is in the advice of the apostle Paul – ‘Owe no man anything.’” Although he knew that credit was unavoidable, he wanted to “purify” it.15

His agency built up a nationwide network of correspondents and branch offices. In 1859, Robert Dun took it over, and by 1880 Dun...
was supervising 69 branch offices and 10,000 correspondents. By centralizing and enlarging the data pool, the agency was able to realize economies of scale. Thanks to the agency’s efforts, the market became more transparent, and the chances of default decreased. A good credit report from the agency could form the basis for lasting business relations. A bad one, however, could spell social death for small businessmen, as they were virtually ostracized.

What kind of data were collected? Going by today’s practices, we would expect balance sheets and tax returns, but this was far from true. Most businesses at that time had either no accounts at all or only dubious ones. Tappan and Dun’s agents dealt with this deficit in three ways. First, they asked local lawyers, bankers, aldermen, merchants, and other putative dignitaries what they thought of the potential borrower and his financial situation. Second, their idea of “credit rating” consisted more in “character rating” than our modern understanding of the term. That is, certain personal traits such as religious faith, moderation in consumption and sexuality, and the “right” ethnicity were used as indicators of creditworthiness. Third, the agencies documented the repayment of loans in the past and took these credit histories as the basis for evaluating the risk of extending credit in the future. This greatly reduced information asymmetries as debtors could no longer hope that defaults would remain unknown. Now anyone, theoretically, was able to buy this information and boycott unreliable debtors. Thus, an effective sanctioning device emerged and the problem of adverse selection was diminished. Solid debtors were now able to build up a good name and benefit from it commercially.

It therefore comes as no surprise that the early “credit reports” provided information not only about the financial situation of potential borrowers but also about their private lives. Leading a godly life was considered an infallible indicator of trustworthiness. On the other hand, a man who cultivated “fast living” or had an “extravagant wife” was someone to whom it was better not to lend money. One San Francisco businessman was a habitué of brothels in Chinatown – mostly accompanied by out-of-town clients. This
was bad for his credit rating but probably good for his existing business contacts. Another entrepreneur was said to “overindulge his appetite for women.” The message was clear: a “good family man” as the expression usually went – with modest financial security was a better risk than a rich but immoral rake. The ratings were guided by the values of the WASP middle class, to which, not surprisingly, the correspondents belonged. The moralistic approach to early credit rating was very much in line with the religious convictions and social reform initiatives of Tappan, who was involved in the anti-slavery movement. He hoped to improve overall morals by disciplining people by means of credit reports. To a large degree, the ratings were an attempt to draw on the values of old-style networks in an era of impersonal exchange.

Ethnicity and religion at first played large roles in the rating system. On average, Jewish businessmen received lower ratings than Christians. One report said, “We should deem him safe but he is not a white man. He is a Jew,” subsequently recommending he be kept on a short repayment leash, for “delay is always dangerous with Jews.” In one case, the correspondent was obviously well versed in the bible and took a very long-term approach to credit history. He held an otherwise very solid merchant house responsible for what had happened during the Jewish exile in ancient Egypt. His report read: “Are doing an excellent business... character and habits good. ... Considered good by all dealers, but they are Jews, and their ancestors took Jewels of the Egyptians when they left Egypt and never returned them.”

Negative credit reports could be devastating and exclude people from credit for good. If a report read “never trust him, will always be worthless” or took whole families into collective liabilities (“The whole lot of the Weatherbys are Bad Eggs”), relentless social execution took place. Judgments like “he has no energy & will never make a dollar” or “has never succeeded at anything & probably never will” make it clear that people were denied a second or even a first chance forever. The reports assigned dollar values to the assets and character traits of individuals. They graded people according to their creditworthiness almost like commodities and placed them in different classes. Others were permanently branded – many as failures and losers. To get out of the trash can, one had to turn to other sources of credit, if these were available, such as friends and families. The agencies institutionalized a comprehensive system of control,

16 All quotations are from Peter R. Decker, Fortunes and Failures: White-Collar Mobility in Nineteenth-Century San Francisco (Cambridge, 1978), 100-1.
18 Quoted in Sandage, Born Losers, 111, 132, 146, 154.
almost in the sense of a Foucauldian disciplinary society. Total surveillance of commercial and private activities and severe punishment in the form of making this information available to anyone willing to pay for it were the main principles of this “panopticon without walls.”

Based on stereotypes, prejudices, and rumors, the early reports were frequently arbitrary and unreliable. In some cases, the agencies were even taken to court and convicted of libel charges. In order to establish themselves for the long term, the agencies had to improve the quality of their information, which they accomplished in three ways:

1. The collection and evaluation of the information required systematic data processing. Summary reports replaced detailed accounts. Taxonomies with letters and numbers like “O.B.” or “A1” shortened the message and signaled that the questioned firm possessed a certain capital and was considered good for a certain amount. Such “ratings” abstracted the specifics of the individual case, allowing information to be compared at a glance and extending the coverage of the rating system without the burden of too much detail. This was reduction of complexity in the extreme.

Beginning in 1859 – two years after the first worldwide economic crisis – a reference book with summary analyses appeared as an alternative to individual reports. The changing number of entries gives some indication of the broadening scope of information compiled. In 1859, there were 20,000 entries; by 1915 the number had reached 1.8 million.

2. The agencies developed elaborate and work-intensive routines for managing information. Thousands of huge volumes contained detailed registers. When the New York agency received an inquiry from a branch office, the reports were copied by hand. Several thousand inquiries were received every day. In 1875, the first mass-produced

19  Sandage, Born Losers, 148.
typewriters were introduced, which triggered a push for rationalization. These typewriters allowed several carbon copies of a report to be made, improving archiving. Instead of distributing entries in many volumes that eventually filled up, one could take individual pieces of paper and collate them according to firm. Furthermore, the speed and ease of reading increased, as the handwritten reports had sometimes been hard to decipher. All these advances simplified matters greatly. In addition, the telegraph was increasingly used. In short, the agencies availed themselves of the latest information technology of the day.

3. Professional “credit reporters” gradually replaced local amateur correspondents. It became standard procedure to use several sources and to make direct inquiries with banks and business partners as well as with the very firms being evaluated. Starting in 1875, increased numbers of firms allowed access to their books – an unmistakable process of objectification. Nevertheless, credit reporters still rendered character judgments, with prudent, conservative, hard-working businessmen as their ideal. All things considered, however, the working methods of the inspectors approached those of modern auditors.

Following the 1929 stock market crash and the onset of the Great Depression, Dun merged with Bradstreet in 1933. Today Dun & Bradstreet is the market leader in the commercial data business.

With success came self-confidence. The agencies described themselves as civilizing forces in an unsafe world. They alleged that, without their services, the whole system would fall victim to moral corruption and would eventually collapse. They hailed themselves as guardians of the market and of society at large for reconciling ethics
and capitalism. This message was translated into figurative imagery. It is not absolutely certain when the bas-relief depicted on this page was created. There are, however, many indications that it was designed for the centenary in 1941, having been displayed since then outside the Dun & Bradstreet headquarters in New York. The sculptor was Georg Lober (1892-1961), who also created several famous statues in New York.

The monumental metal frieze depicts two allegorical men connecting the different parts of the country. A buckskin-clad frontiersman with a rifle and a shirtless proletarian with a large cogwheel hold hands and gaze into one another’s eyes. The center is embellished with symbols of productivity and wealth like fruits, a plough blade, a mallet, a wheel, and a sheaf of wheat. The message is clear: “Man’s Confidence in Man” is the ultimate productive force. Its wealth-creating power is greater than that of mines and factories. Trust is key, so to speak, and it helps society overcome social and geographical divisions. It bridges rural and urban life and connects the hunter and farmer with the worker, although these groups were the most unlikely customers of nine-

Allegorical frieze depicting “Man’s Confidence in Man.” Artist: Georg Lober (1892-1961).

The inscription reads: “Credit / Man’s Confidence in Man / Commercial credit is the creation of modern times and belongs in its highest perfection only to the most enlightened and best governed nations. Credit is the vital air of the system of modern commerce. It has done more - a thousand times more - to enrich nations than all the mines of the world. / Quoted from a speech by Senator and later Secretary of State Daniel Webster in the Senate at Washington, D.C., March 18, 1834.”

teenth-century credit-rating agencies. The scope of the agency’s service is boundless and reaches from the wilderness to the cities of skyscrapers and factories. Despite the international nature of the rating business, the frieze and especially the inscription pay homage to the national self-image of the United States. The frontiersman and the skyline of Manhattan are American motifs representing the symbiosis of the country’s pioneering spirit and modernizing energy. This male-dominated imagery is connected to visions of abundance, national strength, and civilization. The “most enlightened and best governed nations” like the United States can overcome distrust, establishing stable credit across the land – an impressive cultural achievement. Parts of these images were used on letterheads or on forms and brochures of the company. The frieze is still displayed outside Dun & Bradstreet’s main office. A gold-plated replica adorns the entrance to Moody’s Corporation in New York.

As of April 2009, Dun & Bradstreet’s database covered some 143 million enterprises in over two hundred countries, and the firm received almost 100,000 inquiries and fed 1.5 million new data items into the system each day. Moody’s, Dun’s former subsidiary, started to rate bonds in 1909. It developed the standard categories we know today reaching from AAA to junk bonds. In this case, too, an extreme reduction in complexity has taken place. Instead of a detailed analysis of the individual circumstances, three letters suffice to give a risk assessment. Moody decides on the creditworthiness not only of companies but also of states, thus playing a significant political role.

V. Credit Rating in Germany and around the Globe

At first, the services of Dun & Bradstreet were designed exclusively for the American market. However, European firms soon began to tap into the American agency’s information pool. Matthias Hohner, a German harmonica maker, who resided in a remote village located in between the Black Forest and the Swabian Alp, was able to build up his business in America with the help of Dun and Bradstreet. He first established himself in the United States by using the older sociocultural trust mechanism of employing emigrants from his own little village. Once exports to the U.S. had gathered speed, Hohner needed a larger network and approached the agencies. He developed a substantial export business to the U.S. without ever crossing the Atlantic. He did not need to. He simply got the addresses and credit ratings of American merchants from the agencies. Bradstreet offered the following services: classified lists
of potential importers and wholesalers of musical instruments, letters of introduction for representatives, reports on every single North American firm, and the collection of debts. By the turn of the century, Hohner had clients in all the major American cities and was on his way to becoming the world’s leading manufacturer of musical instruments.21

For a long time, the international scope of the American agencies was one-sided. They sold reports on American firms to interested parties in all parts of the world but were unable to satisfy the desire of U.S. firms for similar information on foreign companies. To meet the large demand, starting in 1880 Dun built a global network of branch offices and began working in liaison with foreign agencies. In 1900, Dun had 137 offices, mostly in America; over the next sixteen years, 104 new ones were opened, 77 of them abroad. By 1914, the branch office network covered all of North America and Western Europe and had bridgeheads on every continent except Asia; it was now possible to receive detailed information on almost any company in the world within 48 hours.

This global network included Germany, although Germany remained at its fringe. Credit rating, however, did take place there. In 1872, one year after the unification of Germany, Wilhelm Schimmelpfeng had set up an eponymous company in Frankfurt along the lines of Dun & Bradstreet. By 1900, Schimmelpfeng had grown considerably and called itself the “largest European agency.” It had 133 branches and 1,157 staff.22 But why did Schimmelpfeng not outgrow the American pioneers, and why was it not founded until three decades after Dun?

Smaller challenges required smaller solutions, one might say. Compared to the United States, Germany was smaller in terms of geography, though not yet in population, and more stable. There was no mass immigration, and its industrialization did not coincide with the opening up of a whole continent. German businesses could rely on older economic and social structures to a much greater degree than their American counterparts. There were well-established trust-generating mechanisms. The chambers of commerce acted as important brokers of contact, information, and trust. When, for example, someone from Nuremberg received an offer from an unknown person from Frankfurt, he would write to the Frankfurt Chamber of Commerce and ask for a reference. He could also approach the mayor or other businessmen. Asking for references from local dignitaries, whose status


often went back several generations, was a standard practice within the German business community. In other words, in many cases a non-market approach prevailed and curtailed the market for commercial rating agencies’ information.

In Germany, the big banks also used their branch networks to provide their customers with credit information on people from other cities. The U.S. banking system, by contrast, was weak and decentralized. Especially in the Southern states, “country merchants” acted as a kind of bank substitute. To perform this task, they needed to back up their lending activities using credit rating. The strength of the rating agencies in the United States, thus, also reflects the weakness of the U.S. banking system.

Moreover, in Germany non-commercial alternatives, like cooperatives, sprang up, which are still very important. Today Creditreform is the market leader for domestic German and small business credit reporting. This cooperative goes back to 1879, when 25 shopkeepers and craftsmen in Mainz founded the Verein Creditreform zum Schutze gegen schädliches Creditgeben (Society for the Protection against Harmful Lending). It aimed to ban credit customers who had overdue debts to a member of the Society. It also strove to collect debts and establish an information network. By 1883, there were already 15 local clubs – enough to indulge in the well-known German passion for founding associations, in this case the Verband der Vereine Creditreform (Association of Credit Reform Societies).

This collaborative mode of operation, which grew out of guild and civic traditions, is characteristic of the German variety of capitalism, which has been called “cooperative capitalism.” This method of disseminating credit information was no doubt very effective in
civilizing the German credit market, but it also narrowed the scope for the American form of credit rating, and for American-style, competitive, market-based capitalism.

Still, credit rating did get off the ground in the German empire, and it was no coincidence that it did so at the very moment when the unification of Germany enlarged the market and made trade between the various parts of the country much easier. Almost simultaneously, considerable deregulation took place, which greatly simplified the establishment of new corporations, especially joint-stock companies. The Joint-Stock Corporation Act of 1871 marked a watershed, although commercial law and its application had already been significantly liberalized in the 1860s. There was an increase in complaints that opening the world of commerce to inexperienced newcomers was depriving the Kaufmannsehre (merchant’s honor) of its former binding power and that the levels of education and decency among businessmen were declining sharply. Following the crash of the Berlin stock market in 1873, these complaints became louder and all too often took an anti-Semitic turn.

As in pioneering America, where the railroads created interregional anonymous markets, the unification of Germany and the deregulation of company law created a demand for credit information brokerage within Germany. Prior to the emergence of Schimmelpfeng, the 1860s had witnessed the founding of several German agencies. Some of these remained limited to a regional market, like Salomon (Stettin, 1860), and others failed, despite national strategies, to achieve the importance of Schimmelpfeng, like Lesser & Liman (Berlin, 1862) and Wys, Muller & Co (Holland, 1863).23

At the same time, it became increasingly indispensable for German exporters to tap into the global information networks of the

U.S. market leaders when they wanted to approach new customers around the world. They needed the expertise of Dun and others to protect themselves, just as American companies needed reliable information on potential partners in Germany. For these services, they would not go to Creditreform or write a letter to the chamber of commerce but had to utilize the standardized, commercialized services of modern rating agencies. The German agencies cooperated very closely with the American firms so that an inquiry made to Schimmelpfeng in Frankfurt about an American company in the Midwest would, in effect, be answered by Dun.

In 1984, Dun & Bradstreet took over Schimmelpfeng. Since 2006, this German business has operated under the name of D&B Deutschland GmbH.

**VI. Conclusion**

Nineteenth-century businessmen reacted to the growing uncertainties of their expanding markets in two ways. First, they employed non-market mechanisms for securing loyalty, using the social capital of their families, churches, and ethnic communities. Second, they looked to the market, which transformed the uncertainties into manageable risks by means of commercial expert systems.

The rating agencies were one of these systems. They collected, evaluated, and centralized enormous amounts of data. They enabled their clients to practice active risk management, lessen the probability of defaults, and foster trust among strangers in an increasingly anonymous and insecure world. At the same time, the agencies acted as disciplining institutions with a considerable impact on individuals’ lives and an almost unchecked power to exclude people from access to credit.

Trust is essential to the operation of markets, enabling cooperation and minimizing frictional losses. The emergence of honest dealing in the industrialization and globalization processes has long been interpreted as a result of national and supranational regulation. This is true, but only to a limited extent. Historians and economists have neglected the strategies developed by the business community itself. The new market structures demanded offensive risk-oriented behavior, but that was neither conceivable nor practicable without safety strategies.
Commercial risk management has undoubtedly been fundamental to setting up and expanding markets. However, its history is not a trajectory of ever increasing stability. On the contrary, it would be completely misleading to assume that commercial risk management has always been able to eradicate uncertainty and dishonesty. At the present moment, global capitalism is caught in a deep crisis of trust, and markets are suffering under a severe credit crunch. In the build-up to the current crisis, the rating agencies blatantly failed to serve investors when they assigned investment grade to mortgage-backed securities (MBSs) and collateralized debt obligations (CDOs), whose underlying assets consisted of subprime mortgages. They classified these securities as AAA and put them in the same category as U.S. government bonds.

What happened? Obviously, the rating agencies either grossly underestimated the risks involved and could not imagine a downturn of the real estate market, or they were simply overtaxed by the quantity and complexity of the new investment vehicles. There also is reason to believe that a conflict of interest occurred. The agencies are typically paid by the issuers of these papers, and downgrading their products would have lowered the agencies’ revenue. All three factors seem to have added up. The consequences of this failure were grave, as everyone trusted the agencies. After all, they had acquired a reputation for trustworthiness over a period of 150 years. In this case, excessive trust turned out to be economically more damaging than distrust, with disastrous results – because no one considered it necessary to assess risk themselves. Instead, most investors trusted an expert system that had stopped being an efficient gatekeeper between issuers and investors.

This situation discloses two fundamental dilemmas that will likely prevent capitalism from ever becoming completely civilized. First, those who have earned trust are highly tempted to abuse it. Second, although risk management, like credit rating, brings some risks under control, it also encourages people to take new risks that no one would have previously taken. As Peter Bernstein laconically observed, “seatbelts encourage drivers to drive more aggressively,”24 and, as a result, the number of accidents rises. In the same way, capitalism continues to be plagued by uncertainty and instability.

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