

# State Intervention and the Origins of Speculative Finance in Nineteenth Century Britain

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**Abstract:**

This article discusses the origins of the speculative configuration that has come to characterize English banking. It criticizes Gerschenkron's view that early 19th century English banking developed relatively autonomously from manufacturing. Pointing out that he misunderstood the specific nature of English finance and the reasons that explained the later shift towards speculation, it shows how Gerschenkron and his followers have consistently underestimated the role of the state in shaping the nature of English finance. The main argument of the article is that state intervention was a decisive factor in shaping the nature of English finance. It proved crucial in initiating the divergence between English and continental finance, and contributed to the rise of modern banking in England. Finally, I argue that the speculative configuration of finance often associated with England was a late development of the 19<sup>th</sup> century that reflected again changes in the form of financial and monetary regulation.

**Keywords:** England, finance, gold standard, speculation, state intervention, economic policy

# State Intervention and the Origins of Speculative Finance in Nineteenth Century Britain

Samuel Knafo<sup>1</sup>

## *Introduction*

It has long been established that the state played a key role in the economic development of Continental Europe. England, in contrast, represents a far more complex case because its liberal trajectory has contributed to the wide spread belief in the historically limited role of its state. If scholars point out that the British state established the preconditions for capitalism to develop and for the market to run smoothly (notably by consolidating property rights and ensuring a stable currency), they rarely examine how the state actively shaped the very nature of the economy. The state is thus mostly discussed as playing a role in so far as it instilled confidence in investors, but it is never really clear how it shaped their very practices.

This view of the relationship between the British state and capitalism has been particularly influential in discussions of England's financial development in the 19th century.<sup>2</sup> This literature has emphasized how England's economy at the time was characterised by a divide between financiers and manufacturers, and was dominated by the City (Ingham 1984; Elbaum and Lazonick 1986; Green 1988; Gamble 1994; Cain and Hopkins 2000). Most famously, Alexander Gerschenkron defended the thesis that the advanced nature of English development limited industrial opportunities for financiers and incited them to turn towards more speculative

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<sup>2</sup> While I refer to British state, the discussion here is limited to financial developments in England which were somewhat distinct from financial developments in Scotland and Wales. Monetary and financial regulations were different for each of these regions, thus explaining why I focus here to English finance which was the target for most of the measures adopted by the state that are discussed here.

operations (1962). The main feature of this economy would thus have been its speculative leanings. However, the literature remains surprisingly vague on the reasons behind this development.<sup>3</sup> In particular, the perspective championed by Gerschenkron considerably underestimates the role of the state in shaping the nature of English finance. If anything, it is the lack of intervention by the state that is seen here as a determining factor for the specific way in which finance developed. In short, it is argued, the liberal environment of the 19th century would have allowed financiers to pursue speculative interests to the detriment of long term economic growth. With limited regulation restricting their strategies, they could focus on more lucrative and short term endeavours.

At stake in the debate over the role of the state in England's economic development is the way in which we problematize how capitalism itself is socially constructed. Too often, scholars assume that, because of its liberal regulation, England was prime example of a market economy left to develop autonomously. In this article, I argue that this view underestimates the significant constraints imposed by the state on banking practices, and the resistance of important sectors of the financial community towards the concrete measures adopted by the state. These facts suggest that the intervention of the state was not as benign as is often implied. How then do we assess the role of the state in shaping the financial sector? And what part did it play in pushing the financial sector towards a more speculative configuration in the late 19<sup>th</sup> century?

As I point out, the shift towards a speculative configuration of finance in England occurred later than is often assumed. It was neither a defining feature of English industrialisation, nor a simple consequence of its advanced economic development. Rather, it was a late product of a specific trajectory already set in motion before this 'speculative turn'. This observation raises two questions that will be addressed in this article: what were the distinctive features of English

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<sup>3</sup> Debates have raged over whether the configuration of 19th century finance really hindered or not economic growth in England. While critics have pointed out that it deprived the industrial sector of a financial support to compete with foreign industrialists, various authors have pointed out that the causal relations in fact operated the other way around (Cain 1985). It was in fact low demand for credit which explains why financiers turned elsewhere (Edelstein 1994; Collins 1991).

finance and why did it shift towards speculation? By tracing its specificity to the development of fiduciary money (Ingham 2004), I show how banking followed a distinctive course in England that made it less speculative than banking on the continent, at least before the late 19<sup>th</sup> century. In part driven by the industrial revolution, English banking largely developed in a symbiotic relationship with various industries in the provinces. However, state interventions in the 19<sup>th</sup> century prompted a reconfiguration of the English economy. More specifically, the state's attempt to come to terms with changes in banking led to the peculiar divide between finance and industries that has been traditionally associated with the English economy (Zysman 1983; Elbaum and Lazonick 1986a; Cain and Hopkins 2001).

This argument proceeds through four sections. First, I discuss Gerschenkron's conception of 19<sup>th</sup> century English finance. His contribution is of particular importance since it influenced numerous studies that seek to conceptualise the opposition between British and Continental economies. Moreover, his work rests on assumptions – in particular the idea of the speculative nature of English finance and the emphasis on the non-interventionist stance of its state – that are widely held even by those who do not necessarily embrace his perspective. As I will argue, such views miss the specific nature of English finance and fail to grasp the reasons explaining the late speculative outlook of finance. They make it difficult to grasp how British capitalism was socially constructed as its features are presented as almost natural products of a capitalism left to develop without external interference. To address this issue, one needs to embrace a broader historical perspective on the nature of English finance. The article proceeds in this way in the second section by tracing the roots of English finance back to the early modern era, and more specifically the 17<sup>th</sup> century. In doing so, I argue that the intervention of the state is crucial for understanding the divergence between English and continental finance. Thirdly, I analyze the consequences of this intervention by examining the ways in which it shaped the advent of a different form of banking, establishing in the process the foundations for modern banking. Ultimately, this leads me to show how the speculative configuration of finance often associated with England was a late

development of the 19<sup>th</sup> century that once again reflected changes in the form of financial and monetary regulation.

### ***1. Gerschenkron's Conception of Banking under Capitalism***

In his famous study *Economic Backwardness in Historical Perspective*, Alexander Gerschenkron offered a critique of the conception of economic development that was dominant in the early 1960s. At the time, the modernization school propounded a linear model of economic development which assumed that industrialisation required a series of prerequisites that were similar for all countries (Rostow 1960). In challenging this universalist conception of development, Gerschenkron favoured a nuanced comparative understanding of industrialisation. Industrialisation, he argued, was not only shaped by the distinctive social configuration of a country, but also by its competitive relationship to other economies. Indeed, the condition of economic backwardness, he emphasized, profoundly influences the nature of industrialisation, because the challenge of 'catching up' with more productive economies forced lagging countries to find institutional substitutes to compensate for a weaker economic environment (Sylla and Toniolo 1992).

Among these, Gerschenkron attached special significance to the development of a strong banking sector aligned with the requirements of industrialization (Gerschenkron 1962: 103). Financial institutions, he argued, had developed differently depending on whether they came to assume the role of a substitute in the process of industrialisation. According to him, advanced economies, such as 19<sup>th</sup> century England, faced weak competition from abroad during the early phases of industrialisation. This limited the need for manufacturers to finance large-scale investments, and thus to find external sources of credit (Gerschenkron 1962). As a result, he argued, financiers and bankers, with few opportunities in industry, were compelled to look for more speculative investments with high rewards and short term horizons. The English economy

would thus have reinforced *rentier* activities and encouraged a superfluous growth of finance that was out of line with the needs of other economic sectors. By contrast, what he saw as moderately ‘backward’ countries, such as France and Germany, faced strong competition, notably from English manufacturers, which structured differently their financial incentives. The adoption of industrial technologies from more advanced economies offered interesting prospects for investors, but involved high costs that industrialists could not match without proper financial backing. Bankers could therefore take on a crucial role within these less developed countries, not only in order to pool resources, but also to provide a certain leadership to compensate for lower entrepreneurship, notably by coordinating investments. This difference, according to Gerschenkron, partly accounts for the fact that banks in Germany, for example, are deemed to have had stronger commitments towards manufacturing or production than in England.<sup>4</sup>

Embedded within this analysis was a broader claim about the pivotal role of the state of ‘lagging’ countries in compensating for the market dynamism of an early industrialiser. In England, for example, the state was said to have adopted a liberal approach that was characterised by a relatively low level of state intervention, which would have thus encouraged the development of a speculative configuration of finance. From this perspective, the state would have kept financial markets relatively free of institutionalised constraints and thus freed financiers to focus on short term speculative investments. By contrast, state intervention in lagging countries would have been crucial in disciplining the banking sector in order to ensure its dedication to sustaining productive growth. Gerschenkron posited that the more significant the lag, the more pronounced the responsibility of the state in compensating for economic weaknesses. In sum, by thinking of state intervention in terms of a substitute for poor market activity, Gerschenkron

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<sup>4</sup> While Gerschenkron’s was lauded for his comparative work on banking in Europe, his theory was attacked on a variety of fronts by economic historians who, most notably, demonstrated that banking was neither as speculative, in the case of England, or as oriented towards manufacturing, in the case of continental Europe, as presumed by Gerschenkron (Fohlin 1999; Sylla and Toniolo 1992).

reinforced the impression that more advanced economies generate few incentives for their state to intervene in their economic development.

From this analysis, a highly influential picture of English finance has emerged according to which financiers displayed little interest for industry and operated in a relatively free and liberal context that allowed them to spurn the latter. This picture resonated with a long standing argument running through the work of Hobson and Schumpeter which insisted on the essentially aristocratic and imperialist leanings of financial circles in England. Echoes of Gerschenkron's thesis can also be seen in the ongoing debate on the progressive decline of the British economy, which was partly attributed to the lack of support from the financial sector, and more broadly the state, to industry (Anderson 1964; Hobsbawm 1969; Elbaum and Lazonick 1986; Rubinstein 1993).<sup>5</sup>

However, this conception suffers from two significant deficiencies. The first stems from the suggestion that the lack of state intervention consolidated the development of this speculative configuration of finance. As I mentioned above, the fact that financiers were the most vocal opponents of financial measures adopted by the state in the first half of the 19th century suggests that state intervention had been more disruptive than often assumed (Kynaston 1994: 40). Moreover, the numerous changes in banking regulation at the time indicate that the British state never really conformed to the notion that it established fixed rules of the game for financiers. On the contrary, the emphasis placed by the state on stabilizing its currency compelled it to experiment in various ways with banking regulations, imposing a variety of constraints on

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<sup>5</sup> Various authors have sought to set this speculative configuration in broader historical perspective, generally by showing the convergence of interests between aristocrats who controlled the state and financial interests in the city. (Ingham 1984; Cain and Hopkins 2001; Rubinstein 1993). In one of the most ambitious attempt to chart this evolution, Cain and Hopkins have argued that the revolution of 1688 and the ensuing political settlement, which saw parliament gain a certain control over the Crown, laid out the foundations for an alliance between the aristocracy and the City that would have consolidated this speculative trajectory.<sup>5</sup> However, it is indicative of the lacunae of these approaches that the analysis of the importance of financial sectors rarely translate into concrete discussions of the measures adopted by the state to shape the advent of this speculative configuration of finance. Ultimately, these authors return to the idea that it was the free rein given to financiers and the focus of the state on protecting investments that characterizes financial development in England.

banking that would prove important in reshaping the nature of banking practices. In this way, it distorted the expectations of merchants and bankers making it impossible for them to continue operating as they had previously. Hence, state intervention was important, not so much because it provided a secure environment for financial institutions, but because it moulded, albeit at times unwittingly, the very form of financial institutions themselves. As I will go on to argue, the state thus holds the key for understanding the reasons behind the profound divergence in financial practices between English and continental finance and for explaining the later shift towards speculation that can be observed in the late 19th century.

A second problem is that this theory largely exaggerates the speculative leanings of English finance, especially before the late 19th century. One of the central and formative processes in the development of England's financial system was the dramatic expansion of country banking that took place in the late 18<sup>th</sup> century and early 19th century and which was directly linked to the process of industrialization in the English provinces. Indeed, provincial banks were often created by industrialists, or people close to them, casting significant doubts on the speculative preferences of English banking at the time. Even financial houses in London were more or less connected to this process of industrialisation. As Ian Black notes, the rise of country banks coincided with an important expansion of banking in London as the number of private banks grew – from 42 in 1770 to 70 in 1800 – under the impetus of provincial banks looking to London for discounting some of their assets (Black 1996: 115). For the first half of the 19th century, the discount market, which occupied a critical position in the City, would continue to be tightly connected to these provincial developments (King 1936; Scammel 1968).

Such evidence suggests that Gerschenkron and his followers misconstrue the real specificity of the English financial system at the time. In part, the reason for this lies in the preoccupation of scholars with the dominant figures of the City (i.e. the Barings, the Rothschilds, or the Hambros), which they mistakenly discuss as key representative of English finance. In fact, these bankers were often descendants of continental banking families, and mostly arrived in

England in the late 18<sup>th</sup> or 19<sup>th</sup> century (Chapman 1984: 11). More importantly, they either learned their craft on the continent or by doing business with continental bankers, often acting on their behalf (Ziegler 1988: 45-46; Kynaston 1994: 11). As I will show, the foreign origin of merchant banking is no coincidence. It strikingly illustrates the profound divergence between continental and English banking. Coming from Holland or major German cities such as Frankfurt, these merchant bankers had a long tradition of dealing with long distance trade and speculating on currencies. This was a direct consequence of the type of financial practices that were dominant on the continent where financial instruments had been elaborated for dealing with fluctuating exchange rates. It was these practices which enabled continental bankers to project themselves onto the international scene in a way that few English bankers could afford to. While these merchant bankers certainly became significant in the social and financial fabric of England, they provide a poor basis for conceptualizing the specific institutional form of English finance. Traditional banking in England was notoriously limited in scope. Banks were small in size, created few branches, and operated within a circumscribed and limited area (Pressnell 1956; King 1936: 39). Even traditional financiers in London who were connected to international trade, such as the discount houses that proliferated in the City and financed Atlantic trade, for the most part operated out of London. By contrast to their continental counterparts, English bankers rarely opened branches in other important financial centres and had a limited ability to project themselves internationally.<sup>6</sup> As I will go on to discuss, the most striking features of the English financial system were largely related to a specific form of banking that emerged in England, and which was distinct from the practices of merchant bankers in the City mostly inherited from the Continent.<sup>7</sup>

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<sup>6</sup> For a rich discussion of the early development of finance related to Atlantic trade see Sheridan, 1958. The ways in which continental merchant bankers came to fill a void left open by English banking in London is a complex matter that cannot be fully dealt with here, but there is little doubt that their international outlook and financial instruments would play a crucial role in taking over a niche left vacant in London.

<sup>7</sup> Such differences remind us that finance cannot be treated in an overly simplistic way as if one could to think of the vast array of financial activities that existed in England as being defined by a common financial

## ***2- The politics of sound money and banking***

The significance of English banking and state policies in the 19<sup>th</sup> century cannot be grasped properly without situating them in a broader historical perspective. The attachment of the state to sound monetary policy, for example, was not a novel feature associated directly with liberalism or the rise of financial capitalism. On the contrary, there is a long tradition of sound money in England which goes back to the late Middle Ages (Braudel 1984: 356; Arrighi 1994: 187). A brief review of this history will show that the concern with sound money created significant obstacles for the development of finance. Indeed, far from consolidating a liberal environment for financial investors the state established numerous constraints that impeded the adoption of financial practices common on the continent. Such measures imposed to protect the currency proved crucial in setting up the field for the advent of a novel form of banking in England.

The origins of the emphasis on sound money can be traced back to the struggles between the Crown and landlords over public finance and the emergence of the English parliament from the 14th century onwards. Parliament was initially used by the Crown as a means for convening landlords in order to agree new taxes (Ormrod 1999: 20). In return for granting taxes, landlords imposed certain conditions, thus, in turn, using parliament as a means for defending their own interests. With time, landlords progressively gained somewhat of a veto on taxation, and began discarding practices they deemed detrimental to their interests as a condition for providing extra financing to the Crown. One practice they particularly targeted was the debasement of currencies. Debasements, at the time, had become an increasingly popular means for rulers to amass revenues

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interest. While the great merchant bankers we associate with the City and the brokers tied to the stock market had long been involved in more speculative practices, issue banking in England was mostly linked to trade and industrial activities. These differences were central to the political economy of finance in England and shaped the political cleavages financial regulation that characterized the period.

(Boyer-Xambeu, Deleplace and Gillard 1986). In simple terms, this involved re-minting old coins into new ones which contained less precious metal for the same nominal value. Hence, with the same amount of metal, rulers could mint more coins and keep the difference, or a portion of it, for themselves. These debasements, however, could have serious inflationary effects. As people tended to adjust prices according to the 'real' value of coins, represented then by the content of silver or gold in each coin, the result was often soaring inflation. Landlords thus generally resisted debasements because they could significantly shrink payments they received from their tenants. In England, landlords were relatively successful in fighting off debasements, because they used parliament as a leverage to regularly discard debasements. As a result, England stood as a rare exception in Europe for having very few debasements in comparison to other countries (Munro 1992).

It is important to stress that, while this compromise limited the Crown's ability to manipulate coinage, it cannot be considered to have directly benefited the growth of trade or finance as we tend to assume today. It is often held, for example, that establishing fixed rules of the game offers greater incentives for people to invest because they know what to expect (Bordo and Kykland 1995: 424; North and Thomas 1973: 3). In this way, eliminating currency manipulations and the resulting inflation can be seen to favour trade and finance. In reality, however, these policies had almost the opposite effect because of an crucial unintended consequence.

Since English coins of silver were often less debased than similar coins elsewhere in Europe, a form of Gresham's law was set in motion, as bad money chased good money. It thus became profitable to export English coins with their high content of precious metal, and recoin them in foreign countries where more coins could be minted for the same amount of metal. As the disparity in the quality of silver coins grew, the problem became starker. Between 1250 and 1500, silver coins in Genoa were debased by about 800%, in Florence by 700%, in France by 485%, and in England by only 77% (Spufford 1988: 291). Coins of good quality were thus pushed out of

England, as merchants began exporting them and replacing them with foreign coins of lower quality, often poor imitations of English coins (Munro 1979: 186).

Confronted with this situation, the Crown adopted various regulations for controlling this form of arbitrage. It intervened in trade and finance in order to quell practices that undermined the monetary system and increased the scarcity of silver coins. Notably, the Crown moved to prohibit the export of coins, and condemned the exchange of currency by any other institutions than the Royal mint with the intent to channel foreign coins towards the mint. When these measures proved insufficient, the Crown attempted to ban the use of bills of exchange, and restricted the freedom of foreign merchants, even obliging them at one point to buy English commodities in equal amounts to those they had sold. In this way the Crown hoped to stop foreign merchants from taking home their profits in monetary form and thus limit currency outflows (Munro 1992).

Such constraints on currency exchange and long distance trade were particularly significant due to a second circumstance: the fact that banking became, at the time, increasingly reliant on currency exchange. Spurred by the commercial revolution of the 13<sup>th</sup> century, banking in Italy and the Low countries had initially been developed for addressing the needs of long distance merchants who dealt with various currencies. Partly for this reason, banking had become directly tied to the practice of currency exchange (de Roover 1949). As these practices of exchange expanded, they acquired a financial importance, notably for supplying liquidity or providing short-term credit. The bill of exchange, for example, was initially created for making payments over long distances without having to carry coins, but it began fulfilling various financial roles, notably serving as a means for lending money (Munro 1979: 173). Hence, operations of currency exchange became central to the development of finance, a trend that was reinforced by the fact that these practices enabled bankers and merchants to circumvent laws against usury that prohibited the payment of interest on loans (de Roover 1949). By speculating

on variations in exchange rates between currencies, bankers could thus make a profit without explicitly imposing interest rates.

The success of this form of banking would profoundly shape the financial structure that emerged in continental Europe. Since financial innovations were generally made with the aim of facilitating existing practices, or using them for new purposes, a strong path dependency emerged. Operations based on currency exchange thus remained dominant in continental banking well into the 19<sup>th</sup> century. This also meant that finance on the continent had strong incentives for moving towards speculative practices, since profits depended on arbitrage among currencies. Finally, these practices encouraged bankers to extend their reach over wide distances by establishing branches in various mercantile centers. The great banks dominating the continent relied on large familial networks, as their practices required tight connections to supply information regarding fluctuations of exchange-rates, in order to fully exploit differences in rates across Europe (Braudel 1985).

We can now specify how early policies of ‘sound money’ influenced the development of finance in England. The crucial point here is that premodern banking, dominant on the continent, never took proper roots in England, in part due to the numerous constraints on currency exchange adopted by the English Crown. As I pointed out, containing market arbitrage around currency exchange was a central component of early policies of sound money in this country. While these measures for controlling monetary arbitrage had only limited success in achieving their objectives, and never efficiently quelled premodern financial practices in England, they hindered any *institutional solution* to the problems of liquidity and credit. In other words, even when continental financial practices were adopted informally and used discreetly by merchants, no specialized financial intermediary dealing in currency exchange could afford to openly establish himself as an intermediary *for others* without risking a heavy sanction from the Crown. Premodern practices and monetary dealings thus remained mostly informal, or conducted in foreign centres such as Antwerp.

The most striking consequence of this was that financial intermediaries emerged later in England than in the rest of Western Europe. Early in the 17th century, England was unique in Western Europe for being deeply embedded in great mercantile networks of long distance trade in Europe, while still lacking significant local financial intermediaries. Before the 17th century there was no meaningful development in England of the three characteristic forms of premodern finance (money changing, public banks, and merchant banking related to bills of exchange) (Kerridge 1988: 1-4; Ashton 1960). Thus, far from fostering a 'sounder' environment that was conducive for investments and market development, policies of sound money, arguably, created a threat that stymied financial development and complicated the conduct of long distance trade. As we will see, merchants were thus obliged to invent new types of financial instruments that did not rely on currency exchange, instead of following a path already pioneered on the continent. A strong reminder of this diverging trajectory was the fact that even in the 19<sup>th</sup> century, during the heyday of the City of London, monetary markets for currency exchange remained a distinctly continental affair. It was Paris, and not London, that acted as the center for currency exchange, thus illustrating the strong roots of these operations in continental Europe by contrast to England.<sup>8</sup>

### ***3- The rise of modern finance and banking in England***

Having highlighted the importance of state intervention for understanding the origins of the divergence between English finance and continental finance, I now turn to explore more concretely some of the impacts of these policies on the evolution of finance in England. As I will argue, the specificity of English finance was directly linked to the rise of new forms of banking. Interestingly, and contrary to pervasive assumptions, the banking practices that appeared in this context could be considered less speculative than the practices of continental banking which

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<sup>8</sup> Cassis, notably, points out that financiers in the City had relatively little interests in currency exchange and often turned away from these activities to the benefit of foreign banks (1987: 41-42).

focused on currency exchange. They opened new possibilities that provided great flexibility for business in areas traditionally deprived of metallic coins.

The origins of English banking can be traced back to the 17<sup>th</sup> century. Following Rogers, one can surmise that it was new types of demand for liquidity and credit in the 17<sup>th</sup> century that provided the critical impetus for the rise of modern banking (Rogers 1995). The distinctive feature of these new demands for liquidity was that they were related to trade *within* England, making it difficult to use old financial instruments built around currency exchange. At the time, England was undergoing a unique economic development linked to the rise of a national economy with an increasingly dense network of domestic trade (Braudel 1984: 365-368; Germain 1997: 45).

The early modern English commercial system was thus distinctive in several respects: it depended on a highly developed domestic market and not just on foreign trade, on what might be called intensive rather than extensive expansion, the nexus of increased productivity and a growing market for consumer goods created by the agricultural revolution; this market was rooted in agrarian class relations that subjected direct producers to imperatives of competition; it was based on integration and a specialized division of labour rather than on transactions between separate markets (Wood 1991: 98-99).

The informal and *ad hoc* financial practices used by English merchants before the 17<sup>th</sup> century had been somewhat sufficient for long distance trade, but they could not provide a satisfactory solution for this new internal trade. Seeking ways to supply liquidity and credit without currency exchange, merchants were compelled to devise new techniques of banking. In this context, a major breakthrough was achieved by English goldsmiths when they designed a stable means for

issuing banknotes (Bisschop 2001: 21). It would be the development of this method of banknote issuing that set out the foundations for the rise of modern banking.<sup>9</sup>

What was the distinctive technique elaborated by goldsmiths? Its origins can be found in a practical solution that goldsmiths devised for partially curbing a risk inherent in issuing paper money. Paper money, at the time, was issued on the basis that it could be converted back into precious metal. This was a necessary guarantee for imbuing banknotes with minimal credibility. This commitment, however, posed significant challenges for banks. To begin with, they had to resist the strong incentive to over-issue banknotes in order to finance their own business activities (i.e. using their own banknotes for making loans rather than depend on deposits). Pushed by the imperative of competition, and lured by the prospect of profit, banks had a tendency to lower reserves as much as they could. They could thus easily overstretch their reserves by printing too many banknotes making it difficult for them to fulfill their commitment of converting banknotes back into gold. But even when banks heeded this risk and kept sufficient reserves as required for their normal operations, they were vulnerable to fluctuations in economic activity. Small demands for banknote conversion in normal times could radically increase during times of economic difficulty and leave banks vulnerable. For this reason, the issue of banknotes was fraught with difficulties and often restricted by state authorities in Europe. Most notes were issued against an equivalent deposit that was earmarked specifically for redeeming the note at a later date (de Roover 1948). In other words, no new liquidity was produced by this practice.

English goldsmiths developed a solution to this problem by issuing banknotes through discounting. This provided a relatively secure footing because it partially neutralized the risk of people converting banknotes into gold on a mass scale. Discounting is an operation by which one

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<sup>9</sup> Modern banking can be described as a new set of banking practices that were tied to the debt form of money which came to replace the commodity form typical of the medieval and early modern forms of money. Whereas the commodity form of money based its credibility on a commodity which was said to embody the value it represented (e.g. gold or silver), the debt form rested on a promise for a future transaction (redeeming a banknote into gold, etc.) This new form of money provided possibilities for banking which were exploited in England and gave rise to original institutional arrangements (Sayers 1967).

agent offers liquidity, traditionally coins, to a client for a financial asset that has not yet come to maturity. Its purpose is to provide liquidity to people who have financial assets they cannot immediately use. By using this operation to issue banknotes, goldsmiths created a flexible mechanism that ensured the credibility of banknotes, since they were still convertible into gold, and remained secure since banknotes could only be converted back into gold once the assets against which they had been issued came to maturity (usually 3 months) (See Quinn 1994).<sup>10</sup> This greatly reduced the risk of bankruptcy since the delay allowed goldsmiths to cash discounted assets they had in reserve and acquire the gold coins necessary for redeeming their banknotes in circulation.

This innovation had a profound effect on the role of banking within the English economy. Indeed, the new issuing banks that emerged on this basis began injecting important sums of liquidity into the economy. They established the foundations for a highly responsive banking structure that could adjust the supply of money to the needs of an economy in a relatively precise way. This method also helped them limit the risk that too much paper money would be put into circulation and produce inflation. By issuing banknotes against bills of exchange, bankers contained inflation because bills generally involved the production of goods. Banknotes were thus issued more or less against 'real' economic transactions and broadly fluctuated in tandem with economic activity. This was particularly the case early on when banknotes were generally converted back into gold after short periods of time (about three months), and thus never really accumulated in circulation (Melton 1986). For this reason, the supply of money could be extended roughly according to monetary needs and vary with relative precision according to changes in economic activity.

This method constituted a stepping stone for the rise of modern banking in England and reached its pinnacle during the industrial revolution in the late 18<sup>th</sup> and early 19<sup>th</sup> century. The

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<sup>10</sup> What made these banknotes more liquid than the assets against which they were issued was the reputation of goldsmiths and certain practical features of banknotes, such as their standardized denominations (Nevin and Davis, 1970).

most sustained development of banking at the time occurred in English provinces where the new industries were located. This growth of ‘country banking’ was particularly spectacular between 1784 and 1793 when their number multiplied three fold, reaching over 300 (Pressnell 1956). Such a success was tied to the solution these bankers provided for one of the biggest difficulties that industrialists faced: the need to find means of payment. Industrialization heightening the need for circulating capital in order to pay for wages and raw materials. However, securing means of payments was a difficult task for industrialists mostly operating in the provinces. Specie rarely trickled down from London, and few banknotes from the Bank of England circulated outside of London. As Wordie notes:

In the late eighteenth century, industrialists still found it necessary to strike their own token coinage and to introduce the notorious truck shop and tally systems, in a desperate attempt to find ways of paying their workforce in a monetarized age which still found itself embarrassingly short of enough ready cash to transact all of its business (Wordie 1977: 68).

The pressures on the supply of money increased as industrialists desperately looked for new sources of liquidity. Hence, a ‘first group of bankers consisted of entrepreneurs, whose approach to banking was strongly influenced by the need to provide local means of payment, and was sometimes aided by the wealth already accumulated in business’ (Pressnell 1956: 14). Often born out of commercial or industrial ventures, these banks developed by adapting the techniques of English goldsmiths to their own specific needs. While, they did generally offer short terms credit – in part a legacy of the innovations of goldsmiths – this does not mean that finance had a speculative predisposition as is sometimes suggested. On the contrary, the provision of short term credit partly reflected the demands of industrialists, which were essentially geared towards liquidity rather than credit for investments (Pollard 1964: 305). As various authors have noted, credit only played a limited role in financing fixed capital, such as machinery, in the early phase of industrialization (Cameron 1967: 26; Chapman 1970). Investments were mostly covered by in-

house profits (Pressnell 1956: 113; Crouzet 1985: 145). By contrast, the question of liquidity loomed large as a concern for industrialists, and here country banking appeared perfectly suited for their needs.

It should also be emphasized that the basic practice initially developed by goldsmiths was not inherently opposed to credit for larger investments. As Cottrell shows, country banks often ‘went to considerable lengths to accommodate their industrial clients’ (Cottrell 1979: 236-237). When the need for greater investments was felt, country banks could adapt these short term practices in order to address demands from industrialists for financing heavier investments. The simple way to do so was to roll short term loans over long periods of time (Pollard and Ziegler 1992; Collins 1979). In other words, ‘lending to industry consisted of short-term loans and discounting bills, resulting in long- and medium- term credit being provided by the renewal of short term facilities’ (Newton 1996: 67). These practices required close relationships between industrialists and bankers so as to enable a tacit understanding that short term loans would be regularly renewed. For this reason, one could argue that while practices of discounting might not have been the most appropriate method for large investments, the use of short term credit cannot be viewed in itself as an inherent bias against industrialization, or even less as a bias in favour of speculation.

In sum, country banking played a crucial role in the process of industrialization, notably by contributing to the monetization of English provinces. In this regard, it is striking that British banking appeared more amenable to the interests of industrialists, than the merchant banking that dominated on the continent before the mid 19<sup>th</sup> century. Industrialists in Belgium, France, and Germany had traditionally received little support from continental merchant bankers who focused on commercial activities (Landes 1956: 208). Hence, when these continental industrialists sought financial support, it was towards Britain that they turned for new ideas (Ratcliffe 1973: 32). Many would thus adopt the model of joint stock banking that emerged in Britain, which they saw as a powerful tool for financing their own industrial ventures.

#### *4- The gold standard and financial speculation in the late 19th century*

In the previous sections, I have discussed the role of the British state in actively pushing finance in a different direction to that of continental banking – a path which was closely connected to industrialisation. How then can we explain the shift towards speculation in England? Scholars who follow Gerschenkron conventionally conceptualize the development of finance as if the causal relationship between English finance and regulation ran from the former to the latter. From this perspective, the framework of financial regulation adopted in England was reflective of the influence of financiers and largely accommodated their interests (Rubinstein 1985; Cain and Hopkins 2000). Such a view, however, tends to essentialize the interests of financiers, as if they inherently privileged stable monetary environments to protect their financial assets from inflation. As I pointed out, the opposite actually held true in a premodern monetary environment where currency exchange represented a crucial nexus for banking practices. Monetary instability had long offered speculative opportunities which could be exploited to great effects by well organized merchant bankers. There were thus no intrinsic biases for financiers and bankers in favour of policies of sound money as demonstrated by the significant resistance to such policies among various financiers in England.

However, modern banking did profoundly transform the interest of the financial sector. Yet, even in England, financiers were ambivalent about policies aimed at stabilizing the value of the currency. These bankers were more dependent on monetary stability than premodern bankers on the continent because they kept financial assets in reserve for significant periods of time before redeeming them. Hence, country bankers often privileged a stable currency in order to protect the value of the bills of exchange they had in reserve. A similar concern emerged in the context of Atlantic colonial trade when British merchants fought to stabilize colonial currencies

(Greene and Jellison 1961: 486). But, while bankers needed a stable currency to protect the value of their assets, they generally opposed the specific measures adopted to combat inflation and depreciation in Britain because bankers were themselves the targets of such policies. As I highlighted above, merchants often complained, from the late Middle Ages onwards, about restrictions on their financial dealings. Similarly, bankers in the early 19<sup>th</sup> century were the most vociferous opponents to the gold standard and the various measures to protect the value of the pound that accompanied it (Moss 1981).<sup>11</sup> As we will see, it was only once bankers had adapted to the new institutions of the gold standard that they began defending them. Hence, in many ways, it was not financial interest that motivated the adoption of the gold standard, but the gold standard which shaped finance to its image.

Why then did financial institutions begin supporting the gold standard and how did it take the speculative outlook that is now seen to be characteristic of Anglo-Saxon finance? The key to this problem lies in the form of governance instituted by the state to regulate the specific form of modern banking that had emerged in England. Policies of sound money acquired their classical form with the rise of the gold standard in the 19<sup>th</sup> century, which reflected an attempt by the state to come to terms with a new financial landscape. With the advent of modern banking, the monetary system had been profoundly transformed. Banking became the central channel through which money was created, as banknotes came to represent around 60% of the supply of money in the early 1810s (Marchal and Picquet-Marchal 1977: 84). For this reason, the control of the supply of money became tied to the regulation of banking rather than currency exchange as had previously been the case. The explicit purpose of the gold standard was precisely to control

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<sup>11</sup> One important exception were the London bankers, notably those represented by Henry Thornton. These bankers had the particularity of competing with the Bank of England for discounting bills of exchange in London and constituted an exception among bankers because they did not issue banknotes. Their initial campaign in favour of the gold standard was a clever means to have constraints imposed on the Bank of England's ability to discount mercantile assets through the issue of banknotes, without putting into question its role as a lender of last resort. However, as the gold standard became more stringent and pushed the Bank of England away from its commitment to act as lender of last resort in London, London bankers became increasingly wary of the institutional framework of the gold standard, a development which would lead to Walter Bagehot's demand for profound reforms geared towards supporting this banking community.

inflation by imposing tight constraints on the banking sector (Knafo 2006). Initially, the state believed it could limit banknote issuing by imposing full convertibility of banknotes into gold. Yet, as it proved insufficient, parliament moved to implement further constraints, which curtailed issue banking and gave the gold standard its classical features. Most notably, banknote issuing was gradually centralized under the control of the Bank of England, thus laying the foundations for a tighter form of monetary governance.

The consequences of this shift were far reaching, not only because they institutionalized the first central bank and laid down the foundations for modern monetary policy (Scammel 1968), but also because they profoundly transformed, once more, the relationship between banking and manufacturing. In its attempt to curb issue banking, the state imposed tighter constraints on country banks (e.g. establishing a tight ceiling on the issue of banknotes which blocked the latter's ability to proliferate) and began to systematically favour new types of banks – namely joint stock banks – by offering them specific privileges (e.g. limited responsibility) (Davies 1994: 315-322). In part, the objective was to shift banking practices away from banknote issuing. Indeed, the new joint stock banks, in contrast to the old country banks, operated on the basis of deposit banking and deposit transfers, mostly through the use of cheques, and no longer issued banknotes (Scammel 1968: 136). As the state made Joint stock banks more competitive, these banks began growing at an exponential rate, progressively incorporating old country banks through a process of mergers and acquisitions that became particularly prevalent in the late 19<sup>th</sup> century (Cottrell 1992).

The important point about this shift for our discussion is the way in which it profoundly transformed the relationship between banking and industry by creating new imperatives for banks. As I have argued, country banks were able, to some extent, to produce the liquidity they needed for their operations by issuing banknotes. Joint stock banks, on the other hand, required deposits, and thus had a stronger incentive to expand their operations over a large territory in order to pool larger sums of deposits (King 1936: 39). This expansion, however, posed problems

for the informal practices which had previously linked banking to industrialization (Cassis 1987: 102). Banks were now obliged to formalize their operations in order to confront the growing complexity involved in managing their deposits and their increasing size. They adopted stricter rules of credit allocation and tightened their organization in order to oversee a large network with branches increasingly remote from their center. As a result, banks progressively turned away from their local roots and abandoned their informal credit arrangements, upon which industrialists had come to depend (Baker and Collins 1999; Collins 1991). It is this reorganization of banking, coupled with the growing competition from foreign industries, that sparked the various complaints from industrialists regarding the inadequacies of banking in England in the late 19<sup>th</sup> century (Cain 1985). Thus, the rift between English banking and industrialization was, in part, the effect of broader changes in the nature of banking, rather than the product of some ‘fundamental’ opposition between productive and financial interests. Therein lies the misfortune of an industrial sector that had developed financial tools of its own, but was increasingly sacrificed, not to financial interests in themselves, but to the state's attempt to build a structure of monetary governance at a national level (Knafo 2006). As the gold standard consecrated the shift to joint stock banking, it ultimately pushed provincial banks away from industries.

How then did policies of sound money come to be seen as germane to financial interests? As I mentioned, these policies created finance in their image, rather than the opposite. Once financiers had adapted their practices to the new context, they became dependent on the very conditions upon which they had built their operations, and thus became proponents of such policies. A similar dynamic had occurred in the late Middle Ages and early modern period when the Crown had restricted the extension of continental practices in England, pushing merchants to find novel financial techniques. These constraints indirectly encouraged merchants to develop new banking practices that no longer depended on currency exchange. Bankers, operating in a stable monetary context, could now afford to make commitments that would have been unrealistic in a different environment, thus leading to the specific form of banknote issuing through

discounting that emerged in England. Yet, as I discussed above, the position of these bankers remained ambivalent in this regard. Despite their preference for monetary stability, bankers often resisted the specific ways in which the state tried to ensure this stability, as they found themselves the common target of such policies. However, with the rise of joint stock banking, banks turned away from banknote issuing. As a result, bankers no longer needed to concern themselves with the requirement that banknotes be convertible into gold. Liberated from the constraints of the gold standard, the preferences of bankers once more evolved. Still wishing to protect their assets in reserve, yet no longer affected as before by the gold standard, bankers began defending a system they had previously resisted.

## **Conclusion**

This article has critiqued Gerschenkron's notion that finance in England was characterized by its detachment from manufacturing and the pervasive assumption that the state simply established fixed rules of the game which allowed financiers to go about their business freely. I have highlighted two ways in which this conventional view of English finance has been misleading. First, I argued that the intervention of the state in financial matters was a crucial catalyst in bringing about the new modern form of banking that emerged in England. This intervention was motivated by the attempt to protect the value of the British currency and reduce inflation, and was pursued through attempts to institutionalize, rather than liberalize, the market. Indeed, the ability to pursue policies of sound money required important institutional innovations and was constantly threatened by further banking and financial developments. The institutions of the classical gold standard only represented the culmination of this specific regulatory trajectory aimed at limiting the destabilizing effects of banking and financial markets on the state and on a British society dominated by landlords.

Second, I demonstrated that these policies were not directly tied to financial interests. On the contrary, they contributed initially to hampering financial developments, notably by prohibiting currency exchange on which continental premodern banking was based. This was a crucial factor that pushed English merchants away from the practices developed on the continent and which contributed to the rise of banking as it emerged in England. Once more, in the 19<sup>th</sup> century, state intervention was an important force behind the realignment of banking in England, when the state attempted to contain banknote issuing. The gold standard moulded finance to its image, rather than the opposite. As financiers adapted to this new context, they became the main proponents for sound monetary policies. The fact that the interests of financiers evolved in much more radical ways than is often assumed constitutes a stark reminder that both state policies and financial practices cannot be assessed outside their social context, and that financiers do not have interests that can be inferred prior to historical contextualization.

These arguments illustrate the importance of a closer examination of the role of the state in shaping specific economic practices and a reflection on the broader historical context within which it takes place. Without this historical perspective, it is difficult to assess the real significance of financial developments and the policies that condition them. Ultimately, the role of the English state in profoundly reshaping finance from the late Middle Ages onwards highlights the extent to which the distinction between England and continental countries lies in *qualitative* institutional differences and the specific social struggles that emerged around them, rather than in a '*quantitative*' disparity in the levels of state intervention. Too often liberal forms of governance are equated with either a limited or a neutral form of state intervention. Such assumptions only contribute to an essentialist conception of capitalist development, as if there was a more pristine form of capitalism that could be observed in Anglo-Saxon countries. Against such a view, this article stresses the need for a more sustained examination of the role of the state in the construction of capitalism; one that focuses on the ways in which the state shapes the very

practices of capitalists, rather than simply the preconditions within which these capitalists operate. Only such an emphasis can allow us to grasp how capitalism is socially constructed.

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