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

Bill Mitchell, like the great majority of economists, is an ardent opponent of the gold standard.

He is also one of the world's leading modern monetary theorists and a professor of economics at the *University of Newcastle, New South Wales*.

He wrote an article attacking the gold standard, an article that revealed not only a staggering ignorance of the history of the gold standard but also how it functioned. This response is the first in a series that exposes Professor Mitchell's errors.

He began his attack with the glaring error that the gold standard was in "vogue" in the nineteenth century into the twentieth century, that its acceptance was due to a shortage of silver and that "Britain adopted the gold standard in 1844".

After that, his argument continued downhill.

Unfortunately, the number of economists who share Professor Mitchell's ignorance of the history and economics of the gold standard -- including those on the right -- and what it means for the business cycle is truly disheartening.

The best place to start is 1717 when the UK found itself on a de facto gold standard.

As Master of the Mint it had fallen to **Isaac Newton** to find the market clearing ratio for gold and silver, meaning the price of a guinea in shillings. He finally recommended that Parliament set the value of the guinea at 20s. 8d as this was the prevailing clearing price on the Continent[1]. But Parliament had already set the value at 21 shillings, making it illegal to accept less.

It was therefore Parliament and not Newton who undervalued silver and by doing so unofficially established the mint price of gold at £3 17s. 10½d per standard ounce, where it remained until the Bank Restriction Act of 1797, not 1794 as stated by Professor Mitchell (see here).

On the 22nd of February a French force landed at Fishguard in Wales.

When the news reached London two days later there was a run on the Bank of England with £130,000 in gold being withdrawn as against £90,000[2] the previous day.

Fearing a monetary collapse **Prime Minister Pitt**, by an Order in Council, ordered the Bank to cease making cash payments in order to stem the panic and prevent an internal gold drain generating a deflation. This 'temporary' measure remained in force for 22 years.

What is generally overlooked is that the Bank's gold reserves had fallen from £7,940,000 in March 1795 to £1,272,000 in February 1797, an 84 per cent drop.

In the same period its notes in circulation dropped from £12,432,240 in March 1795 to £8,640,250 in February 1797. (The Banks' notes also formed the reserve for the country banks upon which they pyramided their own note issue thereby greatly expanding the money supply.)

We can now see that the panic of 1797 had only aggravated an existing monetary crisis that the Bank created by issuing notes greatly in excess of its gold reserves. (Nevertheless, that still does not stop some people blaming the gold standard for the crisis.)

The suspension led **David Ricardo** to lament …

> … that from 1797 to 1819 we had no standard whatever by which to regulate the quantity or value of our money[3].

He had good cause to lament.

Now that the Bank was completely unshackled from gold there was no longer any means by which it could decide on the quantity of notes it should issue. (Although notes were then the principal means by which the country's banks expanded credit the London banks largely used demand deposits to expand their loans).

The result was that by 1810 its note issue had expanded by 163 per cent. In addition, the gold suspension was followed by a rapid increase in the number of country banks whose reserves, as I said earlier, consisted of Bank of England notes.

It was **Walter Boyd** who explained that the Bank …

> … is itself now become (what the coin of the country only ought to be) the ultimate element into which the whole paper circulation of the country resolves itself[4].

Then in 1801 a seminal event occurred in the history of monetary theory: Walter Boyd published his open letter to **Prime Minister Pitt** in which he launched a scathing attack on the Bank of England and restriction.

He began by showing that the Bank had greatly expanded its note issue and that it was this inflationary policy that destabilised the exchanges and caused a general rise in prices, emphatically stating that:

> I have laid it down, as a principle, that there is but one criterion by which the issues of paper can safely be regulated, the condition of its immediate conversion into specie. All attempts to ascertain, by any other standard, the quantity of paper which the circulation of a country may require, or can bear, without inconvenience, must necessarily partake of an uncertainty and a danger similar to those which would attend the voyage of the mariner who should venture to sea, without chart or compass[5].

Boyd had made the crucial point that convertibility was absolutely essential to maintaining monetary stability and stabilising the exchanges.

His second point, and one used by other classical economists, is that the gold standard is a self-regulating mechanism, a "beautiful and magnificent fabric" that protected the economy against the implementation of …

> … dangerous quack-medicine, which, far from restoring vigour, gives only temporary artificial health, while it secretly undermines the vital powers of the country that has recourse to it[6].

Boyd's letter created a monetary storm that became known as “the bullion controversy” and which continued for some years, giving birth to the currency school which brought into prominence **Henry Thornton**'s monetary theory of the 'trade cycle'[7] that explained booms and busts as being caused by deviations from the gold standard and not the gold standard itself thereby absolving the free market of any blame. (No wonder **Karl Marx** feared and hated it[8].)

In what became known as Peel's Act a law was passed stipulating that the country would return to gold in stages.

The first stage would begin in 1820 with what would be a gold bullion standard. The second stage would finish in 1823 when cash payments would be fully resumed and the mint price of gold restored.

This would be achieved through a gradual contraction of the currency.

However, in May of 1821 the Bank of England reached an agreement with the government to immediately resume cash payments in the belief that the currency had, according to David Ricardo, depreciated by only about 5 per cent[9] and therefore a mild deflation was all that was needed to restore the mint price.

It was a serious miscalculation that saw the economy go into a steep depression with prices falling by about 25 per cent. (Some contemporaries thought the fall to be much greater).

Ricardo later commented that …

> … I never should advise a Government to restore a currency which was depreciated 30 percent to par; I should recommend, as you propose, but not in the same manner, that the currency should be fixed at the depreciated value by lowering the standard, and that no further deviations should take place. It was without any legislation that the currency from 1813 to 1819 became of an increased value, and within 5 percent of the value of gold — it was in this state of things and not with the currency depreciated 30 percent, that I advised a recurrence to the old standard[10].

If the lesson of 1821 had been remembered the British Government would never have returned to the gold standard (strictly speaking it was a gold bullion standard) in 1925 at pre-war par thereby greatly undermining its own monetary policy by maintaining an overvalued pound.

If anything, this sorry episode reveals the need for politicians, or at least their advisors, to have a basic grasp of sound economics combined with a reasonable knowledge of economic history.

(To be continued ...)

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Notes

[1] See Ralph George Hawtrey's treatment of the subject: *The Gold Standard in Theory and Practice*, Longmans, Green and Co., 1931, chapter III.

[2] Clapham, Sir John, *The Bank of England: A History*, Vol. I, Cambridge: at University Press, 1945, p. 271.

[3] Ricardo, David, *On Protection to Agriculture*, John Murray, 1822, p. 22

[4] Walter Boyd, *A Letter to the Right Honourable William Pitt, on the Influence of the Stoppage of Issues in Specie at the Bank of England*, Printed for J. Wright and J. Mawman, 1801, p. 20.

[5] Ibid. p. X

[6] Ibid. p. 58. The reader should note that this comment amounts to an attack on Keynesianism.

[7] Thornton, Henry, *An Enquiry into the Nature and Effects of the Paper Credit of Great Britain*, Printed for J. Hatchard, 1802, pp.

[8] Marx's so-called theory of the trade cycle is in fact the Banking School theory that John Stuart Mill and Thomas Tooke developed. Unlike Thornton's theory that explained the trade cycle as a result of credit expansion followed by a contraction the Took-Mill theory treated it as a psychological problem or what some might call "irrational exuberance", which treated the money supply endogenous. It should be clear that adopting the Tooke-Mill theory, even though it did not fit the facts, was the only way Marx could argue that the trade cycle was an inescapable product of capitalism. There really isn't anything new at all in *Das Kapital* and that includes his much-lauded treatment of disproportionalities in production. I should add that rather than go to *Kapital* for Marx's 'theory' of the trade cycle it would probably be better to read chapter 17 of his *Theories of Surplus Value*.

[9] The price of gold exceeded the mint price by 5 per cent. Ricardo apparently took this as a measure of the currency's depreciation, as did the Bank.

[10] Edited by James Bonar and J. H. Hollander, *Letters of Ricardo to Hutches Trower and others 1811-1823*, Clarendon Press, 1899, p. 159. The much-neglected 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. The question was 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, G. J., *The Theory of Foreign Exchanges*, London: Effingham Wilson, 1883, p. 88.