

The Global Financial System

1750–2000

LARRY ALLEN



**THE GLOBAL FINANCIAL
SYSTEM 1750-2000**

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Contents

PREFACE 7

INTRODUCTION 9

- 1 The Coming of the Corporation 15
- 2 The Making of Financial Markets 40
- 3 Gold and Silver: Aristocrats of Monetary Standards 72
- 4 The Triumph of Paper Money 88
- 5 The Passage from Free Banking to Central Banking 99
- 6 The Birth of World Currencies 126
- 7 The Road to Flexible Exchange Rates 142
- 8 The Evolution of International Banking 155
- 9 The Paths of Foreign Investment 173
- 10 The Struggle for Free Trade 184
- 11 The Vicissitudes of Capitalism 210
- 12 The Age of Financial Integration Begins 223
- 13 In the Shadow of the Global Financial System 232

REFERENCES 237

BIBLIOGRAPHY 242

INDEX 249

Preface

This book strives to bring together all the threads of financial development that played a role in creating the globally integrated financial system of today. It is a history book, tracing the development of the world financial system since 1750 and when necessary reaching further into the murky recesses of economic history, searching for the seeds that grew into the current global system.

Historians have long adjusted to the idea that economic events rival political events in historical importance, that the passage from hunting to tillage (Agricultural Revolution) and the passage from domestic industry to the factory system (Industrial Revolution) rank on a level with the French Revolution or the American Revolution. Great political events are often the product of economic factors.

Financial markets put a premium on knowledge of the future. Expectations of the future and a passion to decipher it can engender a contempt for the past, for historical knowledge regarded as as dead and useless to market participants as the snake's dead skin is to the snake that has just shed it. Constantly teased by a modestly illusive future, players in financial markets are too busy to look back, their minds a battleground for hopes and fears that feed on partial knowledge, too focused for rational thought. The powerful emotions that recurring fluctuations induce in experienced market participants suggests that more perspective is needed in the understanding of financial markets, the type of perspective not supplied from the vast statistical and time series studies of existing financial markets, but a perspective akin to the wisdom that comes from the study of history in a wide sweep. The historical sweep brings to light an obstinate force of organic growth more powerful than social and political institutions, one that continues to drive innovation

and evolution in the global financial system.

In the not too distant past, evolution of the global financial system required governments to abandon a gold standard hal-
lowed by time, considered the mark of financial probity, in
favour of an inconvertible paper standard, previously the symp-
tom of unsound public finance. More recently governments
have given up trade barriers, and formed trading blocs of politi-
cal rivals, decisions as difficult as giving up the gold standard.
Current problems of the global financial system call for hard
choices to be made, choices between regulation and deregula-
tion, between fixed and flexible exchange rates, between trade
restrictions and free trade, between competition and coopera-
tion and between capitalism and socialism. As evolution of the
global financial system accelerates, governments may have to
adapt even faster, facing issues equally difficult, having less time
to settle them. A historical knowledge of the global financial
system will remind us these dramatic adaptations are not new.

The research for this book was done at the Mary and John
Gray Library on the Lamar University campus in Beaumont,
Texas. I am grateful to the librarians who assisted me and to my
students at Lamar University whose questions remind me that
mastering a subject is a lifelong process.

Introduction

Let us imagine that the global financial system's history is a dome of many-coloured glass, presenting to insiders a different view from each angle of observation. As we observe the historical dome from different angles the financial system graduates from landed wealth to financial wealth, from family businesses to corporations, from debtor's prison to limited liability, from mercantilism to *laissez-faire*, from free banking to central banking, from a gold standard to a paper standard, from government initiative to private initiative, from national enterprises to multinational enterprises, and from isolation to globalization. Since the global financial system is an interdependent system, the first question before us is where to start, which angles offer observers the deepest insights into the global financial system, which bring into focus those components whose evolution can be traced over a significant span of time, and whose role in the global financial system have helped pave the way for growth in its size and interdependence.

We will begin with the corporation, trying to find the secret impetus to bigness in these irrepressible business organizations. Multinational corporations are not a late development in the corporate form of business organization, but rank among the first corporations organized. The ability of individuals to quietly buy into part ownership of a corporation, or sell out a partial ownership, without the permission of other owners (stockholders), enabled bold corporations to amass larger amounts of capital, and assemble groups of owners from wider geographical areas. By limiting potential loss to the amount of initial investment, these corporations reduced the risk to owners (stockholders), reducing the rate of profits required to attract capital. These corporations became a conduit for capital

surplus nations to invest in remote areas of the globe (remote to Western Europeans at least), where risks were high because knowledge of local conditions was poor.

Next the growth of the corporate form of business organization cleverly enrolled the exuberant forces of speculation in the service of global expansion. Because corporations from the outset marched to the beat of foreign trade, stockholders had imperfect and limited knowledge of economic conditions governing the profits of individual companies. Stockholders in corporations floated on a thin film of confidence, rapidly rising or sinking with the next day's inflow of partial and fragmentary information. By the end of the twentieth century the globe is brightly dotted with animated financial markets sensitive to financial inflows and outflows emanating from a global reservoir of capital, reinvigorating parts of the world once thought moribund.

A financial system is a framework that facilitates financial transactions, and these transactions require an accepted form of money, something that can serve as a medium of exchange, a unit of account, a store of wealth, and a standard of deferred payment. The swelling ranks of corporations, propelled by speculative fever, searching the globe for markets and raw materials, brought the added momentum needed for the development of a global financial system, but for it to freely run its course a world monetary system was necessary. Trade itself can function, awkwardly, on the basis of barter, and credit agreements can be individually negotiated under a barter system if political entities exist that can enforce contracts. The rub to a barter system is the investment of time in finding opportunities for transactions, since each transaction requires a coincidence of wants between the parties to it. An acceptable form of money multiplies the rate of exchange for goods and services, and the number of viable creditor-debtor relationships. A global monetary system facilitated transactions between economies as diverse as the colony of Virginia, where tobacco functioned as money, and the province of Canada, where beaver skins served as money.

Gradually the diverse economies of the world take hesitant steps toward developing a monetary system capable of facilitating trade on a global scale. Money-smart English investors asked

Parliament for the banishment of paper money in busy American colonies, not wanting to extend loans to colonists if these loans could be repaid in the depreciated paper money of colonial governments. In the late nineteenth century budding Russia reverently adopted the gold standard, wanting to become more attractive to foreign investors. In the eyes of anxious investors in England and Germany, only the stiff-necked gold standard could secure the safety of investments in Russia, Japan, and other capital-short countries, assuring that profits earned in these places were transferable back to England or Germany, and that investments could be liquidated and returned to the country of origin without loss from currency depreciation.

The gold standard triumphantly advanced to the forefront of monetary metals as the volume of trade expanded and stretched over wider distances, putting a premium on forms of money that carry the maximum value per unit of weight, reducing the burden of transport. As gold edged out silver as the reigning monetary metal, countries without either of these metals began daring experiments with paper money, a form of circulating money that maximized value per unit of weight. Sweden, warmly rich in copper deposits, boldly issued copper notes, redeemable in copper. In seventeenth-century Sweden copper coins circulated as money but were too heavy for convenient transportation in transactions involving large sums of money. Lighter copper notes redeemable in copper lightened Sweden's burden of coinage transportation, but evolved into an inconvertible paper money system, a stage of development that all paper money systems eventually reach. Sweden experienced currency debauchery and political chaos before turning up its nose at copper and paper and establishing a silver standard in 1776. This paper money drama was played out again and again in the Old and the New World. Central banks progressed in managing paper money without monetary licentiousness, without maintaining convertibility of paper money into a precious metal, and without causing inflation or deflation. The stately rise of reigning world currencies, such as the US dollar, and the intelligent development of foreign exchange markets for currencies, removed an immeasurable impediment to the easy flow of goods, services and capital between societies endlessly

different in culture, political organization and geographical location. Finally, in the latter half of the twentieth century, an overworked world monetary system impatiently shrugged off the last vestiges of a gold standard, coldly putting the world's economies at the mercy of newly fledged inconvertible paper systems, counting solely on sound central banks to manage money stocks, disciplined by freely fluctuating exchange rates between top-ranking currencies.

The growth in international banking began in Italy, where gold coinage, after disappearing from Europe during the Middle Ages, returned in the thirteenth century. The monetary system of the Mediterranean, rooted in gold and silver, afforded the kind of protection to creditors necessary for the multiplication of creditor-debtor relationships crossing national boundaries. With the flowering of trade between Europe and the Far East, coupled with the mining of precious metals in the New World, precious metals poured into Europe, and international banking blossomed. The Fugger family of bankers, enthroned on a mining empire of silver and copper deposits, patiently developed methods for raising the monumental sums of capital needed to finance wars between France and Spain. Then came the rise of baronial banking houses in Europe and America, the Rothschilds, Barings and Morgans, merchant princes applying the same methods to finance private ventures during the Industrial Revolution. The Rothschilds helped finance England's heroic struggle against Napoleon (1800-15), and the strategic purchase of the controlling interest in the Suez Canal Company (1866). In the New World Barings helped the United States finance the Louisiana Purchase (1803). In the classic years of the gold standard (1875 to 1914) the Rothschilds, Barings, Morgans and other merchant bankers quietly wielded vast political and financial power, proudly financing railroads and canals around the globe, often allowing European governments to use access to credit as a political lever, 'to jingle the purse instead of rattling the sabre'. In the twentieth century Switzerland became a top-ranking world gold market and a centre of international banking. By the end of the twentieth century vast banking corporations in Japan and Europe ranked among the largest banks worldwide, operating branches in every

quarter of the globe, holding deposits and making loans in several currencies. The growth of digital communications enabled even small rural banks to participate in international banking.

The moneyed paths followed by financial capital lead to an old question: whether imperialistic governments obediently followed the paths of tender-footed financial capital to other parts of the world, or whether capital followed the groping influence of imperialistic governments. Poor but self-respecting countries proudly discouraged an influx of foreign capital, fearing that shiny foreign investments would attract a dark and bitter foreign influence to local governments. In the name of protecting foreign investments owned by domestic corporations, controlling economic superpowers such as the United States heavy-handedly involved itself in the politics of foreign countries. The paths of colonialism and regional clashes between capitalism and communism helped channel the flow of capital from capital-exporting countries. Towards the end of the twentieth century we see many countries quietly lifting restrictions on capital flows, and foreign investment moving upwards to heights not seen since the end of the nineteenth.

With a suitable monetary system, communication and transportation systems that can overcome distance, and financial markets and institutions that can finance trade and move capital, the remaining barriers to unrestricted global trade are legal restrictions intended to give a nurturing advantage to domestic products and to immunize domestic economies from contagions in the global economy. The idea of free trade took root in Great Britain, a relatively small country geographically but often a rival of larger countries of the European continent. England, intoxicated with the Industrial Revolution, manufactured products far in excess of domestic needs, and its unequalled shipping capabilities enabled it to trade worldwide. English economists explained the superiority of free trade policies for maximizing living standards in individual countries and worldwide. Germany, France, the United States and others unfurled the banner of trade restrictions to protect their own domestic manufacturing from foreign competition. Eventually even Great Britain forsook the side of free trade and joined the fray as the world's major trading partners embroiled themselves

in a vicious trade war during the 1930s, sparked by the unthinking enactment of the Smoot–Hawley Tariff in the United States. Post World War II the United States joined the side of free trade, successfully urging a reduction of trade barriers worldwide. The rise of regional trading blocs, such as the European Union and the North American Free Trade Agreement, provides for free trade in individual regions.

Lastly we cover the development of the global financial system, beginning in the late 1970s with a capitalism revolution in Great Britain and the United States which swept through the global economy, emphasizing privatization, deregulated markets, freedom to import and export and unrestricted capital flows between countries. Just when the introduction of flexible exchange rates added a speculative touch to foreign investment and trade, legal and political barriers to foreign trade and capital flows came crumbling down, and innovations in communication and information systems gave investors opportunities in virtually any quarter of the globe. Foreign trade, investment and speculation experienced a burst of growth amid a worldwide wave of fresh confidence in market institutions. In 1997–8 the old nemesis of capitalism reappeared when financial crises in several countries rocked the global financial system, raising new questions and old fears about its stability. The postmortem on these financial crises is ongoing at the beginning of the twenty-first century.

The Coming of the Corporation

The world's financial centres, New York to Hong Kong, boast stock markets whose stirring rallies and jittery retreats are measured by arithmetic indices, the most readily available means of taking the temperature and pulse of the global financial system. These stock markets owe their noisy existence to the triumphant rise of the corporate form of business organization, whose exuberant growth largely coincided with the strident growth in world trade following the swashbuckling age of discovery and the reorientation of world trade from the Mediterranean to the Atlantic.

Corporations are creatures of the law, legal entities that in the eyes of the law have many of the privileges of individual persons, including the acquisition of resources, and the production and marketing of goods and services. Money can be borrowed in the name of the corporation, which itself can be a lender, and before the courts a corporation can sue or be sued just as a person. As a legal entity a corporation may enjoy a life of unlimited duration, well beyond the lifespan of its original founders.

This special status as a separate legal entity confers upon the corporation an immeasurable advantage over other forms of business organization, an advantage referred to as 'limited liability' because of the limited liability of the owners (stockholders) for the debts of the corporation. In contrast to business partnerships, which render each individual partner personally and equally liable for all debts incurred by a failed business venture, an individual stockholder cannot be sued for the debts of a corporation, limiting the investor's maximum loss to the value of stock invested.

Furthermore, under the corporate form individual business partners can sell their shares of stock without permission of other partners, and anyone can buy shares of stock put up for

sale without the permission of existing business partners, or stockowners. Before the advent of the corporation personal relationships among business partners stood paramount, and joint business ventures were often kept within a circle of family members who could be trusted because of bonds of kinship. With personal relationships left aside as a factor in business ownership, capital could be amassed from around the globe to finance business ventures, encouraging the quiet flow of capital across political boundaries.

The various evolutionary threads of corporate development do not necessarily stem from a single root, but the primal seed of the corporate business organization may have lain embedded in the double-entry method of bookkeeping, which records all business transactions within the logical framework of a formula that equates total business assets with total business liabilities plus owner's equity. The sale of goods reduces assets invested in inventories but increases assets invested in cash, adding an equal amount to assets and owner's equity if the transaction is profitable. The payment of debt reduces assets invested in cash, but reduces business liabilities by an equal amount, leaving untouched the equality between assets on one side, and liabilities and owner's equity on the other. The credit for formally introducing this system belongs to a friend of Leonardo da Vinci, Luca Pacioli, a mathematics professor at the University of Pavia who inserted a chapter on double-entry bookkeeping in a arithmetic textbook, *Summa Di Arithmetica, Geometria, Proportioni E Proportionalita*.

With double-entry bookkeeping the business organization buds as an impersonal abstract concept independent of an individual owner. The throbbing life of a business lies recorded in a sober ledger of transactions that maintains a balance in an accounting equation, and shows the impersonal impact of each transaction upon owner's equity. The transparent logic of double-entry bookkeeping cranks out with stern precision a measure of profits independent of the judgement of a particular business owner, and changes in business ownership have no necessary impact on the life of the business as recorded in the ledger.

Independent of the growth in the business organization as an abstract concept emerged the practice of governments legally