An MMT professor's attack on the **gold standard** fails dismally

PART TWO

Professor Mitchell tells us that under the gold standard gold was the principle means of making international payments (see here). So when countries developed "trade imbalances" (for which he gave no explanation) gold would have to be shipped from one country to another until the balances were restored. Using Australia and New Zealand as a hypothetical example he argued that if Australian exports to New Zealand exceeded the latter's exports to Australia "this would necessitate New Zealand shipping gold".

He follows through with the Hume's specie-flow theory (the classical theory of gold flows) that the inflow of gold would inflate Australia's money supply which would drive up prices, making her exports more expensive and hence reversing the gold flow by sucking in more imports. In the meantime, poor old New Zealand's loss of gold would cause a monetary contraction bringing about a deflation that would cause "rising unemployment and falling output and prices" until the trade balance was restored.

We now see that Professor Mitchell is using the theory of international gold flows to blame the gold standard for nineteenth century depressions, which is precisely what he did in the paragraphs that followed where he states that "a gold standard introduces a recessionary bias to economies". He makes the perverse assertion that this results in "the burden always falling on countries with weaker currencies (typically as a consequence of trade deficits)." This is nonsense. There can be no such thing as "weaker currencies" when adherence to the gold standard is being maintained because in essence gold is the currency.

Let us assume countries are on a pure gold standard in which money consists entirely of gold coins of various weights. It's obvious that in such a monetary world the idea of a 'weak' currency is meaningless. The same applies to a world where the paper currency represents the quantity of

gold in the banks' vaults. Therefore, if a country finds itself losing gold it is because the note issue exceeds the quantity of gold in those vaults and not because it is on a gold standard. (Temporary exceptions would, for example, be caused by threats of war or harvest failures requiring sudden large imports of food.) Expanding the note issue increases purchasing power which then raises the demand for imports resulting in a gold drain that has to be countered by a monetary contraction to reverse the outflow.

We now see that Professor Mitchell's trade imbalances were not created by a gold standard but by an inflated currency, a fact that classical economists generally[1] understood. It therefore turns out that New Zealand's hypothetical gold drain was created by an expansionary monetary policy that violated a fundamental principle of the gold standard which was that convertibility is to be maintained by having the note issue correspond with the amount of gold held by the banking system. (It was later realised that convertibility in itself was not sufficient to prevent the banks from over-issuing notes, despite the contrary views of the banking school.)

Notwithstanding what most people think, nineteenth century international trade involved very few gold shipments. The idea that international debts were settled by fleets of gold-laden boats sailing from country to country is a fiction. International settlements were nearly always carried out by bills of exchange. To get a sound grasp of how the gold standard really operated with respect to international trade one needs to know how these bills worked, something that was once taught to every economics student.

A bill of exchange is just a transferable credit instrument drawn up by the drawer instructing the drawee (the debtor) to pay a certain sum of money on a given date to the payee. A simple example would be an American Chicago merchant who has exported wheat to a British corn merchant while at the same time a British manufacturer has sold machinery to an American factory. Instead of the British dealer shipping gold to Chicago and the American factory shipping gold to Britain our American wheat merchant writes up a bill (draws it) on the British corn merchant for the money he is owed while the British machine exporter does the reverse. To avoid the expense of shipping gold the American

manufacture buys from the Chicago dealer his bill drawn on the British corn dealer, instructing him that on the due date he is to make the payment to the British machine company. (I assumed for the sake of simplicity that the sums owed are equal). Thanks to this process not a single ounce of gold is shipped.

For our second example let us assume that an Australian colonial government wanted to borrow several million pounds from London to pay wages for a very large labour-intensive project. The London-based lending agency from whom it borrows would have bought bills drawn on Australia. (In fact, exporters would have sold their bills as soon as their goods shipped). It would then remit those bills to the colonial government. Those Australian importers on whom the bills were drawn would then make their payments to the agency responsible for the project. Hence, instead of shipping gold to pay for the imported goods the gold remains in Australia as a loan to pay for labour.

A slightly more complex transaction would be if the colonial agency wanted to buy British rolling stock. It first places an order with a British engineering firm. Instead of shipping gold to Britain to pay for the order it will have bought bills drawn on British traders (those who owe money to Australian exporters). Those traders would be instructed to pay the British company. Once again, no gold is shipped. Millions of international transactions were made each day without a single ounce of gold being shipped to pay for them.

As London was then the banking centre of the world it was also the financial hub for this vast trade in bills. This brings into light an interesting fact that totally undercuts Professor Mitchell's argument. As Professor Viner noted,[2] for the period 1850 to 1890 the huge credit structure that had developed in Britain was based on remarkably low ratios of gold reserves to gross liabilities thus making a mockery of the idea that gold played a significant role in the settling of "international payments"[3].

A major benefit of the gold standard, and one of the main reasons it was so strongly supported, was that it kept the exchanges so stable that even a 10 per cent variation was "considered something extraordinary and only occurs under rare combinations."[4] But what about trade deficits? Well, one has to be careful here. From 1820 until WWI, a period of 94 years,

the UK ran 92 annual trade deficits. According to Professor Mitchell's approach this must have created the longest gold drain in economic history as well as the longest depression. With respect to gold drains the focus was never on trade deficits but on the exchanges, something that classical economists stressed time and time again as exemplified by Thomas Tooke when he stated:

> The only test of excess, therefore, is the tendency to an efflux of the metals; in other words, the exchanges[5].

This was the heart of the bullion controversy. The abandonment of gold in 1797 eventually caused the currency to depreciate against gold. The depreciation was measured[6] by the price of gold over the mint price of £3 17s. 10½d per standard ounce. In 1813 the gold price had risen to £5 10s, nearly 30 per cent above the mint price. By 1819 the gold price had dropped to £4 2s, 5 per cent above the mint price. It was this difference in price that mistakenly led Ricardo to conclude that a 5 per cent deflation would be sufficient to restore parity.

Therefore, so long as there was no significant difference between the price of gold and the mint price, which meant the exchange was within the gold points, no depreciation was taking place, meaning that the exchanges were considered to be in equilibrium. Moreover, it should be noted that the gold standard made the emergence of the Dutch disease[7] impossible.

(A very important but little-known fact is that the classical economists did not use the purchasing power parity theory of exchange rates where the equilibrium rate is the quotient between the price levels of different countries. In fact, Ricardo stressed that no such measure should be used[8].)

Notes

[1]I said "generally" because the Banking School that Tooke founded argued that convertible notes were not money but credit instruments that could not be issued in excess, despite all the evidence to the contrary. It's the Banking School's fallacious theory of the trade cycle that Professor Steve Kates adheres to and erroneously calls the classical theory. Another of that school's serious errors and one it adopted from Adam Smith is that the price of a good does not exceed the total expenditure on the production of that good. This is an important point because Tooke thought that Smith's opinion validated Banking School doctrines. It's also curious that Professor Kates managed to overlook the role of James Wilson (founder of *The Economist* and the school's most formidable advocate) in developing and popularising the theory that the conversion of circulating capital into fixed capital was a crucial part of the trade cycle, a theory that became generally accepted during the latter half of the century.

Tooke, Thomas, *An Inquiry into the Currency Principle*, Longman, Green, Brown, and Longmans, 1844, pp 33-37 and 71.

Smith, Adam, *The Wealth of Nations*, Liberty Classics, Vol. I, 1981, p. 322.

Wilson, James, *Capital, Currency, and Banking*, Published at the office of *The Economist*, 1847

[2]Viner noted that gold reserves with respect to the "gross demand liabilities of the banking system" were extremely low during the nineteenth century and from 1850-

1890 they never exceeded 4 per cent and sometimes dropped low as 2 per cent. Viner, Jacob, *Studies in the Theory of International Trade*, Harper & Brothers, 1937, p. 267.

I think two points must be borne in mind: The first being that most of the colossal amount of credit in the country consisted of bills of exchange which are not money but very effective money-economising credit instruments that were never dependent on gold reserves. The second point is that only the note issue was tied to the amount of gold in the banking system while demand deposits were ignored. This is because the 1844 Act made the dangerous assumption that demand deposits are not money.

[3]Using a low ratio of specie to a large credit structure was not a nineteenth century development. Thomas Mun, a prominent English mercantilist, had lived for some years in Italy and was heavily impressed by how little money Italian traders used in their transactions. (See *Mercantilism*, Eli F. Heckscher, volumes I and II.)

[4]The question was really one of an adverse exchange which George Goschen described as a situation in which the demand for foreign bills of exchange exceeds

the supply to the point where it becomes cheaper to ship gold. Goschen, George, J, *The Theory of the Foreign Exchanges*, Effingham Wilson, 1883, p. 88

[5]Tooke, Thomas, *On the State of the Currency*, John Murray, 1826 p. 66

[6]James Pennington wrote in 1840 about the difficulty of using the exchanges to ascertain a depreciation. Edited by Sayers, R. S., *The Economic Writings of James Pennington* , University of London, 1963, p. 113.

[7]The hollowing out of a country's industrial base by maintaining an overvalued currency. This process is usually associated with the discovery of a natural resource that raises the value of the country's currency thereby making its manufactures less competitive while lowering the price of foreign manufactures. In short, the currency does not reflect the classical definition of purchasing power parity. It could be argued that Ricardo's defence of an industrial tariff could also apply to an overvalued currency.

[8]Ricardo understood, as did the other classical economists, that "the value of money is never the same in any two countries" which is why purchasing power parity could only be maintained through the exchanges. This explains why when discussing free trade they largely did so through the framework of a gold standard because it was rightly considered to be a self-regulating mechanism. I should add, that only someone totally ignorant of what the classical economists said on this subject could draw the conclusion that comparative advantage was somehow based on the gold standard. Ricardo, David, *Political Economy*, Penguin Books, 1971, p. 161 and p.165.

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