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Bagehot's Classical Money View: A Reconstruction

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ABSTRACT

Bagehot is difficult for modern economists to read with understanding, for three reasons. He was a classical economist not neoclassical, his orientation was global not national, and, most importantly, his intellectual formation was as a practicing country banker not an academic. This paper adopts all three perspectives, and uses this frame to reinterpret his mature work, both *Lombard Street* and the unfinished *Economic Studies*, as the origin of the key currency tradition which continues as a minority view in modern economics.

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> [Political Economy] is an abstract science which labours under a special hardship. Those who are conversant with its abstractions are usually without a true contact with its facts; those who are in contact with its facts have usually little sympathy with and little cognisance of its abstractions… And so the 'theory of business' leads a life of obstruction, because theorists do not see the business, and the men of business will not reason out the theories. Far from wondering that such a science is not completely perfect, we should rather wonder that it exists at all. (Bagehot 1880, 227)

150 years after the publication of *Lombard Street*, what the modern economist knows about Bagehot is the Bagehot Rule for central banks dealing with financial crisis: Lend freely at a high interest rate against security that would be good in normal times.[1] Some people like the Rule, valuing stability, and some people don't, fearing moral hazard, but either way it has long been accepted as the central message of *Lombard Street*. Historians of economics have of course always known that Bagehot was more popularizer than inventor of lender of last resort (Laidler 2003, citing Fetter 1965), so if that's his biggest contribution, maybe the book is not so much worth celebrating? Perhaps we could say that as Hansen was to Keynes, so Bagehot was to Thornton?

For present purposes, however, my concern is not with conventional wisdom but rather with Bagehot himself. Putting aside subsequent use of his writings, what did *he* intend as his central message? He must have known that lender of last resort was nothing new, so why did he labor so long and hard on *Lombard Street*? To address such questions, we need to understand the book both in historical context and in biographical context, contexts that for Bagehot, as longtime editor of *The Economist*, were inextricably intertwined.

First of all, we need to understand Bagehot as a *classical* economist, unseduced by the neoclassical revolution that was bubbling up in his lifetime. He was, as he says proudly, the "last man of the ante-Mill period" (St. John-Stevas 1978, XI, 394). The neoclassical revolution brought professionalization of economics and even greater separation of academic economics from business and the practical wisdom of actual trade. In 1866 Bagehot supported Jevons' appointment at Manchester on the strength of his book on gold (Jevons 1863). But he had serious reservations about Jevons' subsequent advocacy for a tabular standard in *Money and the Mechanism of Exchange* (1875), which book proved foundational for subsequent developments in neoclassical monetary theory (Laidler 1991). Says Bagehot, in his review of the book: "He has far more hope from economic science than we have" (1875 [1892], 472).[2]

Second, we need to understand him as an *international* economist (as indeed was typical for classical economists), and a forward looking thinker about the monetary system of his day, very

[1] The Rule is however quite commonly misstated as involving a "penalty rate", indeed by no less an authority than Kindleberger (1978, 165, 178, 181) and hence also by all those who learned their Bagehot second hand from him.
[2] See the letters from Bagehot to Jevons, 10 March 1866 and 30 October 1875, reprinted in St. John-Stevas (1978, XIII, 606-608 and 671-672). Bagehot seems to have sent Jevons a copy of *Lombard Street* when it came out, apparently with the hope that Jevons would review it. See Jevons' polite reply of 23 June 1873 in St. John-Stevas (1978, XIII, 642-643).

much anticipating the role that sterling (and London) was coming to play during those early years of what today we look back on as the international gold standard. The modern economist thinks of the Bagehot Rule as appropriate policy for *national* central banks, but a careful reading of Bagehot reveals that his central concern is with *international* lender of last resort, in anticipation of the need for a backstop of the financial infrastructure of the emerging first age of globalization.

Third, we need to understand Bagehot's intellectual formation as a practical country *banker*. As such he was a natural "money viewer", though unconsciously so, as it was the water in which he swam, along with his readers. For him, the economy was essentially monetary, and the daily ebb and flow of the London money market was the essential substance of his weekly columns. Schumpeter has praised *The Economist* as the best source of "the facts, the techniques, and the current practical problems of banking," in effect the "raw material" from which a proper economic analysis could possibly have been built, but wasn't (Schumpeter 1954, 1110). He is talking about Bagehot.

All three of these perspectives are challenging for the well-trained modern economist who swims in very different waters indeed: neoclassical not classical, in service to national policy makers not international, and, perhaps above all, professionally committed to the idea that money is a veil rather than the essential infrastructure of a market economy. Modern judgement has it that Bagehot was not much of an economist, and that is certainly right if we adopt modern notions of what constitutes economics. He writes (beautifully) in our language, but fundamentally Bagehot is not one of us. To understand him we must be prepared to enter a foreign country, and a foreign mind.

Perhaps the best place to start is with the epigram above, and the observation that from the very beginning Bagehot (1826-1877) was both a keen observer of money market current events *and* a serious student of classical political economy, and even more that these two projects very much informed one another. In 1848, when he was but 22 years old, he published his very first article "The Currency Monopoly", purportedly a review of three books about the 1847 crisis as a test of the 1844 Bank Act--by Torrens (a Currency School man), Tooke (a Banking School man), and Wilson (editor of *The Economist*, and Bagehot's future father-in-law)—but actually a sustained (if somewhat juvenile) analytical defense of the Act, and also its 1847 suspension.[3] And soon after that he published his second article, "Principles of Political Economy", a review of John Stuart Mill's recently published *Principles*, focused not at all on his monetary views but rather on the labor market (Bagehot 1948b). Read these, and then read the analogous mature products of the same mind, namely *Lombard Street* (1873) and *Economic Studies* (1880). It is the same project.

In my understanding, here we find the dialectical tension that drove Bagehot's thinking for his entire life. As a practicing banker, he was naturally a money view man, seeing the economy as a

[3] "Under this law the monetary affairs of the country were transacted, until October 25, 1847, when a letter from Lord John Russell and the Chancellor of the Exchequer empowered the Bank of England 'to enlarge the amount of their discount and advances upon approved security', at the rate of 8 per cent, at the risk of an extraordinary issue of bank notes unrepresented by bullion; thus abolishing *pro tempore* that portion of Sir Robert Peel's Act which limited the amount of notes not represented by bullion in the issue department." (1848a, 238).

web of interlocking promises to pay, which promises are regularly tested at the economy-wide clearing when they come due, and which promises also trade before maturity for a price determined in dealer markets. At the same time, as an economist, he was always trying to abstract from these mundane institutional facts in order to see the underlying logic, following the lead of Adam Smith and the classical tradition that built on him, most importantly Ricardo. Holding these two ideas in his head at the same time, he always had something to say to the economists speaking as a banker, and he also always had something to say to the bankers speaking as an economist.

Many have remarked on Bagehot's high opinion of David Ricardo, but I think it was more than appreciation for the work itself, which developed to a greater analytical height the line first opened by Adam Smith. Bagehot knew that Ricardo had written *Principles of Political Economy* (1817) after making a fortune in the stock market (primarily government debt at that time).[4] I read Bagehot as having the ambition to do something similar himself, building from his experience in the money market of his own day, very much changed from Ricardo's. Unlike Ricardo, he never managed to win a seat in Parliament, though not for lack of trying, and so had to make do with *The Economist* as his platform.[5]

Perhaps we can see Bagehot as a kind of Marx, whose *Critique of Political Economy* (1867) was similarly a response to Ricardo, albeit a response channeling the proletariat's exploitation rather than the banker's money view. From this biographical standpoint, it is important to appreciate that, immediately after finishing his famous *Lombard Street* Bagehot was working on a three-volume treatise on political economy, of which only fragments were completed before his untimely death. We need to read *Lombard Street* and these fragments as part of a common intellectual project in order to understand them both, a common intellectual project that was in fact the culmination of a life-long inquiry. Marx had Engels to put his fragments together. But Bagehot had only Richard Holt Hutton (not an economist and so reliant on the assistance of Robert Giffen) who produced *Economic Studies* (1880), and Norman St. John-Stevas who subsequently produced the definitive *Collected Works* (1978). So there is significant work of interpretation yet to be done.

In the event, it was Marx, not Bagehot, who captured the imagination of the age, and also Alfred Marshall as the anti-Marx. At the request of Bagehot's widow, Marshall famously wrote a preface for Bagehot's posthumous *Postulates of English Political Economy* (1891), a student edition of two essays in the first volume of *Economic Studies*, but it was Marshall's own *Principles of Economics* (1890) that the next generation would actually study (Keynes 1924). And so Bagehot's money view for classical economics was relegated to minority status, collateral damage of the larger project of replacing classical economics with neoclassical.

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[4] The monetary writings of Ricardo, long neglected, have recently attracted new scholarly attention (Marcuzzo and Rosselli 1994, Deleplace 2017). Apparently not only Bagehot but also Ricardo was not what modern economists think he was.

[5] Notwithstanding Grant (2019), the best biography is still Buchan (1960), though too light on the economist side of this Victorian polymath and so usefully supplemented by Giffen (1880) and Sayers (1978) who focus entirely on that dimension of the man. Neither one however brings the money view into central focus, instead viewing Bagehot through the lens of the economics that was more typical of their own times, and so emphasizing that Bagehot was not really an economist.

Could it have been otherwise, had Bagehot lived? I do not suggest that Bagehot had the analytical chops to stem the tide; he was no Ricardo. Rather the point is that his untimely death deprived Jevons and Marshall of their best interlocutor within the world of practical banking. As a result, the history of neoclassical monetary economics became essentially the history of the quantity theory, following an internal logic of development quite separate from events in the external world (see Laidler 1991).

I. Lombard Street

Lombard Street, Bagehot says on the very first page, is so named in order to draw attention to the fact that he is drawing his analytical conclusions not from abstract theory, but from real life experience. He was of course a banker himself, at Stuckey's, one of the largest banks outside of London, and he was also editor of *The Economist* (1860-1877) for which he wrote weekly, on many topics but very often commentary about the money market. It is this material that he was pulling together in *Lombard Street*, so it is important to see this culminating work in light of the monetary events he witnessed (indeed experienced first hand) over the decades earlier. Most prominently, repeatedly he references the three crises of 1847, 1857, and 1866. In each case the Bank of England ran its reserve nearly to zero, and in each case the government stepped in to help by suspending the Bank Act of 1844 which had required all new note issues to be backed fully by gold. "Three times 'Peel's Act' has been suspended because the banking department was empty." (Bagehot 1873, 61; see also 78, 80, 104 and Notes B and D on 1857 and 1866 respectively.)

But there is more. The business of Stuckey's was entirely domestic, basically intermediating between structurally surplus districts (agricultural) and structurally deficit districts (manufacturing).[6] At the time Bagehot was writing, the key banking asset was the bill of exchange, and the key banking liability was the deposit account, which was replacing the bank note as the main monetary instrument. One consequence of that institutional evolution was the rise of the check used for transferring deposits from one person to another, and the rise of the clearinghouse for settling interbank transfers, increasingly for securities market transactions which settled twice a month (Bagehot 1873, 145). Thus, Bagehot tells us, the remittance business transmuted into the banking business, and the Bank of England transmuted from the government's bank into a banker's bank.

Bagehot was a country banker in his bones, but as editor of *The Economist* he was also exposed to the larger world of banking. Stuckey's was not so involved in that world, but the readers of his paper were, and they eagerly sought out news about it, which Bagehot supplied. Most important to Bagehot was the increasing use of the London banking apparatus by foreigners. Bills on London were used not only to transfer funds from surplus regions to deficit regions within Britain, but also from surplus regions to deficit regions throughout the world. The clearing in London was thus world clearing, and that meant that the reserve of the Bank of England was the world reserve. Repeatedly Bagehot points to the suspension of gold payments by the Bank of France in 1870 as an accelerator of that pre-existing trend, sending more business to London and therefore putting more pressure on the Bank of England (Bagehot 1873, 63, 141).

[6] "Lombard Street is thus a perpetual agent between the two great divisions of England—between the rapidly growing districts, where almost any amount of money can be well and easily employed, and the stationary and the declining districts, where there is more money than can be used." (Bagehot 1873, 53)

The increasing international role of sterling meant further that moments of crisis quite typically involved both internal and external drains at the same time. In Bagehot's view, high interest rates are the remedy for the latter, whereas free lending is the remedy for the former.[7] This is what we remember today as the Bagehot Rule, without perhaps appreciating the centrality of the international dimension in Bagehot's original formulation. Indeed, his emphasis on the need for the Bank of England to hold a large reserve is pretty clearly a response to its new larger international responsibility. Similarly, Bagehot's trade cycle (Ch. 7) is an international phenomenon, involving fluctuations in international prices (the cost of money, the cost of corn) amplified by credit.[8]

But there is more as well. Again, Stuckey's was not really involved in it, but London was also becoming the world capital market, not just the world bill market, and this too Bagehot watched as it developed during his lifetime. The British consolidated debt traded in a famously liquid market — "According to the saying, you 'can sell consols on a Sunday'" (Bagehot 1873, 77)— and on that score the consol became a favored bank reserve asset, good security for advances from the Bank of England as needed. Indeed, lender of last resort in Bagehot's time was substantially about advances on consol security, not just rediscount of bills. The important point is that, building on the dealer apparatus that made consols the most liquid security, London became the place where foreigners came to borrow and lend as well, issuing and purchasing securities as well as bills. "If any nation wants even to make a railway—especially at all a poor nation—it is sure to come to this country—to the country of banks—for the money" (50).

Importantly, that security business was also increasingly integrated with the bill business, as stock was quite typically purchased by using the security itself as collateral for short term borrowing. Bagehot is aware of all this, most acutely because of the recent Franco-Prussian indemnity. With the help of the City, in 1871 France floated a huge loan, with the consequence that the German government found itself with a huge portfolio of bills on London, for which it could in principle demand bullion on maturity. Repeatedly Bagehot appreciates the patience of the German government on that score, which made life easier for the Bank of England (Bagehot 1873, 56, 63-5, 121, 203-5).

> Since the Franco-German war, we have become to a much larger extent than before the bankers of Europe. A very large sum of foreign money is on various accounts and for various purposes held here. And in a time of panic it might be asked for…The collection of these immense sums in one place and in few hands is perfectly new (56-57).
>
> A large part of the 'indemnity' was paid by France to Germany in bills on England, and the German government, as those bills became due, acquired an unprecedented command over the market. As each bill arrived at maturity, the

[7] "The holders of the reserve have, therefore, to treat two opposite maladies at once—one requiring stringent remedies, and especially a rapid rise in the rate of interest; and the other, an alleviative treatment with large and ready loans." (Bagehot 1873, 75)

[8] Rostow (1948) reads Bagehot as primarily concerned about the trade cycle, but he misses the international dimension. He also reads Bagehot as a proto-macroeconomist, a kind of early Keynes concerned with investment spending as the driver of the cycle, not so much the instability of credit.

German government could, if it chose, take the proceeds abroad; and it could do so in bullion, as for coinage purposes it wanted bullion" (205).

Not to put too fine a point on it, Bagehot was writing *Lombard Street* at the very birth of what today we know as the international gold standard, whose last days have been chronicled by DeCecco in his magisterial *Money and Empire: The International Gold Standard, 1890-1914*. For Bagehot, the French indemnity represented a pivot point in the international role of sterling, which very recently had seemed to be in decline. Just so, in 1869 Bagehot had been invited to present his views on the future of the international monetary system, and the result was his pamphlet *Universal Money*. There he is worried that the world is passing Britain by:

> Before long all Europe, save England, will have one money, and England will be left outstanding with another money (65).[9]

But subsequent events, i.e., the Franco-Prussian war and subsequent indemnity, took a different turn. Only four years later, in *Lombard Street*, Bagehot sees sterling well on its way to becoming in effect universal money, a dream come true perhaps, but also a potential nightmare, as the new responsibility was already putting strain on the system of governance of the Bank of England. *Lombard Street* is not just or even mainly about the Bagehot Rule; mostly it is a case for reform of the Bank of England, in preparation to be central bank of the world.

In this respect, *Lombard Street* needs to be read as the money market analogue of Bagehot's earlier *English Constitution* (1867).[10] *English Constitution* investigated the workings of the four main institutions of British politics: The Cabinet, The Monarchy, The House of Lords, and The House of Commons (Ch. I-IV). *Lombard Street* similarly investigates the workings of the four main institutions of the London money market: The Bank of England, The Joint-Stock Banks,

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[9] The occasion of the pamphlet was the invitation, at the International Monetary Conference of 1867, for Britain to join the France-led Latin Monetary Union, formed in 1865 with Belgium, Switzerland, and Italy. The original idea of the Union was to create a common 5-franc silver coin to facilitate trade. The new idea for an expanded Union was to create a common 25-franc gold coin to expand the reach of the Union, not only to Britain but also the United States and Germany, among others. Bagehot took this invitation quite seriously, in part because he expected Germany to join.

More generally, Bagehot thinks a universal money would be a genuinely good thing, if only it were possible. He argues that the French proposal is not in fact workable—too-top-down, disregarding facts on the ground—and so proposes his own alternative road to universal money. In 1869, Bagehot's alternative proposal was for an Anglo-Saxon Monetary Union between Britain and the US, which he thought Germany might find more attractive than the Latin Union. His idea was to link the US $5 gold piece with the British pound, while at the same time decimalizing the British currency by treating the farthing (1/4 penny) as 1000th of a new pound. The future he envisaged was a world of two Unions, the Teutonic and the Latin, between which other countries would be free to choose whether to join, and which to join.

"In that case there would be one Teutonic money and one Latin money; the latter mostly confined to the West of Europe, and the former circulating through the world. Such a monetary state would be an immense improvement on the present. Yearly one nation after another would drop into the union which best suited it; and looking to the commercial activity of the Teutonic races, and the comparative torpor of the Latin races, no doubt the Teutonic money would be most frequently preferred. In this case, as in most, the stronger would daily come to be stronger, and the weaker daily be in comparison if not absolutely weaker. Probably in the end the less coinage would merge in the greater, but at any rate it would be a great step to have but two moneys, and we could well make shift to do with that if we were sure, as we should be, that there never were to be any more" (1869, 93).

[10] Giffen himself suggests as much (1880, 215), though he does not develop the point.

The Private Banks, and The Bill Brokers (Ch. 9-12). Repeatedly in the book, the Bank of England is referred to as the monarch. "You might as well, or better, try to alter the English monarchy and substitute a republic as to alter the present constitution of the English money market, founded on the Bank of England, and substitute for it a system in which each bank shall keep its own reserve" (Bagehot 1873, 214; see also 80, 93). It is perhaps telling that Bagehot published a second edition of *English Constitution* in 1873, more or less the same time as *Lombard Street*; he himself saw the two books as a pair.

The message of the two books is similar. In both, Bagehot tells us that these are not the institutions we would have chosen, but they are the institutions we now have, bequeathed to us by a process of institutional evolution that is not for us to reject. (I choose the word deliberately, to recall that Bagehot was writing in the age of Darwin's *Origin of Species*, 1859.[11]) For him, this is our ecosystem, and our job is to make the best of it. Just so, the Bank of England was created in 1694 as a mechanism of war finance—"if we had not been able to raise that money we should have been conquered by France and compelled to take back James II" (Bagehot 1873, 95)--and over time the consequence was a system where the Bank of England held the reserve for the entire rest of the banking system (as opposed to the "natural" system of multiple reserves).[12] Peel's Act of 1844 then created a rigid supply of currency, but regular suspension of the act in times of crisis over time made the gold bullion of the Issue department available for export. A key passage of *Lombard Street* draws the distinction between suspension of payments, and suspension of Peel's Act. "After the panic of 1866, especially after the suspension of Peel's Act (which many foreigners confound with a suspension of cash payments), a large amount of foreign money was withdrawn from London" (64).

The pressing problem at the moment that Bagehot is writing is that the Bank of England is quite substantially not fit for purpose, that purpose being to serve as central bank of the world. A central problem is that the "Court" which governs the Bank of England is comprised entirely of merchants, not bankers, and that the role of Governor is a rotating position; as a result there is no one who really knows how to run a bank, and the few who have learned something from long experience are only in leadership for a short time before rotating off. The solution according to Bagehot is creation of a professional staff and opening the directorship to bankers (analogous to his emphasis on the importance of the Cabinet in *English Constitution*). Bagehot is sure that, with the right governance structure—i.e., with people like himself on the board—the right policy will be enacted, which is to say the Bagehot Rule. But without the right governance structure there is always danger of error that could be avoided.

That's a lot for one book to do, which may explain why it took Bagehot so long to write it, quite apart from his health challenges (as he himself says). In the end, he pushed the institutional analysis to the end (Ch. 9-12), led with his conclusion (Ch. 1-3), and put the analytical chapters in the middle (Ch. 4-8). It's the only book he ever wrote as a unity--everything else was

[11] "Mr. Darwin, who is a disciple of Lyell, has shown how one vera causa, 'natural selection', would account for an immense number of the facts of nature" (1880, 232).

[12] It is not clear that Bagehot sees this "natural" system as ideal. Possibly he is channeling Adam Smith's account of the "natural progress of opulence" which of course Smith well recognized was at variance with the actual progress of opulence. Laidler (1991, 184) suggests that on this point Bagehot may have been influenced by a misunderstanding of how the American banking system worked, back in the days before it had a central bank.

published serially first—and in my reading it feels like the first three chapters were written last. By contrast, the *Depreciation of Silver* (1877), which was the most immediate follow-up, was initially published as a series of columns in *The Economist.* But notice the theme, and its connection to *Lombard Street*. If sterling is going to be universal money, as Bagehot apparently thought, what about the empire, meaning India, and its historic connection with silver instead of gold? The depreciation of silver is of course also the appreciation of gold driven, according to Bagehot, by German use of the French indemnity to acquire bullion for coinage purposes. Notwithstanding the pressing policy importance of this question, for Bagehot himself *Depreciation of Silver* seems to have been only a minor follow-up. When he finished *English Constitution*, he had followed up with an analytical text, *Physics and Politics*. When he finished *Lombard Street,* his eyes were similarly on a follow-up analytical text, his inspiration being Ricardo. The fragments posthumously collected as *Economic Studies* (1880) were his main focus. Let us read them as follow-up to *Lombard Street*.

II. Economic Studies

Already in *Lombard Street*, Ricardo is clearly very much on Bagehot's mind (1873, 55, 58, 75), indeed already since 1848. Ricardo treats a world where the rate of profit is equalized by the movement of capital in search of profit. Bagehot sees the money market as the concrete mechanism by which the rate of profit is equalized. Key to that is the bill broker, whose business requires eternal vigilance to the credit of the bills he accepts and then uses as collateral for borrowing from the joint-stock banks. Bagehot tells us that this credit is constantly in flux; the man whose credit was unassailable at the beginning of the year may well be questionable by the end, and vice versa. It is the credit judgement of the bill brokers that facilitates the movement of capital, expanding credit to the rising industries and withdrawing it from the declining. In Bagehot, the central agency is not so much the capitalist shifting his own capital, but rather the capitalist's banker shifting it for him, by accepting the bills offered by the rising capitalist and denying the bills of the declining.

Here he is in *Lombard Street*:

> Political economists say that capital sets towards the most profitable trades, and that it rapidly leaves the less profitable and non-paying trades…In England the process would be visible enough if you could only see the books of the bill brokers and the bankers. Their bill cases as a rule are full of the bills drawn in the most profitable trades, and *caeteris paribus*, in comparison empty of those drawn in the less profitable…Thus English capital runs as surely and instantly where it is most wanted, and where there is most to be made of it, as water runs to find its level (1873, 53-4).

These few sentences in *Lombard Street* became an entire chapter, Postulate II, in *Economic Studies*. Here is one extract:

> Supposing the corn trade to become particularly good, there are immediately twice the usual number of corn bills in the bill brokers' cases; and if the iron trade, then of iron bills. You could almost see the change of capital if you could look into the bill cases at different times (1880, 258).

Here we find the core idea of Bagehot's entire political economy project, and all the rest of it can best be understood by organizing around this idea.
Unfortunately, it does not appear that the editors of *Economic Studies* appreciated this logic, as the organization of the fragments rather conceals than reveals it. It was apparently known that Bagehot intended three volumes. Sayers (1978, 40) tells us: "The first was to be methodological, the second a survey of classical theory as exemplified by Adam Smith, Ricardo, and Mill, and the third a collection of biographical studies of the great economists." But *Economic Studies* seems to have been edited with the idea of foregrounding the bits that were published (the Postulates) and pushing to the end the bits that were most unfinished.
To my reading, by contrast, the three volume logic would appear to suggest the following alternative ordering:

Vol. I—English Political Economy for Today
- The Preliminaries of Political Economy [concerned with land rent, and population growth]
- The Postulates of English Political Economy—I [concerned with the mobility of labor]
- The Postulates of English Political Economy—II [concerned with the mobility of capital]
- Cost of Production
- The Growth of Capital

Volume II—Development of English Political Economy
- Smith
- Malthus
- Ricardo
- [Mill]

Volume III—Contemporary authors
- Mr. James Deacon Hume
- The Late Professor Cairnes

Insofar as I understand Bagehot's work process, I would say that the earliest essays are probably those on Smith, Malthus, and Ricardo (all unpublished). They are clearly in his mind when he is writing about contemporary authors Hume and Cairnes (published)[13], as well as when he was writing the essays I have grouped as Volume I. He is trying to stand on the shoulders of Ricardo, and so he needs first of all to understand Ricardo.

[13] One imagines that, had Bagehot survived, the third volume would have been fleshed out with many other contemporaries, not sparing Jevons and Marshall. But at the moment he died it is pretty clear that he was just starting to grapple with the emerging neoclassical theory of money. His review of Jevons (1875) is the best indication we have of where he was going in that regard: "First,--it is wholly unfit for a nation which has a foreign trade. Secondly,--It would make banking impossible…thirdly,--…And lastly, there is a fundamental fault of principle in the scheme upon which the foregoing objections more or less depend. In a good currency the paying medium ought either to be identical with, or be readily interchangeable into, a definite quantity of the standard of value." (1875 [1892], 474-476).

But he appreciates that his own society is much changed from Ricardo's day, and the question is therefore how much of English Political Economy still holds, and what needs to be changed or added. The most substantial changes, as he elaborates in *Lombard Street*, are four:

From notes to deposits, from remittance to banking
From government bank to banker's bank
From domestic to international
From money market (loan fund) to capital market (speculative fund)

All of these, he seems to believe, only make English Political Economy (as he understands it) more true, as they make it easier than ever for capital to move to its highest return, now not only within England but increasingly worldwide.

Throughout, as is well-known, Bagehot is at pains to emphasize that English Political Economy is a theory for a very specific sort of society, "a society of grown-up competitive commerce, such as we have in England" (1880, 235). Political stability in England had created the environment where the core postulates of EPE, namely free mobility of labor and capital, are substantially true. As a classical economist, Bagehot thinks of capital as largely a wage fund, and that creates a tight link in his mind between labor and capital mobility. "We see at once that it is principally remunerative capital which is transferable from employment to employment" (263). "Complete freedom of capital pre-supposes complete freedom of labour, and can only be attained when and where this exists" (266). It is the capitalists of new industries, bidding to attract labour from the declining industries, and using borrowed money for the purpose, who drive the progressive process. It is the money market, and in particular the bill broker, that makes it all go.

Bagehot's big criticism of J.S. Mill is that he treats EPE as a kind of universal theory, applicable to all societies, which exaggerated claim has brought the subject into disrepute in some circles, even as it obscures the genuine insights it offers for the societies to which it actually applies. As opposed to Mill, Bagehot offers instead the (prescient) idea that the postulates of English Political Economy are *becoming* more universally true, as the competitive commercial society characteristic of England is increasingly spreading across the face of the globe. Toward that end, international access to the English money market and capital market is a key driver, specifically allowing the mature English economy to finance the growing US economy. "The Americans in the Mississippi Valley are naturally a borrowing community, and the English at home are naturally lenders" (1880, 277). "In this way the same instruments which diffused capital through a nation are gradually diffusing it among nations" (279).

There is in Bagehot an underlying optimism about the advance of commercial society that runs through all of his essays. He thinks commercial society is a good thing, and so he thinks the role of the money market in facilitating its development (within England) and its expansion (outside of England) is also a good thing. Throughout his life, he had been observing this process, bit by bit, but now, at the end of his life (as it happened), he sees the French indemnity as a kind of pivot point of history, a demonstration of the maturity of the mechanism, and its readiness to tackle ever larger projects.

> The mode in which the indemnity from France to Germany was paid is the most striking instance of this which ever occurred to the world. The sum of £200,000,000 was the largest ever paid by one set of persons to another, upon a

> single contract, since the system of payments began. Without a great lending apparatus such an operation could not have been effected. The resources of one nation, as nations now are, would not have been equal to it. In fact, it was the international loan fund which did the business (1880, 276).

Conclusion

In the event, it was the neoclassical turn in economics that carried the day, not Bagehot's proposed money view, which however lived on as a minority view mainly among the bankers to whom it spoke most plainly. Thus, there is a straight line from Bagehot to the key currency view of John H. Williams and Charles P. Kindleberger, though of course they were talking about the dollar system that rose from the wreckage of the sterling system, and their problem was somehow to insert money view realities into the neoclassical worldview that rose on the wreckage of the classical system (Mehrling 2022a, 57-63; Mehrling 2023; Mehrling forthcoming).

What Bagehot says in the epigram to this essay remains true today, and his efforts to straddle between the world of practical banking and the world of political economy continue to inspire students today, accounting for the continued publication success of a book written for a previous age. Read in the context of his time, the book appears as an attempt above all to reveal the dynamic of globalization when global money was sterling. If it speaks to us today, it is because we are living in a very similar time of globalization albeit with global money as the dollar. Bagehot's concern was whether the Bank of England would be fit for purpose; our concern must be whether the Fed is so. Only time will tell, but it can easily be imagined that the Bagehot of *Lombard Street* would have looked with approval on the institutional evolution in the wake of the Global Financial Crisis of 2008-9 (Mehrling 2022b). International lender of last resort operating through central bank liquidity swap lines is now an established fact, as demonstrated by the response to the March 2020 Covid Crisis (Avdjiev et al, 2020; Arslan et al, 2020).

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