Introduction

Monetary theories, Sir John Hicks taught us, are always closely related to monetary histories, even more than general economic theory is related to economic facts. The institutions making up the monetary system the mediums used in a nonbarter economy, the preconceptions of the participants in the various transactions as to what does and does not constitute money, and even the observers' prejudices all play crucial roles in constructing theories. Monetary theories have obvious consequences for policy, so much so that positions on the right policies also have significant effect on theoretical discussions.

Monetary Theory and Policy from Hume and Smith to Wicksell: Money, Credit, and the Economy surveys the major developments in monetary theory and associated positions on policy. The book begins with David Hume and Adam Smith, moves through Henry Thornton and David Ricardo, and ends with Walter Bagehot and Knut Wicksell. The period covers the one hundred years of the Classical School, from the 1770s to the 1870s, with a brief look before, at Hume, and a look beyond, to Alfred Marshall and Wicksell.

The book covers the period's major monetary theorists and asks: What role did commodity-money, and in particular gold and silver, play in their conceptualizations? How did they explain the roles of the invisible and visible hands in money, credit, and banking? What did they think about rules and discretion? Did they distinguish between the two different roles of the financial system – making payments efficiently within the exchange process and facilitating intermediation in the capital market? How did they perceive the influence of the monetary system on macroeconomic aggregates, whether nominal, such as the price level and exchange rates, or real, such as output, employment, and the accumulation of wealth? And finally – and crucially – what did they think about monetary policy? In particular, a central issue we address throughout this book concerns the puzzlingly slow development of a theory of central banking.

Henry Thornton stands out among the major figures whose ideas shaped monetary theory, primarily for his innovative analysis of the complicated phenomena that were just taking shape after the introduction of an inconvertible monetary system in 1797. Thornton drew unprecedented conclusions about monetary policy and about the links between money, credit, and the "real" economy. Perhaps most important in the present context, he developed a theory of central banking. For reasons which will be discussed in the book, Thornton's influence was limited. He was not able to convince contemporaries to look beyond the conventional wisdom at the turn of the nineteenth century as defined by Hume and Smith, the founding fathers of classical monetary theory. To Hume, contemporaries owed the analytical apparatus – known as the Price-Specie-Flow mechanism – that linked the internal money supply to automatic, international forces and relieved analysts from any worries about its determination. To Smith, contemporaries owed the extension of the "invisible hand" argument to money, credit, and finance. Later theoreticians became indebted also to Ricardo for turning the Quantity Theory into the cornerstone of monetary theory. The book will elaborate on the founding fathers' respective roles in blocking Thornton's path-breaking ideas on both monetary policy and the feasibility of a well-functioning inconvertible system.

The first part of this book discusses the analytical foundations of classical monetary theory. We survey the monetary theories of Hume, Smith, and Ricardo, which assumed convertible monetary systems where bank notes could, in principle, be exchanged for commodity-money; in other words, these were theoretical discussions of the gold and silver standards. We start our journey by exploring the state of monetary theory in the mid-eighteenth century through the important contributions of Hume. The common view that classical monetary thought was "metallist" owes much to Hume's conceptualization. We then address the major message of Adam Smith's monetary theory, namely, that the invisible hand should rule in money and the payments system as well as in credit creation and intermediation, as it should rule elsewhere. Smith's theoretical approach, though not explicitly reliant on Hume, did not depart from the conventional wisdom associated with Hume. Thus, Smith accepted convertibility, granting gold a pivotal role, and supported free trade in banking and finance. The ideas of Hume and Smith influenced many, though by no means all, of the well-known schools that followed.

In this book we argue that the classical hegemonic thinking of Hume and Smith became, in fact, a serious obstacle to the development of monetary theory and stood in direct contrast to Thornton's innovative ideas. The similar theoretical structure used by Hume and Smith concerning money and credit was typical of what came to be termed, after Schumpeter, a "monetary theory of credit." Their theories were based on the unique role of commodity-money; these theories provided the cornerstone of Ricardo's thinking, although his monetary theory must be read against the background of the Restriction Period (1797–1821), when bank notes became inconvertible, whereas Hume and Smith analyzed convertible systems. After describing the background for and the basic economic facts of the Restriction, we discuss the critical early round (1800–1802) of the post-1797 debate between the Bullionists and anti-Bullionists, and argue that important lessons relevant for later classical and modern debates concerning monetary control can already be found in this early period. We will analyze the early Bullion Debate through the ideas of two of its famous contenders, the Bullionist Walter Boyd and the anti-Bullionist Francis Baring.

The Bullion Debate provides a context in which to understand Thornton, the most outstanding monetary theoretician of the time and a pragmatic visionary neglected by economists for many years – but no longer. A major section of the book covers Thornton's innovative ideas and emphasizes his contributions both to the refutation of the invisible hand approach in banking associated with Smith, and to the critique of the Price-Specie-Flow mechanism and the Quantity Theory associated with Hume and later with Ricardo. Perhaps because Thornton's theories were ahead of their time, his impact, though significant, was only indirect; it was felt mainly through the reliance of later economists on his compelling ideas. Thornton formulated many of the elements of modern monetary theory, including a compelling argument advocating central banking; what is surprising is that his groundbreaking ideas did not enter mainstream thinking until the twentieth century. In the concluding sections of this book we try to explain why.

Returning to the major persona, we then devote some attention to Ricardo's well-known contributions to economic theory, beginning with his appearance on the scene in 1809 during the famous second round of the Bullion Debate. Ricardo helped shape classical monetary theory in the tradition of Hume. Unlike Smith, he pushed it in the direction of the Quantity Theory of Money, a well-known and deeply rooted approach. The Quantity Theory has since become such a basic tenet of monetary theory that many scholars believe it to be *the* monetary theory. We will try to convince readers (a difficult job indeed) that Ricardo's uncritical attitude toward the Quantity

Theory became the third obstacle to the development of monetary theory beyond Hume's adoption of the Price-Specie-Flow mechanism and Smith's adoption of the concept of free trade in banking matters.

The Resumption of cash (gold) payments, that is, the return to convertibility, finally took place in 1821. We will follow some aspects of the development of the monetary system from 1821 to the end of the nineteenth century. Since the Resumption, inconvertibility had become a side issue, attracting the interest of only a few economists. The focus of the post-Restriction debates concerned various reforms in banking, both in the Bank of England and the other banks. The continuing crises in the economy, in particular those of 1825 and 1836–1837, shaped the debate about country banking, small notes, and joint-stock banking as well as the major debate around the renewal of the Bank charter in 1832. This led to the famous and defining exchange between the Currency School, represented by Samuel J. Loyd, Robert Torrens, and George W. Norman, and the Banking School, represented by Thomas Tooke, John Fullarton, and James Wilson that culminated in the Currency School's victory with the 1844 Bank Act. We will also present some of the figures who belonged to neither school, like Thomas Joplin and Henry Parnell, the latter of the so-called Free Banking School. We shall see how this period brought to the forefront the tensions between Laissez-Faire, Rules, and Discretion that have played out in arguments about monetary policy ever since.

We next discuss the work of Walter Bagehot, who introduced a consistent discretionary policy role for the Bank of England. The major aims of this policy were to maintain convertibility and provide stability. However, we will argue that even though Bagehot is commonly presented as the "father" of modern central banking, his conception of the Bank's role fell short not only of a modern, active theory of monetary policy, but also of Thornton's formulations. We then turn to two more political economists, Karl Marx and Alfred Marshall. The former has been strangely neglected in the spheres of money and banking; in our discussion, we attempt to answer the question of how he fits into our story. We will see that his ideas on money and banking drew heavily from the Banking School, though his metallic view of money is tied to his real analysis and is not linked to the Currency School. We will then review the positions of Marshall and address the issue of bimetallism that bothered economists in the last quarter of the nineteenth century, and that likely had an important impact on our last, but certainly not least, scholar.

Our review of major figures ends with an examination of Wicksell's contribution to the development of monetary economics, with a particular focus on his innovative articulation of an "active central banking" concept similar both to the one raised by Thornton one hundred years earlier and to that used today. We will show how Wicksell clearly distinguished between financial systems based on commodity-money and those based on pure credit (the "pure credit system"). The achievements of Wicksell and the progress made by those before him who slowly came closer to active central banking are explained in part by the emphasis on the role of the monetary system, not just in supporting the exchange process, but also in facilitating intermediation.

By this point, we would have laid the groundwork for an analysis of the slow rise of central banking. To this end, we introduce a distinction between what we term "defensive" and "active" monetary policies, policies that differ both from one another and from what is commonly known as the central authority's role as Lender of Last Resort. I will argue that defensive central banking was first roughly articulated by the Banking School and then, famously and clearly, in the work of Walter Bagehot, who introduced a consistent discretionary policy role for the Bank of England. The major aims of this policy were to maintain convertibility and provide stability; it thus fell short of a fully developed active monetary policy such as that which we know today. Most interesting, we shall see that Thornton had already developed a theory of active central banking a full seventy years earlier than Bagehot.

The book concludes by bringing together the major themes raised by the Thornton–Banking School–Bagehot–Wicksell link, especially those concerning monetary policy. The clear distinction drawn between the two functions fulfilled by the financial sector – one in the exchange process and the other in intermediation – and the different theoretical structures developed to explain these functions are typical of these scholars. Because the two functions deal with very different processes, we emphasize the distinctions theoreticians should have drawn between them, both in Thornton's era and after. This final chapter assesses the reasons for the slow rise of central banking, distinguishing between more ideological obstacles and more theoretical ones, which together delayed an earlier understanding of the importance and contribution of intervention in banking to the economy's real performance. The explanations for the slow rise of a theory of central banking follow the tensions – ideological, theoretical, and political – throughout the nineteenth century between Laissez-Faire, Rules, and Discretion as dominant concepts for analyzing the financial system. These obstacles still seem to be with us today, as those in the field of economics struggle to understand the structural weaknesses in the modern financial system. A better understanding of the past can hopefully contribute to overcoming our present difficulties.

PART ONE

ANALYTICAL AND HISTORICAL FOUNDATIONS

ONE

Monetary Theory circa 1750

David Hume

Introduction

David Hume's (1711–1776) writings on economics are found primarily in the collection of essays published in 1752 as *Political Discourses*. As we will see, this relatively short work became a benchmark analysis in later years; references to Hume's monetary theory appear repeatedly in later discussions of monetary issues. Hence, Hume's monetary theory and the analytical framework he used are natural starting points for our journey into the debates concerning monetary theories.[1] Although many scholars who have studied the subject (Viner [1937], Rist [1940], Schumpeter [1954]) agree that none of the major analytical tenets of Hume's thought constitute a "discovery" but rather could be found among the writings of others at the time; the impact of his monetary ideas and the unique position that they came to assume are beyond doubt. This is probably due both to Hume's other major achievements as a philosopher and historian and to the comprehensive character of his economic formulations. Most important, Hume's monetary theory distanced him from the Mercantilist perspective on money, which was still very influential in the mid-eighteenth century; he clearly contributed significantly to its decline.

The Mercantilists, as is well known, associated the wealth of a society with the stock of money it held. In particular, this school of thought held the view that not only were the precious metals a good measure for wealth,

[1] For studies of Hume's economic writings see Rotwein's (1955) detailed introduction to a volume in which Hume's economic texts can be found; Skinner (1996); Wennerlind (2001, 2005); Wennerlind and Schabas (2008) and many references therein, as well as in the more general studies of Vickers (1959, chapter 11) and Taylor (1965, part 1, chapter 3 and part 2, Chapter 3). As Rotwein (1955) observes, "monetary theory…is the most extensive and detailed part of [Hume's] political economy" (p. lv). For a more general view on moral philosophy and political economy in Scotland, see Hutchison (1988) and Skinner (1996).

but also that accumulating a bigger stock of precious metals would serve to increase the wealth of a country.[2] Hence, the Mercantilists supported policies that were intended to create a surplus in the balance of payments; the resulting surplus was supposed to be maintained consistently over time. The comprehensive interventionist measures that the Mercantilists advocated, with a view to achieving surpluses, culminated in a set of policies directed at both internal economic affairs and external trade (for a review of Mercantilism, see Angell [1926], Viner [1937], and Magnusson [1994], as well as many references therein). Hume and other critics of Mercantilism rejected the fundamental argument of the Mercantilists on two accounts: First, they proposed a different conceptualization of wealth than what the Mercantilists adopted; and second, on a more technical level, though not less influential, they pointed out a flaw concerning a logical inconsistency in the Mercantilist argument. We will address the first argument briefly in the chapter on Smith and will present later an analysis of the second critique, the "logical flaw," as Hume presented it in 1752, because developments in monetary theory cannot be understood without it.

In brief, Hume argued that it was impossible to permanently achieve a surplus in the balance of payments as the Mercantilists hoped, because the surplus would create counter-forces that would abolish the surplus. Thus, the Mercantilist policy recommendations were inherently inconsistent. While developing this critique of Mercantilism, Hume provided us with a sophisticated monetary theory that attracted the attention of contemporaries, including that of his Scottish friend Adam Smith.

"Of Money" and Commodity-Money

In "Of Money," one of the better known and often quoted of Hume's texts, the first paragraph states:

> Money is not, properly speaking, one of the subjects of commerce; but only the instrument which men have agreed upon to facilitate the exchange of one commodity for another. It is none of the wheels of trade: It is the oil which renders the motion of the wheels more smooth and easy. If we consider any one kingdom by itself, it is evident, that the greater or less plenty of money is of no consequence; since the prices of commodities are always proportioned to the plenty of money … (Hume [1752] "Of Money," p. 33; references are to Hume's texts as appear in Rotwein [1955])

[2] See Thornton (2007) on Hume and a critique of Mercantilism as well as on the difficulties surrounding the definition of Mercantilism. See also Magnusson (1994) and Coleman (1969).

Thus, money serves exchange as oil helps the wheels' movements: Neither, it seems, is contributing to the creation of genuine new value or more energy via their quantity, but the presence of money, as of oil, significantly improves the functioning of their respective wheels. In fact, the two are necessary conditions for the systems to work efficiently. The usage of money in the economy's exchange process transforms the economy from a less efficient regime of exchange – barter – to the more efficient regime of a monetary economy; the existence and use of money is of course essential, but the *quantity* of money in itself has no significance in this transformation. Some commentators have perceived this conclusion as relevant only to the case of a "closed economy." However, as we will see later, Hume extended the argument about the limited importance of the quantity of money per se to the "open economy" case as well.

The relationship between Hume's philosophical and economic writings, particularly the ability to analyze the latter separately from the former, has been a subject of continuing debate over the years. Skinner (1996) quotes Rotwein's valuable introduction to *David Hume: Writings on Economics* (1955) approvingly to remind students of the importance of Hume's philosophy to his economic discussions and the dependence of his economic writings on the "science of Man."[3] Nakano (2006) similarly emphasizes the importance of Hume's "philosophy of social science in his philosophical works" to his "economic theory."[4] Hume perceived the individual as an interacting person and attributed to institutions an important role in shaping behavior. Thus, argues Nakano, "for Hume, individuals could not act together without pre-existing, socially shared symbols. … Hume's interactionism is shown in his discussion of conventions." A convention, Hume writes,

> gives us a confidence of the future regularity of their conduct: And 'tis only on the expectation of this, that our moderation and abstinence are founded. In like manner are languages gradually establish'd by human conventions without any promise. *In like manner do gold and silver become the common measures of exchange*, and are esteem'd sufficient payment for what is of hundred times their value. (Nakano quotes Hume's *A Treatise of Human Nature* [1739–1740], p. 490; emphasis mine)

On the basis of such quotes, many have described Hume as a "metallist." Wennerlind (2001, 2005), who studied Hume's philosophical and economic writings carefully, disagreed with Schumpeter (1954), Vickers

[3] See Skinner (1996, p. 233) quoted from Rotwein (1955, p. 4).

[4] Nakano lists Schumpeter and others as agreeing with him, but strangely does not quote Rotwein (1955). The other position, which "examine[s] Hume's economic writings" without linking the examination to his philosophy, is rejected by Nakano.

(1959), and many others who have described Hume as a "theoretical metallist." Wennerlind argues that in Book 3 of Hume's *A Treatise of Human Nature*, in a section entitled "Of the Obligation of Promises," Hume "prefigures a monetary theory." The theory seeks to explain how individuals can exchange beyond barter.[5] According to Wennerlind, Hume's solution "was a conventional agreement in which a particular symbol or sign would function as a guarantor of the promise." Moreover, "[o]nly if an efficient mechanism for keeping promises is established, can the transition from a barter economy to one with monetized markets occur" (Wennerlind 2001, p. 146). Thus, Wennerlind goes all the way to argue that "Hume's exposition moves towards a fiduciary concept of money," wherein a symbol can act as money. Though he admits that "Hume did not explicitly state that a symbol was money per se," he insists – wrongly, I believe – that Hume "proposed a monetary theory centered around fiduciary money" (2001, p. 147). Clearly, however, the money Hume discusses is gold coins. Gold coins are not considered "fiduciary money" by most accounts.

Caffenzis (2008) makes an even stronger argument than Wennerlind's against the idea that Hume based his monetary theory on commodity-money (and therefore against Hume as a metallist). Caffenzis draws on Hume's philosophical distinctions between natural and artificial fictions to make the case that for Hume, the differences between metallic money and paper money are "philosophical" rather than just "technical" (p. 165). Hume describes metallic money as "fictitious" whereas paper money earns the title "counterfeit." The former results from conventions whereas the latter results from promises, distinctions that are rooted in Hume's general philosophy of Man. Hence, both lead, with due differences, to a view of the monetary, nonbarter economy as a fiduciary – rather than metal-based – monetary system. In any case, even Wennerlind accepts that Hume was a "practical metallist," if not a "theoretical" one.[6] As we shall argue later, in Hume's monetary theory, "money" cannot be understood unless it functions in international transactions, a sphere in which fiduciary money did not function and was not accepted. According to Hume, the use of money transforms society and the economy from barter to a monetary economy wherein commerce becomes well developed. Commerce is important to the sovereign, to individuals, and to the public at large:

[5] Although problems already exist in a nonpure barter economy when "trading goods of unequal value, services to be discharged in the future, and general, as opposed to particular, commodities." See Wennerlind (2001, p. 143).

[6] For a somewhat different version, closer to what we present here, see Wennerlind (2008, pp. 108–113).