A barbarous relic

Pragmatism and ideology in the story of the gold standard

TIM CONGDON

William Rees-Mogg, editor

THE CASE FOR GOLD
Three volumes
849pp. Pickering and Chatto. £295.
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Kenneth Mouré

THE GOLD STANDARD ILLUSION
France, the Bank of France and the international Gold Standard, 1914–1939
297pp. Oxford University Press. £45.
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Gold alternately fascinates and irritates economists. The fascination lies in its past role as the successful basis for monetary arrangements over most of modern history; the irritation stems from mankind's apparent difficulty in making a more scientific system work efficiently. *The Case for Gold*, a three-volume collection of the writings of eighteen leading economists from 1601 to 1962, contains more of the fascination than the irritation. Edited by William Rees-Mogg, the collection admirably compiles and presents the key ideas behind the historical achievements of the Gold Standard.

With the exception of Richard Cantillon, the writers in the first two volumes are all British. This is not an accident. The emergence of the European nation-state in the sixteenth and seventeenth centuries implied new opportunities both to regulate and to abuse the currency. The centralization of power allowed the sovereign to establish a uniform money standard and to determine the legal framework for early banking and, in due course, embryonic central banking. Britain – the leader in the Industrial Revolution and the home of parliamentary democracy – turned out to be the most successful of the European nation-states. It was also the champion of the Gold Standard.

British exceptionalism owed much to its unusual constitutional balance between the Crown and Parliament. Frequent wars against other European powers forced the Crown to borrow, leading to the creation of a large national debt. The lenders – the wealthy landowning and merchant classes – were represented in Parliament. They wanted to be repaid in money of stable and reliable value, and had the political muscle to get their way. Monetary theory in Britain was therefore developed by a sequence of high-quality analytical contributions from defenders of price stability, while for almost four centuries the bias of policy-making was to put the interests of creditors above those of debtors. It is mostly from this rich body of intellectual ore that Lord Rees-Mogg's material has been mined.

The main threat to monetary stability under the Tudors and Stuarts came from debasement, the practice of issuing coins with a face value above the intrinsic value of the metal inside them. As is notorious, Henry VIII used this device as well as the expropriation of the monasteries to finance his extravagances, leading to much discontent in following decades over the quality of the coinage. His daughter, Elizabeth, was the first of a number of rulers to choose a different and more virtuous path. She took the advice of such counsellors as Sir Thomas Smith and Sir William Cecil, and agreed to a major recoinage in 1560. A pamphlet literature on currency management – which at this stage meant only the management of the coinage – started in her reign. It is represented in Rees-Mogg's collection by a treatise from Gerard de Malynes on "the canker of England's Commonwealth", which he regarded as a balance-of-payments deficit leading to the export of precious metals.

Almost a hundred years later, John Locke made the first substantial English contribution to monetary theory, with a long essay on "Consequences of the Lowering of Interest, and Raising the Value of Money". He also managed to persuade the monarch of the day, William III, that a recoinage was superior to acquiescing in currency depreciation. But William's wars were expensive, and the cost of the recoinage was unwelcome. By now, goldsmiths had evolved into banks, and paper money had begun to supplement the coinage. Two crucial financial innovations were the inauguration of the national debt and the creation of the Bank of England in 1694. The Bank's foundation was partly a response to another burst of pamphlet literature, with two Scotsmen, William Patterson and John Law, among the most interesting contributors.

The growth of banking raised the vital question of how far paper could substitute for gold and yet still serve as a reliable measure of value. In 1716, Law managed to persuade the Regent of France that the basis of the greater prosperity of England and Holland was the extensive use of paper money, and advocated the issue of paper against the collateral of land. A crazy speculative boom followed, ending in collapse, bankruptcy and national disgrace. This was the beginning of a long tradition of French suspicion of paper and veneration for gold. Rees-Mogg includes some of Locke's writing, but nothing from Patterson and Law. His excerpt from Cantillon (who made a fortune in Law's bubble) contains a chapter on "Banks and their credit", but it is dominated by references to the bankers of London, Amsterdam and Venice and, in particular, to the Bank of England. Cantillon was not an enthusiast for paper money, banks or the Bank of England, but instead – like de Malynes – favoured policies to improve the balance of payments and attract gold.

None of Britain's many wars in the first ninety years of the eighteenth century raised profoundly difficult questions of financial policy. The national debt grew, but the Bank of England flourished and a remarkable degree of price stability was achieved. On the advice of Sir Isaac Newton, Parliament fixed the price of gold at £3. 17s. 10 ½d. an ounce in 1717. Increasingly gold, not silver, became the centrepiece of British monetary thinking and analysis. Cantillon sneered at Newton, for having "sacrificed the substance to appearances", but the Frenchman's mercantilist equation of gold imports with an increase in national wealth was a mistake. His near contemporaries, David Hume and Adam Smith (two more Scotsmen), brilliantly explained that a nation's wealth originated in its production of goods and services, not in the amount of gold its citizens hoarded. Hume's famous 1752 essay "On Money", which forms the middle contribution to Rees-Mogg's Volume One, began, "Money is not, properly speaking, one of the subjects of commerce, but only an instrument which men have agreed upon to facilitate the exchange of one commodity for another."

The financial histories of Britain and France diverged markedly in the eighteenth century. In Britain, the Bank of England was a stable and successful institution which dominated the banking system, and its banknotes and those issued by private banks largely replaced gold as a medium of exchange. Confidence in the paper notes stemmed from the Bank's consistent ability to pay back an ounce of gold when people handed over £3. 17s. 10½d. of notes and small coin. In France no central bank existed, and the issuance of paper by an assortment of quasi-bankers and rich individuals was open to abuse. Against this background it is hardly surprising that the two nations responded very differently to the twenty years of war which followed the French Revolution.

France experienced inflationary turmoil from the over-issuance of paper money, in the form of *assignats*, in the 1790s. The national prejudice against paper and in favour of gold was reinforced. According to Kindleberger, the leading American financial historian, Napoleon was a financial primitive who had "strong objections to paper money and to government debt, to speculation and free markets". When he created the Bank of France, in 1802, it was on a rigid gold basis. Britain went in the opposite direction, with an increasing reliance on paper money.

Its traders and industrialists – and, in particular, the merchants in the City of London – suffered a severe cyclical downturn in 1793, after the French declaration of war in February had caused people to cash in their notes and demand gold from their bankers. The shortage of gold drove up interest rates, caused a contraction in credit and the note issue, and led to sharp declines in demand and output. When fears of a French invasion threatened a similar sequence of events in 1797, over 1,000 City merchants signed a statement of willingness to accept Bank of England notes in place of coin. Parliament suspended the Bank's obligation to convert its paper into gold. Interest rates subsided and commercial activity recovered.

The leading political economists of the day began to theorize about how Britain might manage a paper money without the backing of gold. The next few years saw the first flowering of modern monetary theory. The most brilliant contribution came from a wealthy City banker and philanthropist, Henry Thornton, with his 1802 *Enquiry into the Nature and Effects of the Paper Credit of Great Britain*. The extract from this outstanding work is the longest in the collection, at 158 pages, and takes up the second half of Rees-Mogg's first volume.

Thornton – like all his leading contemporaries – favoured the Gold Standard. But his *Paper Credit* understood that all the important monetary functions of gold could be replaced by paper. It also suggested that, as early as the start of the nineteenth century, the level of economic activity depended far more on the quantity of paper money created by the banking system than on the nation's gold holdings. It even anticipated Keynes by describing the linkages between the Bank of England's policy towards discounting bills of exchange, the size of its note issue and the rate of interest. D. H. Robertson, one of Maynard Keynes's antagonists in the monetary debates of the early twentieth century, was once asked for an opinion on Thornton. The reply was uncompromising: "He knew everything."

The final page of Volume One contains Thornton's panegyric on Britain's paper credit. In his words, "we [that is, the British, as opposed to our unfortunate Continental neighbours] have been greatly benefited by the circumstance of our having been previously accustomed to the free use of paper credit. In a commercial country, subjected to that moderate degree of occasional alarm and danger which we have experienced, gold is by no means that kind of circulating medium which is most desirable." With these remarkable words, Thornton had written gold's obituary as a monetary commodity by showing that – theoretically, at least – paper could be superior to it.

Not the least of *Paper Credit*'s insights was that, in order to provide a sound paper currency, the central bank had to accept that its own profitability was subordinate to some principle of restriction of its note issue. Thornton's vital principle – undoubtedly a precursor of the money supply rule advocated by Milton Friedman in the 1960s and adopted across the industrial world in the 1970s – was "in no case materially to diminish the sum in circulation, but to let it vibrate within certain limits; to afford a slow and cautious extension of it, as the general trade of the kingdom enlarges itself; [and] to allow of some special, though temporary, increase in the event of any extraordinary alarm or difficulty." Macroeconomic stability could be achieved by maintaining steady growth in the money supply and inflation prevented by keeping such growth in line with the quantity of goods and services.

It is true that gold's official monetary role somehow survived – among the confusions of diplomacy and high finance, and despite the tensions between theory and practice – until the US's suspension of the dollar's convertibility into gold in 1971. But after Thornton no well-read economist could deny that the value of money was determined by the relationship between the demand to hold money balances and the quantity of money supplied. John Stuart Mill explained the point with particular clarity in his 1848 *Principles of Political Economy*, seven chapters of which take up almost seventy pages of Rees-Mogg's second volume. But the classical economists of the nineteenth century were worried that, whatever the theoretical virtues of paper, the vital practical merit of a gold link was that it stopped politically motivated over-issuance of paper money. Mill was eloquent on the follies of the *assignats* and condemned an inconvertible paper currency as "an intolerable evil". Mill – like David Ricardo, Thomas Malthus and all the other authors in the second volume – wanted Britain to stay on gold.

The pivotal intellectual figure in the overthrow of the Gold Standard was Keynes. In the immediate aftermath of the First World War, in which Britain had spent its gold on weapons and subsidies to allies, it could not sustain the old price set by Newton back in 1717. In his *Tract on Monetary Reform*, a collection of newspaper articles published in book form in 1923, Keynes condemned gold as "a barbarous relic". He urged Britain not to return to the Gold Standard, but instead pursue "a managed currency" focused explicitly on domestic price stability. He acknowledged that gold had worked well in the nineteenth century, but said that this was a fluke, as inadequate increases in the amount of gold (which curbed money supply growth) had been offset by better financial technology (which boosted it). In words strongly reminiscent of Thornton, he warned that in future "it is too much to expect a succession of accidents to keep the metal steady".

Rees-Mogg's third volume has nothing from Keynes. This is an omission so serious as to undermine the authority of the project. If this work is intended as a contemporary case for gold, it needs to present both sides of the argument, even if the case in favour is given more room than the case against. There are interesting extracts from Ludwig von Mises, D. H. Robertson and Ralph G. Hawtrey, but the absence of Keynes – a much greater influence on economics than these three combined – leaves a gaping hole.

The inclusion of a paper from Murray Rothbard, a tiresome American free-marketeer, is another mistake. As the doyen of libertarian economics, Rothbard might have had the sense to respect the free choices made by private citizens over several centuries. His advocacy of 100 per cent gold reserve banking in the 1960s and 70s was mere silliness. The questions he did not answer in his paper were "how can anyone make a profit from holding 100 per cent of wealth in a sterile, non-interest-earning asset?" and "so why should anyone in the late twentieth century choose to be a 100 per cent gold reserve banker?" The Cantillon essay in Volume One, written in the early eighteenth century, understood the problem very well. Paper money, and the whole story of banking and central banking, began precisely because goldsmiths stopped maintaining 100 per cent gold reserves. By issuing paper, they took on new risks, but made themselves richer. It was a free and profitable choice. Rothbard and the assorted hard-money backwoodsmen of the American gold lobby cannot reverse the 400 years of financial progress described in Rees-Mogg's excellent first two volumes.

One theme throughout financial history has been the quarrel between British pragmatism towards gold and the more ideological French attitude, a quarrel which – as we have seen – goes back to the days of Locke and Law, and Hume and Cantillon. After the First World War, Keynes's opposition to returning to the Gold Standard arose partly from the difficulty of returning to the pre-war exchange rate (now expressed in dollars, but implicitly still the same as the price fixed by Newton in 1717). But a more fundamental objection was the imbalance between the amount of gold in the world economy and a global price level greatly increased from 1914 by war expenditure. Quite simply, at the new higher price level the world did not have enough gold.

In his scholarly *The Gold Standard Illusion*, Kenneth Mouré demonstrates that the Bank of France was largely responsible for Britain's inability to maintain the gold link. Given France's mercantilist traditions, it was logical for the Bank of France to use the opportunity created by Poincaré's fixing of the franc at an undervalued rate in 1926 to pile up vast and quite unnecessary amounts of gold. But that meant less for Britain, which was forced off gold in 1931 and immediately let the pound slump in international value. Over the next few years, exchange rates between the main countries fluctuated violently, while all countries became inward-looking and protectionist. International financial anarchy aggravated the downturn in world trade and output. The Gold Standard can therefore be blamed for the interwar depression. This thesis is not new. Not only Keynes, but many other contemporary economists regarded French behaviour in the late 1920s as suicidal and perverse. However, Mouré tells the story with an impressive narrative verve and, unusually, tries to see the situation from a French perspective.

The final piece in the Rees-Mogg third volume is an interview between Jacques Rueff, monetary adviser to de Gaulle, and Fred Hirsch, an English financial journalist. Under de Gaulle, the French had Napoleonic ambitions to control the bulk of the world's gold stock and to demote the dollar from its pre-eminence. In the 1960s that was eccentric to the point of dottiness. Today it would be crazy. Now that a large chunk of France's gold and foreign exchange reserves is held by the European Central Bank, the French have scrapped the franc and thrown in their monetary lot with the rest of Europe. A fair comment is that Anglo-American pragmatism towards gold has finally got the better of French geopolitical daydreaming.