The Making of Modern Finance
Liberal governance and the gold standard

Routledge/RIPE Studies in Global Political Economy

Samuel Knafo
The Making of Modern Finance

The Making of Modern Finance is a path-breaking study of the construction of liberal financial governance and demonstrates how complex forms of control by the state profoundly transformed the nature of modern finance.

Challenging dominant theoretical conceptions of liberal financial governance in international political economy, this book argues that liberal economic governance is too often perceived as a passive form of governance. It situates the gold standard in relation to practices of monetary governance which preceded it, tracing the evolution of monetary governance from the late Middle Ages to show how the nineteenth-century gold standard transformed the way states relate to finance. More specifically, Samuel Knafo demonstrates that the institutions of the gold standard helped to put in place instruments of modern monetary policy that are usually associated with central banking and argues that the gold standard was a prelude to Keynesian policies rather than its antithesis. The author reveals that these state interventions played a vital role in the rise of modern financial techniques which emerged in the late eighteenth and nineteenth centuries and served as the foundation for contemporary financial systems.

This book will be of strong interest to students and scholars of international political economy, economic history and historical sociology. It will appeal to those interested in monetary and financial history, the modern state, liberal governance, and varieties of capitalism.

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Samuel Knafo
To Dinah
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Acknowledgements

This book marks the end of a long journey that started as an overly ambitious doctoral project on the capitalist transformation of finance in Britain. As I began to survey the historical literature, I was forced to revise many of the assumptions that had initially guided me towards this topic. In place of the familiar script of liberal governance and its disengaged state, I was confronted with policy experiments which seemed to contradict the very liberal discourse that had been used at the time to justify these policies. The difficulty I had in trying to reconcile the historical evidence with the common image of liberal financial governance led me to reflect more fundamentally on the ways in which we analyse this form of governance. I was struck by how often these practices of governance were characterized in the negative, by what they are not or what they refrain from doing (i.e. a non-interventionist form of governance) rather than what they actually do. As a result, this book took shape as an attempt to offer an alternative history of the emergence of liberal financial governance which inverts the usual narrative of the gradual retreat of the state, for it became clear to me that the construction of this form of governance was the product of an extension of state power.

In the course of this project, I have accumulated a great many debts to teachers, colleagues, students and friends. I owe much to George Comninel who supervised the first stages of this project as my PhD supervisor and made me first appreciate how much history can teach us about the present. I am also particularly grateful to professors and supervisors who influenced and directed me. Eric Helleiner, Tony Porter, Gregory Albo and Jonathan Nitzan were all particularly generous in providing extensive feedback on some of my earlier ideas about liberal financial governance. York University was a very stimulating place to study and it owed that to an exceptional body of students, many of whom have remained close friends. The foundations for the book were laid during countless discussions with some of them, most notably Étienne Cantin, Frédérick Guillaume Dufour, Marc-André Gagnon, Paula Hevia-Pacheco, Matina Karvellas, Geoff Kennedy, Thierry Lapointe, Rodney Loeppky, Marie-Josée Massicotte and Leandro Vergara. I am particularly indebted to a close friend and collaborator, Martijn Konings, with whom I developed some of the key theoretical and methodological ideas which have come to define the way I approach finance.
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Introduction

The golden touch of liberal financial governance

In late 2010, the head of the World Bank, Robert Zoellick, caused a stir by calling for a new gold standard in an article in the *Financial Times*. His intervention was motivated by growing international tensions over currency manipulations for national gains. As a solution, Zoellick proposed to depoliticize monetary governance by providing investors and central banks with a shelter against the fluctuations of individual currencies. He suggested that a new currency standard be created and based on a basket of key currencies combined with gold, since this metal has become, as Zoellick put it, ‘an international reference point of market expectations about inflation, deflation and future currency values’ (Zoellick 2010). For advocates of a return to gold, such as Zoellick, the appeal of this metal is clear: as a physical commodity, they believe, gold could offer a useful standard independent from political manipulations, since its value is fully determined by the market.

Zoellick’s appeal to a new monetary standard encapsulates a growing sentiment, especially in the United States where the idea of a return to gold has been gaining momentum within conservative circles. In recent years, Ron Paul, the congressman from Texas, has called for a revival of the gold standard in response to the Federal Reserve’s policy of quantitative easing. Joining voices with him is the magazine *Forbes* which has put its editorial weight behind the idea of a return to gold. Its CEO and editor Steven Forbes even predicts ‘a return to the gold standard for the United States within 5 years’ (Dykewicz 2011). The campaign for a return to gold can now count on established figures such as the influential economist Robert Mundell,¹ and none other than the former head of the Federal Reserve, Allen Greenspan himself, who endorsed a form of the gold standard and spoke of his admiration for the previous incarnation of this regime in the nineteenth century.²

The campaign for a new gold standard has also found support abroad where policy makers have been concerned by the instability of the dollar. With the Federal Reserve launching successive rounds of quantitative easing, foreign central banks holding large reserves in American dollars are becoming nervous. The flight towards safer reserves has led numerous central banks to buy gold at a rapid pace after being net sellers over the past decade. The interest in an alternative to the dollar is now growing. Political leaders such as Nicholas
Sarkozy in France and Dimitri Medvedev in Russia have publicly criticized the management of the US dollar and the policies of the Federal Reserve (Beardsley 2011). The chief of China's central bank, Zhou Xiaochuan, has gone further explicitly invoking the possibility of a return to gold as a way of curbing 'credit-based' excesses based on the dollar (Evans-Pritchard 2011).

This call for a new gold standard has, however, been greeted with scepticism from other corners (Harding 2010). Analysts have doubted the viability or realism of such a proposal which seems steeped in nostalgia for a mythical past which never really conformed to its later idealization. They fear that gold would create too great a strain for the complex monetary and financial systems that exist today. According to Bradford Delong, ‘attaching the world economy’s price level to an anchor that central banks cannot augment at need is another source of deflation – we learned that in the fifteen years after World War I’ (cited in Harding 2010). In the eyes of those who criticize this project, the monetary system has become so intricate and leveraged since the 1970s that it is inconceivable that we could return to a monetary regime based on gold.

While there are significant reservations towards such a return to the gold standard of the nineteenth century, it remains a potent symbol for those yearning for a depoliticized monetary governance. As Martin Wolf notes,

It is not hard to understand the attractions of a gold standard. Money is a social convention. The advantage of a link to gold (or some other commodity) is that the value of money would apparently be free from manipulation by the government. The aim, then, would be to ‘de-politicise’ money

(Wolf 2010)

Following this reasoning, the federal state of Utah adopted a bill in March 2011 which recognized gold and silver as means of payment. Since then numerous American states such as Minnesota, North Carolina and Idaho are considering similar bills. While these initiatives may have changed little, they reflect the power that the gold standard still carries as a symbol, which is now harnessed to challenge the Federal Reserve.

As an immutable anchor, the gold standard offers the shimmer of a monetary base that is impervious to political machinations. Even for its critics, it represents the great symbol of monetary stringency. It is routinely invoked as the enduring icon of economic stability as a bulwark that places economic governance beyond politics. This image is etched in well-known idioms of the English vernacular. Expressions such as the ‘gold standard’ or ‘as good as gold’ reflect this belief that nothing is more real, nor more trustworthy than gold, nothing further from politics. In the words of von Mises ‘the excellence of the gold standard is to be seen in the fact that it renders the determination of the monetary unit’s purchasing power independent of the policies of governments and political parties’ (von Mises 2009: 416).
The assumption that the gold standard provided a monetary foundation independent from state manipulations explains why this institution epitomizes the spirit of liberal governance more than any other. Seen as the paragon of economic liberalism, it is held up as the archetypical instrument of laissez-faire financial governance. In the words of Karl Polanyi, it was the supreme vehicle of market society (Polanyi 1957: 214). According to this image, the gold standard represented a safeguard against policies that were detrimental to capitalists. When underwriting the value of their currency with gold, governments could no longer afford to face sustained outflow of gold which would rapidly deplete their reserves in gold and put into question their commitment to gold. For this reason, it is often believed, liberal states were forced to avoid policies that scared capitalists away. Liberal states would have been compelled to remain passive and only adopt pro-market policies. As Ruggie puts it, ‘the role of the state […] became to institute and safeguard the self-regulating market’ (Ruggie 1982: 386) or in the words of Capie, Goodhart and Schnadt, ‘the philosophy of laissez-faire dominated much of the [nineteenth] century and under its influence the state’s role was a diminished one’ (Capie et al. 1994: 51).

That the gold standard has come to be seen as a bulwark against political manipulations of money is, however, ironic. For when the gold standard was initially adopted it was largely viewed from the opposite perspective. It was first implemented in 1821 and promoted by social forces that emphasized the need for money to be brought under public control. Robert Peel, who chaired in 1819 the Parliamentary Committee that was responsible for setting up the gold standard, stated clearly the intentions behind this institution when arguing that ‘the House [of Commons] had too long transferred its powers [to financial agencies]’. Thus he called upon Parliament to ‘recover the authority which it had too long abdicated’ by adopting the gold standard (quoted in Evans 1991: 12). Peel shared with the prime minister at the time, Lord Liverpool, the conception that the gold standard was an attempt to protect the stability of money from market activity. At the time, banknotes were issued privately by hundreds of banks scattered across Britain. Banknote-issuing was then viewed as a manifestation of the arbitrary power of private banks which needed to be reined in and brought under public control.

That the operation of the gold standard never followed the script that has since been written for it is now widely acknowledged in the specialized literature on this subject. Ingham remarks that ‘The gold standard was supposed to be an independent self-regulating mechanism but it increasingly required interventionist management upon which the [Bank of England’s] power came to be based’ (Ingham 1984: 133). As numerous authors have pointed out, the historical record largely contradicts the idea that the gold standard was a market-led form of governance with little state intervention (Milward 1996; Flandreau 1996). Scholars of monetary governance have repeatedly rejected the myth that adjustments under the gold standard were automatic and driven by market forces (Triffin 1964). They emphasize that central banks did intervene to counter the effects of international capital flows on their national monetary system thus
blocking the free operation of market forces (Bloomfield 1959; Cohen 1977: 79). As Gilpin points out, ‘[central] banks could and did respond to gold flows in a highly discretionary manner in order to cushion the effects on domestic prices and the domestic economy’ (Gilpin 1987: 124).

Following this revisionist literature, Eric Helleiner makes the important point that the construction of the gold standard was perceived at the time as a significant element in the ‘consolidation of state-managed national currencies’ (Helleiner 2003b). This puts into stark contrast what we often assume to be the intentions behind the adoption of the gold standard and the actual operation of this monetary regime. There is indeed a fundamental tension at the heart of the project of liberal financial governance deployed under the gold standard in the nineteenth century. For, while it was articulated in the language of liberalism as a means to free markets from state intervention, the result was often the opposite. According to de Cecco, the gold standard ‘was in most cases a giant step towards dirigisme’ (cited in Helleiner 2003b: 221). Such a viewpoint may not be prevalent in the literature but it reflects a sense of unease as scholars struggle at times to match historical evidence with a received idea of liberal financial governance. If scholars now recognize that the gold standard was a more complex and ambivalent structure of governance than previously believed, few have gone past the acknowledgement that history did not live up to the theory. Despite challenging the conventional account of liberal financial governance, they remain hesitant to let go of the idea that the gold standard was a regime that restricted state intervention. The frequent remarks that central banks enjoyed discretionary power have not led these scholars to reconsider the received assumption that liberal states were passive actors in financial and monetary matters.

If the myth of the gold standard has had a resilient life in the field of International Political Economy (IPE), it is partly because there are few alternatives on which to fall back. Despite the substantial revisionist body of work on the topic, this research has not been used to rethink the nature of liberal financial governance. Rare are those who take the extra step to reconsider what was the actual purpose of liberal financial governance. As Philip Cottrell points out, ‘with very few exceptions, most modern scholars of nineteenth-century international monetary history have taken the post-1880 gold standard almost for granted and, so instead of asking why it emerged […] have concentrated upon trying to understand how it operated’ (Cottrell 1992: 221). In the absence of a proper alternative, there is a tendency to gravitate back towards the traditional assumptions of liberal states as passive agents of governance. While few would argue that these states do not intervene in the economy, we continue to think of liberal forms of governance as ‘thin’ regulatory frameworks governed by non-interventionist states. The construction of this supposedly ‘hands off’ governance continues to be mostly read as the story of a calculated retreat of the state, one which is characterized by deregulation and liberalization.

The central objective of this book is to go beyond the usual admissions of discretionary power under liberal financial governance. It is my contention
that the rich historical evidence unearthed by economic historians warrants a substantive revision of our understanding of liberal financial governance. I argue that liberal financial regimes cannot be understood as projects meant to subject governance to market imperatives. As I show, the gold standard was not a minimalist nor a passive approach to governance. On the contrary, it represented an important extension of state power over financial activity. Far from providing a permissive regulatory framework, liberal financial governance disciplined financiers in important ways. Here I reveal how policies widely held up to usher in an age of free markets through the rollback of the state, in fact bolstered the ability of the state to control the economy. The gold standard profoundly transformed financial governance and created the institutional foundation for a new form of state power: modern monetary governance in the form of central banking. As this book demonstrates, the trajectory of nineteenth-century liberal financial governance is foremost the story of the rise of central banking.

This historical argument leads to a broader theoretical point about liberal financial governance. For if this evidence about state interventionism and discretionary power seems to contradict our assumptions about the gold standard it is not simply because there was a gap between theory and practice. It is rather an indication that liberal financial governance is not, and has never been, what we assume it to be. The term liberal financial governance generally designates a regime geared towards securing stable conditions for investments through various institutional commitments (e.g. guaranteeing a fixed exchange rate). In this book, I take liberal financial governance to mean practices of governance which focus on sound money. My argument is precisely that policies that seem to establish fixed rules of the game to protect investors, in fact contributed to an extension of state power over finance. Or more specifically, I show how the state was forced to frequently change the rules of the game in a discretionary manner in order to achieve sound money.

As this study will show, liberal financial governance cannot be understood as a form of governance aimed simply at protecting markets from the discretionary power of the state. What distinguishes it is not its intimate relationship to the market, nor its supposed apolitical nature. On the contrary, liberal financial governance relies, as any other form of governance, on power. In its relationship to the market, liberal governance is not fundamentally different from other forms of governance. Since it seeks to influence market actors it requires disciplinary mechanisms and institutional structures. The specificity of liberal financial governance is therefore a historical question and concerns the nature of the power that is developed by liberal states, not the degree to which it is exerted.

The myth of the gold standard: why did we get it wrong?

Many of the misunderstandings about the gold standard can be traced back to the early twentieth century when the modern conception of the gold standard was established. It was first set out by the Cunliffe commission. The commission was
created in 1918 to enquire into Britain’s transition towards a post-war economy and was placed under the supervision of the Governor of the Bank of England, Walter Cunliffe. It issued a report that largely reflected the views of key officials from the Bank of England and influential financiers, recommending a swift return to the gold standard which had been abandoned during the First World War. This conclusion was based on the idea that market-led adjustments provide the most efficient method of governance ‘for a world that is human rather than divine’ (cited in Redish 1993: 787). As humans are fallible, the commission argued, there should be as little scope as possible for ‘arbitrary decisions’. From its perspective, a rigid structure such as the gold standard represented the best foundation for ‘objective’ market mechanisms to operate.

The Cunliffe report became an influential benchmark which set out the parameters for later debates on the gold standard. It has often been noted that the members of this committee exaggerated the extent to which the gold standard of the nineteenth century had been an automated regime of governance that rested on the self-regulating logic of the market. According to van Cleveland, it was nothing less than ‘a bit of ideology invented by later generations of bankers and economists attempting to play down the political dimension of monetary policy’ (van Cleveland 1976: 14). At the time, the role of the Bank had come under close public scrutiny as monetary policy became highly politicized. By arguing that the only role of the Bank was to enforce market-led adjustments in a technical and apolitical way, the Cunliffe report could present monetary governance as devoid of discretionary power.

The extent to which bank officials believed this depiction is debatable. Yet what lends strength to van Cleveland’s scepticism is a fact curiously neglected in most discussions of the gold standard: that is that the Bank of England remained a privately owned institution until 1946 and explicitly served the interests of its own shareholders. For this reason, one should not be surprised to see Bank officials insisting on the claim that the gold standard was a market-led form of governance, as it allowed them to reject the idea that the Bank should be held responsible for financial and monetary instability.

Such denials by the Bank of its own discretionary power were not new. As history teaches us, the idea of self-regulation had always suited the Bank in order to minimize its public responsibilities and downplay the politics that framed its action. Throughout the nineteenth century, Bank officials were keen to reject responsibility for financial or monetary governance. The Bank repeatedly refused to acknowledge, or downplayed, its own power and influence over the British economy in a bid to escape public scrutiny and avoid regulations. During this period, it deflected criticisms regarding its role in fuelling speculation by lending too freely or denied provoking financial crises by abruptly cutting lending in times of economic difficulty. Instead, the Bank consistently emphasized that the monetary and financial system was self-regulated and thus in no need of special intervention.

This rhetoric is partly responsible for modern misunderstandings about the nature of liberal governance. Too often, scholars have taken notions of ‘market
led adjustments’ and ‘self-regulation’ at face value and missed their normative and discursive function. It was common in the nineteenth century to emphasize the need for self-regulation and market autonomy, but such ideas could serve to justify a wide range of policies. Market self-regulation, for example, could be invoked to promote state intervention on the basis that a specific regulation would enable the market to finally function properly and regulate itself. Opponents would then respond that intervention was unnecessary, as the market was already efficiently regulating itself. Often espoused by competing parties to defend opposite positions, the idea of self-regulation did not predetermine the policies that would ultimately be promoted in its name. It served to justify specific agendas more than it defined them.

As I show later in the book, self-regulation per se was never the purpose behind the adoption of the gold standard, if we mean by this a self-contained idea with a clear programme attached to it. Rather, the motif of self-regulated markets had a strong rhetorical force because it suggested that a policy could bring British society closer to a natural, and thus objective, state of affairs. For this reason, the idea of self-regulating markets became a crucial parameter around which discursive struggles were waged. It was a currency for ideas to be considered legitimate within liberal circles, a virtual shibboleth that actors were required to espouse in order to achieve influence. Yet even if most participants in British monetary debates defined themselves as liberals and defended self-regulated markets, it is a mistake to believe that they shared a common project. There was no belief that the state should unconditionally limit its interventions in financial and monetary matters. Rather, political debates in Britain largely gravitated around the question of what role the state should play in economic development, not how it should retreat from intervening in it (Knafo 2008). As Eric Helleiner points out, liberals could in practice, move far away from the notion of laissez-faire even while they used it ultimately to justify the policies they promoted (Helleiner 2002).

The notion of market-led governance played a similar ideological function in the classical debates about the gold standard. It provided a perfect rationale for the Bank of England in order to justify its own freedom from government oversight. Yet there was always a significant discrepancy between the official position of the Bank and its internal operations (Ingham 1984: 238). The records of the Bank show that its governors knew full well that their story of the gold standard was at best a partial account (Flanders 1989: 39). In the late nineteenth century, the Bank experimented with all sorts of expedients explicitly meant to control a buoyant financial market. There was a tangible concern at the time that the Bank was losing control over its ability to protect its own reserves of gold and for this reason various informal tactics were deployed in order to reassert the authority of the Bank over the British financial system. These experiments explain why in practice, the behaviour of the Bank never conformed to the myth of the gold standard. As Sayers shows, the Bank struggled in the late nineteenth century to make its discount rate effective and experimented to gain a form of control over the market (Sayers 1976). Despite what the directors of the Bank
claimed publicly, they were better placed than anyone else to know that the gold standard did not operate as the idealized depiction they promoted. This would be finally recognized in the latter half of the 1920s, when the governor of the Bank of England, Norman Montague, finally admitted that he was presiding over a managed-currency system (Schuker 2003).

Few scholars now accept the idea that the gold standard was a fully automated system of governance as presented by the Cunliffe report. Yet two key assumptions from this narrative continue to inform current conceptions of nineteenth-century liberal financial governance. The first idea often associated with the gold standard is that it limited state interventions in monetary and financial markets. Liberal financial governance is thus commonly presented as a passive form of governance. The second theme directly borrowed from these debates is the idea that the gold standard depoliticized monetary governance by placing money beyond politics. And the gold standard is indeed now often presented as a set of fixed rules of the game intended to depoliticize financial governance (Bordo and Kykland 1995). While the underlying notion of an automated self-regulatory market has been abandoned by many IPE scholars, these two underlying assumptions still inform much of the literature on the gold standard. One of the goals of this book is to show how both are mistaken.

Towards a historicist approach to liberal financial governance

The depiction of the gold standard given by the Bank of England in the early twentieth century gave birth to a specific conception of liberal financial governance which remains highly influential. But how can we account for the tendency to hold onto the main tenets of a conception which has been repeatedly labelled a myth? Perhaps the greatest obstacle to a proper reassessment of the gold standard is a small piece of formal reasoning that overrides what a large body of historical evidence tells us: the Mundell–Fleming theorem. Also known as the unholy trinity, this notion has been one of the most influential ideas in the field of IPE. It seeks to capture the essential dilemma that policy makers face in terms of monetary and financial governance. The theorem articulates three different policy options which are all deemed to be beneficial in principle yet impossible to implement all at the same time. The first is the adoption of fixed exchange rate which is seen as facilitating trade, and more generally investments, by stabilizing currencies. The second is free capital movement which is meant to make the allocation of capital more efficient by allowing capital to go where it is most profitably employed. Finally, the third option is domestic autonomy for policy makers which gives them more flexibility to tackle economic or social issues.

The basic idea behind this theorem is that only two of the three options can be adopted at once. This conclusion stems from a simple problem: if states plan to adopt policies that are seen to be detrimental to capitalist investors, they have to ensure that capitalists will not put undue pressure on the currency of this country by moving capital abroad. To stop this from happening, policy makers must
either limit the free movement of capital and stop capital outflows or they must allow the currency to fluctuate in order to absorb the impact of this outflow. Inversely, if the preference is for an open economy with fixed exchange rates, then states have to avoid policies that may trigger capital outflows. In other words they must abdicate their autonomy in policy making.

While formal templates such as the unholy trinity can be useful to grasp the complex relationships between various aspects of the economy, they quickly become problematic when used as a basis for characterizing specific monetary regimes. The main problem with this template is that it often leads scholars to assess these regimes in abstraction from their historical context. In the case of the gold standard, the theorem implies that this regime necessarily limited domestic autonomy because it fixed exchange rates and allowed free capital movement. Scholars have thus been reinforced in their belief that the gold standard was, by definition, a restrictive form of governance. In this way, the formal logic of the theorem has insulated assumptions about the purpose of the gold standard from the historical evidence that confounds them. For even when historical facts show that it never operated in an automated way, scholars can still conclude from the logic of the theorem, that the constraints of the gold standard must have reduced the discretionary power of states.

As is often the case, what seems perfectly sound in the abstract is more problematic when history comes back into the picture. For the three variables upon which this theorem rests (fixed exchange rates policies, freedom of capital movement and domestic autonomy) are rarely clear cut as the theorem would require them to be in order to yield significant insights about history. In reality, all three variables are usually present to some degree in any monetary system. For example, states never lose their full domestic autonomy. How great a margin of manoeuvre does the state require then before we speak of policy autonomy or lack thereof? Similarly, capital control is not an absolute criterion, for rare are the capitalist societies without some form of capital control. It is interesting to note, for example, that we often see the current era as a period of high freedom in terms of capital mobility, yet there are more regulations that govern the movement of capital now than at any other period in history (Vogel 1997). What degree of control, or more specifically what types of capital controls, are then necessary to enable us to draw conclusions on the basis of this model? Finally, exchange rate policies can also be ambiguous even if they appear more straightforward. States that adopt flexible exchange rates are usually wont to let their currencies fluctuate too wildly and often intervene in order to smooth changes or limit depreciations when they are seen to be problematic. Even fixed exchange rate regimes come in all manners and can be far more ambiguous than they initially appear (Reinhart and Rogoff 2004). The fixed exchange rate system under the gold standard was based on the fact that banknotes were convertible into gold. In principle this guaranteed a fixed exchange rate since once a currency was pegged to gold, its relative value to other currencies also fixed to gold would remain the same. Yet this did not mean that the exchange rate between currencies did not vary. As long as market arbitrage was not perfectly
efficient, either because of institutional constraints limiting convertibility or simply because of the costs of moving gold from one place to the other, then there was scope for market prices to fluctuate. Currencies thus did fluctuate even when pegged to the same standard.

Social and institutional complexity of this sort makes it difficult to carry out deductions on the basis of the Mundell–Fleming theorem for the latter relies on a categorization that is too imprecise to be really helpful for historical analysis. In the case that interests us, it has led to a conception of the gold standard that is largely independent from historical facts. IPE scholars can thus highlight discretionary interventions by the Bank of England or the British state when looking at history, without changing their conception of liberal financial governance as a restrictive institution of governance. In most cases, the historical work remains confined to the rank of details that are deemed of historical significance but generally ignored when theorizing about liberal governance. When turning to theory, scholars revert back to a conception of liberal financial governance which emphasizes the passive and non-interventionist role of the state. As a result, there continues to be a large gap between our theoretical conception and our historical knowledge about liberal financial governance. As I show in this book, knowledge of history too often appears of little significance for the way in which we theorize liberal financial governance.

In order to overcome the formal obstacle posed by the Mundell–Fleming theorem, this book adopts a historicist approach that resituates the gold standard in its broader historical and social context. Institutions such as the gold standard may appear to be restrictive from our own contemporary vantage point, but this is often the case because we compare them to our own more modern institutions. Indeed, the argument that the gold standard restricted domestic autonomy is usually based on the fact that it hindered the use of expansionary monetary policies which were in fact only developed in the twentieth century long after the creation of the gold standard. By contrast, I invert the classic viewpoint on the gold standard by analysing it in relation to practices of monetary governance which preceded it. I thus trace the evolution of monetary governance in Britain from the late Middle Ages onwards and show how the nineteenth-century gold standard transformed the way states relate to finance and provided new tools for intervention.

More specifically, the book demonstrates that the institutions of the gold standard put in place instruments of modern monetary policy that are usually associated with central banking (for example open market operations). In this regard, the gold standard was a prelude to Keynesian policies rather than its antithesis as is often assumed. It constituted a crucial stepping-stone towards modern monetary policy, rather than a fundamental constraint that limited its development (Knafo 2006: 97).

An outline of the book

The book is divided into three sections. First, I reconsider the idea of liberal financial governance with the objective of arriving at a more precise conception
of this form of governance. This serves to set up the historical problem that I explore in the next two sections. More specifically, Chapter 1 reviews the literature on the gold standard and examines the ways in which scholars have dealt with the findings emerging from economic history. Here, I am particularly interested in the conceptual solutions developed to take account of the growing evidence that states enjoyed a considerable degree of discretionary power under the gold standard. As I show, a common trait in this literature is a tendency to relegate these findings to the background in order to preserve the assumptions that liberal financial governance was a passive and depoliticized form of governance. Against this background, I argue for a reconception of the gold standard that takes into account the question of state power. What distinguishes liberal financial governance, I argue, are the particular forms of leverage it developed in order to intervene and discipline market actors. These structures for discretionary interventions by states and central banks must be used as a starting point, rather than a set of exceptions, when theorizing liberal financial governance.

In Chapter 2, I complete this theoretical foray by reconceptualizing the gold standard from a historical perspective. I do so by comparing nineteenth-century liberal financial governance, or what I call modern financial governance, with the premodern practices which still prevailed on the European continent at the time. This chapter highlights three key features that distinguished financial governance in Britain: the emphasis on sound money, gold monometallism, and the rise of central banking. As I show, these features were tied to a specific path dependent development that was distinct to Britain; one which profoundly transformed the parameters of governance. By specifying more clearly the nature of this transition, this chapter will help clarify what was the novelty of the gold standard and thus what needs to be explained in subsequent historical chapters. It will ultimately lead me to show that these three features were driven by considerations of power and tied to attempts by the state to extend its authority over finance.

Having re-examined the nature of liberal financial governance from a conceptual perspective, I then turn to the historical study of the rise of liberal financial governance in Britain. The second section of the book covers the early gestation of monetary governance in late medieval and early modern England (up to the late seventeenth century). This historical perspective on the construction of liberal financial governance is vital as the pursuit of sound money emerged in England long before the advent of economic liberalism. As I show, the rise of sound money in England constituted a first cycle in the rise of liberal financial governance.

This section of the book proceeds in two steps. First, Chapter 3 examines the distant origins of sound monetary policies. It begins with the observation that, by the fourteenth century, the pound was following a distinct trajectory characterized by its unparalleled stability. As I show, the rise of sound money was inextricably tied to the formation of the English state and was in part linked to a fiscal compromise that crystallized in the late Middle Ages. Through this
compromise, landlords were able to secure various commitments on the part of the Crown in return for funding. Particularly important here was the ability of Parliament to limit currency manipulations and protect the value of the pound. This development played a vital role in the rise of modern finance, but not the one that is commonly assumed. It is often believed that such an emphasis on sound money must have encouraged the development of finance because it stabilized conditions for investments. Yet the result was exactly the opposite. For the development of sound monetary governance proved incompatible with the development of finance. The reason for this was that the dominant financial instruments pioneered in Italy and the Low Countries relied primarily on currency exchange. For this reason, they were often seen by the English as a source of currency instability. Perceived as a threat to sound money, these financial practices were mostly prohibited by the Crown. The pursuit of sound money in England thus resulted in a crucial problem: the measures to protect the stable value of the pound often hindered the adoption of more advanced continental financial practices. To a large extent, the pursuit of sound money came to be defined by its attempt to discipline merchants who controlled currency exchange and its impact on the value of the pound. This explains the belated development of finance in Britain where specialized financial intermediaries only emerged in the seventeenth century.

Chapter 4 picks up the story in the seventeenth century by looking at the English financial revolution. During this time, England saw the emergence of modern finance, a development that was reflected most impressively in the creation of the Bank of England (1694). The chapter is constructed around a discussion of Douglass North and Barry Weingast’s influential interpretation of the financial revolution which broadly follows the classic paradigm of liberal financial regulation (1989). Starting from the assumption that liberal governance is a limited form of governance, North and Weingast focus on events that curbed the power of the Crown and provided greater security to financial investors (most notably with the Glorious Revolution of 1688). Building on this approach, a broad literature has come to interpret the financial revolution as a product of the partial autonomy given to the Bank of England and the assurances provided to financiers.

By contrast, I argue that the radical breakthrough came from the evolution of new financial practices which were compatible with the emphasis on ‘sound money’ that characterized English monetary governance. The key here was the emergence of banknote-issuing, that is a financial practice that no longer relied on currency exchange. This advance finally enabled a much-needed development of public and private finance previously crippled by monetary governance. A first cycle in the construction of English monetary governance thus came to a close with the resolution of the tension between the development of finance and the construction of sound monetary governance.

The third section of the book turns to the construction of liberal financial governance in modern England and to a second cycle in the development of financial and monetary governance that was launched with the rise of modern banking. As mentioned above, new financial practices based around banknotes
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consolidated the distinctive framework of sound monetary governance. But they also set in motion a profound transformation of the monetary system which would force a radical revision of the old paradigm of governance. Indeed, older practices of governance were tailored to an economy based on precious metal and were rapidly losing their efficacy with the rise of banknote-issuing. Outflanked by new financial practices, state officials were forced to experiment with new forms of state intervention in order to regain a measure of control.

Having shown that the pursuit of sound money was a distinct English development but not a novelty of liberal governance itself, these last chapters examine the two other features usually associated with the nineteenth-century: gold monometallism and central banking. Here I highlight how liberal financial governance was developed as a response to a radically changing financial environment. Crucially I show how innovations in governance were intended to empower the state and thereby secure a grip over financial practices.

Chapter 5 focuses on the eighteenth century. It deals with the second feature that came to be associated with liberal monetary governance: the adoption of gold monometallism. This shift to gold represents a striking development considering that England had traditionally based its monetary system on silver. Few analyses have examined the political ramification behind this shift, as most authors point to accidental causes such as the decision in 1717 by Newton to overvalue gold. What these accounts cannot explain, however, is why the official adoption of the gold standard only took place a century later (1821). This chapter resituates the adoption of the gold standard within the context of the development of modern banking and the political struggles it engendered. I argue that the emergence of modern banking created new challenges for monetary governance which forced an important revision of the traditional paradigm of governance. Most notably, these financial practices politicized monetary governance in a radically new way. For, as banknotes became increasingly important, so did the requests for the state to discipline issuing banks. As I show, it was precisely this attempt to exert power over these banks that motivated the adoption of gold monometallism. The gold standard, I argue, was conceived as a means to subject private banks to public control, initially by forcing upon them the commitment to convert banknotes into gold.

Chapter 6 focuses on the first half of the nineteenth century and analyses the creation and evolution of the gold standard. Having shown that the two features traditionally associated with the gold standard were already in place by the beginning of the nineteenth century, I argue that the real novelty of the era of the gold standard was the slow and gradual construction of central banking. The notion of lender of last resort, which emerged at this critical juncture, illustrates the changing parameters of financial governance at the time. With the growing realization of the central position of the Bank of England, the policies of this institution became increasingly politicized and contested. This new configuration of the financial system posed great challenges for state officials because the most powerful monetary authority, the Bank of England, was still privately owned. The chapter explores how political struggles surrounding the
role and responsibilities of the Bank of England came to revolve around a central issue of power: if the Bank is privately owned, how can the state ensure that the Bank would act in accordance with what was perceived to be the public’s interest. I argue that the main institutional developments of the gold standard were directly related to these struggles and the attempts by the state to find means to exert influence over the Bank of England and, more generally, the monetary system.

Finally, Chapter 7 turns to the second half of the nineteenth century. This period provides a fitting conclusion to the historical study for it allows us to come to terms with the period which constitutes the focus of most discussions on the gold standard. The main characteristic of this period was the widespread adoption of the gold standard by countries other than Britain. This internationalization of the gold standard created the restrictive conditions usually associated with this regime. With fixed exchange rate and the relatively free movement of capital at the time, the gold standard appeared then to have narrowed domestic autonomy. But this view has led many to overemphasize the restrictive aspects of the gold standard. Building on the historical perspective developed in previous chapters, I offer an alternative interpretation.

The chapter starts by recognizing that the widespread adoption of the gold standard did indeed pose significant constraints for monetary policy. But while the establishment of fixed exchange rates imposed constraints on the Bank of England, it would be wrong to conclude that these constraints limited the development of monetary policy and financial governance. On the contrary, this chapter shows how growing pressure from the international monetary system forced the Bank of England and the British state to make crucial innovations in governance both at the domestic and international level. As I will show, market pressures forced greater interventions and the development of new institutional structures which laid the foundations for modern monetary policy.

It is a central contention of this book that financial governance often developed in ways that are surprising to modern eyes. For this reason, it is possible that some of the terms and categorizations which are used in this book will appear idiosyncratic to the reader. For example, I speak of practices of governance to refer to measures adopted by medieval rulers and I often treat monetary phenomena under the rubric of financial governance. This use of words reflects a series of difficult dilemmas which I had to confront in writing the book.

The first concerns the scope of this study which covers some nine hundred years of history in all. In any analysis of this scale, concepts may travel poorly. Their meanings may be appropriate for one period but not for others. It is thus fashionable today to be careful in restricting the use of terms such as state or governance to the modern era. But what one gains in terms of precision, also accentuates the sense of discontinuity between historical periods. This makes it difficult to deal with phases of transition or complex lineages which only gradually set in motion the modern practices we have come to know. In the spirit of an evolutionist account, I have decided not to let words dictate periodization
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and arbitrary cut-offs. Since my primary goal is to recover a history that is too often buried under our modern assumptions about governance, I have decided to emphasize lineages. As I show, liberal financial governance emerged from developments which we do not usually associate with monetary and financial governance. For this reason, I have decided to use key terms, such as monetary and financial governance or sound monetary policy in a relatively flexible way, cutting across historical periods and subject matters in order to unify this study. One could label this use of words as genealogical, in the sense that it seeks to retrace the lineages of the present.

This leads me to a second difficulty which relates to the terms of monetary and financial governance. Here again, vocabulary has often dictated an arbitrary division as scholars compartmentalize the study of money and finance. The literature on the gold standard, we will see, analyses it simply as a monetary institution. This binary has meant that the financial considerations tied to monetary governance are too often excluded with problematic results. Financial practices have important monetary effects and were thus frequently the target of monetary governance. In fact, the regulation of finance in England has often been driven primarily by monetary considerations. I therefore use both terms relatively freely. When I speak of either financial or monetary governance it is mostly in order to highlight one of the two dimensions, but they should always be seen as two sides of the same coin. There are exceptions that are discussed in the book, for example when there was a clear attempt in Britain to distinguish both in the mid-nineteenth century. But for the most part, monetary and financial governance were always treated as integral to one another. In this book I analyse the gold standard as an institution of financial governance in part because my interests lie in the symbiotic relationship which developed between governance and finance (see Chapter 2). As will become clear, any separation of monetary and financial governance was largely arbitrary before the nineteenth century as policies geared toward money often targeted financial practices in the process.

A third and final difficulty concerns the object of study itself: English finance. This book focuses specifically on English finance, but it must be acknowledged that other regions of Britain made important contributions to the development of modern finance (Munn 1988). Scotland, for example saw a very important development of joint stock banks in the eighteenth century which proved to be influential in shaping events in England. Yet the financial systems of England and Scotland followed different dynamics and were regulated differently for a long period. For this reason, I have decided to treat England more or less as an independent unit. I refer in the book mostly to English finance and the English state, except for the eighteenth and nineteenth centuries when I use the term British state to reflect the new political reality following the Act of Union of 1707, while still referring to English finance in order to acknowledge the compartmentalized nature of the British financial system.

These decisions reflect my particular motivation in challenging received assumptions about liberal financial governance. Since the rise of modern finance