MONETARY THEORY AND POLICY FROM HUME AND SMITH TO WICKSELL

This book provides a comprehensive survey of the major developments in monetary theory and policy from David Hume and Adam Smith to Walter Bagehot and Knut Wicksell. In particular, it seeks to explain why it took so long for a theory of central banking to penetrate mainstream thought.

The book investigates how major monetary theorists understood the roles of the invisible and visible hands in money, credit, and banking; what they thought about rules and discretion and the role played by commodity-money in their conceptualizations; whether or not they distinguished between the two different roles carried out via the financial system – making payments efficiently within the exchange process and facilitating intermediation in the capital market; how they perceived the influence of the monetary system on macroeconomic aggregates such as the price level, output, and accumulation of wealth; and finally, what they thought about monetary policy. The book explores the analytical dimensions in the various monetary theories while emphasizing their policy consequences.

The book highlights the work of a number of pioneering theoreticians. Among these Henry Thornton stands out, primarily because of his innovative analysis of the complicated phenomena that developed after the introduction of an inconvertible monetary system in 1797. A major question addressed by the book is why theoreticians and policy makers were so resistant to his ideas for so many years.

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Professor Arnon has published articles in *History of Political Economy, Oxford Economic Papers*, the *Economic Journal*, and *Middle East Journal*. He has served on the editorial boards of the *European Journal of the History of Economic Thought*, the *Economic Quarterly*, and the *Journal of Welfare and Social Security Studies*. He has held visiting positions at the University of California, Berkeley; Stanford University; the University of Pennsylvania; The New School; and the School of Oriental and African Studies, University of London. He has also served as a Senior Economist in the Research Department of the Bank of Israel and as a consultant to the World Bank.

Since 2002, Professor Arnon has been the coordinator of the Israeli team in the Aix Group, where experts from the Palestinian Authority, Israel, and the international community discuss various economic aspects of the conflict and develop scenarios and policy alternatives for a permanent peace settlement. A recent publication of the group is entitled *Economic Dimensions of a Two-State Agreement between Israel and Palestine* (2007).

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Money, Credit, and the Economy

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To Ruth, my greatest love;

Yes, more than the history of monetary thought and

Peace in the Middle East.

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Preface

I was first attracted to the history of monetary thought many years ago, puzzled by an enduring question: What is the right balance between the visible and invisible hands in economics? I thought then, and still think, that the appeal of the invisible hand is even less convincing in the fields of money and banking than in other fields. The necessity of interventions in money and banking, and more generally in finance, seem so obvious that I assumed that such interventions had a long history. I was surprised to learn that this was not the case. Rather, I soon learned that the classical conventional wisdom, represented by David Hume, by Adam Smith, and by David Ricardo in most of his writings, unreservedly adopted the invisible hand/no policy approach.

Most of the eighteenth- and nineteenth-century scholars who thought about the subject believed that the "natural order," organized spontaneously around the precious metals, would suffice to establish a well-functioning monetary system. As we shall see, there were some dissenting views, but they had little influence. Rather, for many years, the dissenters were almost completely ignored. The recognition that it is up to society to regulate and direct the monetary system came to take center stage only toward the end of the nineteenth century.

The slow rise of a theory of monetary policy is the story told in this book. Understanding this story also means understanding the obstacles and stiff resistance that for so long delayed recognition of the failure of the invisible hand. The debate over the correct balance between the two hands is far from over, both in banking and in spheres outside of banking. Therefore, understanding the obstacles that stood in the way of a theory of central banking may help in present-day and future debates over similar issues. In any case, that is the constant hope of those of us who would study the history of thought not just for its own sake, but in the belief that important lessons can be gained from it.

My personal route to studying the history of monetary theory took me from Karl Marx back to those who most influenced his thinking about the sphere of money and banking: the Banking School, and primarily Thomas Tooke. In an effort to understand Tooke, I looked further back to the canonical figures of classical monetary theory. Although my journey moved backwards through time, the present book naturally begins with the state of monetary theory in the mid-eighteenth century; in other words, with Hume and Smith, who define the "state of the art" at the time. In the first part of the book, I also briefly review the institutional setup, a decentralized banking system linked to the precious metals. In the last chapter in Part One (Chapter 4), entitled "'Monetary Theories of Credit' in Exchange," I present an analytical summary of a system based on gold, wherein other debts and credits are linked to that anchor. Part Two of the book deals with an exciting period when the sovereign purposefully decided to give up the gold anchor. The Restriction Period (1797–1821) brings us to an amazing group of thinkers, most notably Henry Thornton (Chapter 7). Chapters 6 and 8 introduce Walter Boyd and David Ricardo on the one hand, and Francis Baring and Charles Bosanquet on the other hand, arguing on opposite sides of the famous Bullionist–anti-Bullionist divide. Chapter 9, entitled "'Credit Theories of Money' in Exchange and Intermediation," presents the analytical perspective most suited to understanding Henry Thornton, the most original thinker. His analytical framework will reappear with Knut Wicksell. Readers less interested in the analytical framework can skip this chapter but might be tempted to return to it (and to Chapter 4) after perusal of the rest of the book.

Part Three covers the years after the 1821 Resumption, when Great Britain was back on gold. Although the famous debates between the Currency and Banking Schools about bank reform are well known, I link them both not only to the phenomenon of reoccurring crises, but also to a relatively neglected aspect of our story: the different roles of the monetary system in exchange and intermediation. The slow rise of a theory of monetary policy and the hegemony of the Currency School for so many years in the mid-nineteenth century are clearly two sides of the same coin, as we shall see. In Part Four, we encounter Walter Bagehot, one of the better-known scholars who helped to speed up the slow rise of discretionary monetary policy, though in a restricted form. I argue that Bagehot's achievements were both less original than many think and less comprehensive than those of Thornton, seventy years earlier. Wicksell, covered in the last part of the book, is the scholar who closed the circle that began with Thornton.

In a few of the chapters, I draw on material from published papers. I wish to thank Duke University Press and the *History of Political Economy* for permission to use materials from:

Arnon, A. (1984), "The Transformation in Thomas Tooke's Monetary Theory Reconsidered," *History of Political Economy* 16, pp. 311–326.

Arnon, A. (1984), "Marx's Theory of Money – The Formative Years," *History of Political Economy* 16, pp. 555–575.

Arnon, A. (1999), "Free (and Not So Free) Banking Theories among the Classicals or Classical Forerunners of Free Banking and Why They Have Been Neglected," *History of Political Economy* 31, pp. 79–107.

Arnon, A. (2009), "Reexamination of Thornton's Innovative Monetary Analysis: The Bullion Debate during the Restriction Once Again," *History of Political Economy* 41, pp. 545–574.

I wish to thank the Verlag Wirtschaft und Finanzen for permission to draw from:

Arnon, A. (1997), "Thomas Tooke, The Currency Principle and the 1844 Bank Act," Introductory Essay to Tooke's "An Inquiry into the Currency Principle," reissued in 'Klassiker der Nationalokonomie' series, B. Schefold, (Ed).

I wish to thank Oxford University Press and *Oxford Economic Papers* for permission to use:

Arnon, A. (1987), "Banking Between the Invisible and Visible Hands: A Reinterpretation of Ricardo's Place within the Classical School," *Oxford Economic Papers* 39, pp. 268–281.

During my many years of study of the major monetary scholars in the British tradition, I received, directly and indirectly, much help from many persons both deceased and alive. Although experience has taught me that listing one's debts is a dangerous mission, it is a risk well taken. I owe special thanks to Laurence Harris, who guided me during my first steps in this field. Sam Hollander provided advice in many instances, both when he was in Toronto and more recently, when we are closer in Beer Sheva. Neil Skaggs, David Laidler, Cristina Marcuzzo, Bob Dimand, Jerome de Boyer, and Mauro Boianovsky all discussed with me, at various stages, the ideas covered in the book. Three anonymous referees of Cambridge provided excellent and constructive criticism at different stages of writing. I wish to thank all of them for their advice and contributions. None of them is responsible for the views expressed in the book; any remaining errors are, of course, mine alone.

I wrote most of this book between 2006 and 2009, drawing on drafts written through many years of study and teaching of the history of monetary theory. I spent a sabbatical year in 2006–2007 at UC Berkeley, where I

remained in 2008–2009 as the Helen Diller Visiting Israeli Professor in the Department of Economics, the Center of Middle Eastern Studies (CMES), and the Institute for Research on Labor and Employment (IRLE). I thank the Institute and especially its director Michael Reich for their hospitality and intellectually stimulating environment.

Throughout the work on the final drafts, I enjoyed the excellent editing assistance of Wendy Schor-Haim, for which I am very grateful. At Cambridge University Press, the consistent good advice and encouragement of Scott Parris were indispensable.

Last, but not least, I wish to thank my partner in life, Ruth. She and I know well why.