§ v. *Peel's Act of 1844 and the Currency and Banking Principles Controversy*

Since Tooke's ideas were undoubtedly correct, and the majority of continental economists supported his views, as well as, in England, such men as John Stuart Mill, how can we explain the success of the Currency School, and the embodiment of their ideas in the Peel Act of 1844? To do so we must take into account the dominating influence of facts and sentiments which count for more in the decisions of statesmen than reasoned arguments.

Peel was up against a problem which disturbed public opinion deeply. One crisis followed another, usually accompanied by an increase in the number of notes in circulation; then, suddenly, certain banks would fail and the bearers of their notes, who quite often had never had any business with the banks, would find their holdings repudiated. Similar events occurred in America, where crises were followed by the failure of innumerable banks. No doubt it might be argued theoretically that current account deposits are the equivalent of bank-notes, that notes always come back to the bank if they are in excess, that the quantity in circulation is therefore subject to automatic regulation, and that notes cannot be thrust on the public. But was it in fact possible to dispute that credit was excessive? Tooke himself had been compelled to admit it. If the conduct of many bankers was beyond reproach, there were nevertheless many others who took advantage of periods of boom to grant credits in too great abundance, to offer their services at very low rates of interest. Competition among banks increased their natural tendency to persuade the public to take up loans. Moreover, the multiplicity of different kinds of bank-notes was a source of embarrassment. To accept a cheque as payment is to display confidence in the payer, whom the payee knows; to accept a note is an act of trust in an unknown bank, whose standing is known only by hearsay. Therefore it was *essential to have only one kind of bank-note*; this idea prevailed against all opposition and ended in the recognition of only one bank of issue.

These, no doubt, were the wholly practical reasons which induced Robert Peel to accept the principles of the Currency School. On this point—when it was merely a question of limiting the private banks' right to issue notes, and of granting the Bank of England a monopoly—there was in fact no divergence between the two schools. Tooke was in favour of note regulation and of Bank of England monopoly. He agreed with those who cried: freedom of banking is freedom of swindling.

Although the idea was never given precise formulation, bank-notes henceforth were regarded as privileged currency instruments; they were there to satisfy *abnormal credit requirements*, to meet exceptional circumstances and to act as a safety-valve in moments of monetary tension. The theoretical identity of credit instruments is one thing; their identity, as a matter of practical functioning, is another. By giving one bank only the right to issue notes, it was given a means of action which other banks did not possess, and also a means of control. The role of "national central bank" which history had gradually conferred on the Bank of England was ratified, and, most important, the currency of the country was unified.

Looking back to-day, it is this aspect of the Peel Act which strikes us as the most important. Later developments in all other advanced countries were to confirm the usefulness of one central bank charged with the privilege of issuing notes. But the dispute between the two schools was concerned not so much with this point (on which, at bottom, they were both agreed) as with the organisation of the Bank of England itself. In regard to organisation, Peel accepted principles which history has shewn to be false, and which Tooke and Fullarton contested with arguments whose validity is no longer disputed.

The Currency School, blindly following the suggestions put forward by Ricardo in 1823, advocated two measures:

1. The division of the Bank of England into two departments, an issue department and a banking department;
2. All note issues to be covered by coin or bullion, with the exception of a small quantity, for which the Bank should hold State bonds.

It was on these two points that the two schools differed. It is precisely these two points that have lost all interest for us to-day. In the first place, eighty years after the Act was passed, both these measures were abandoned in fact if not in law. In addition to its legal balance sheet, the Bank of England has for some years past published a statement similar to those published by all issuing banks, in which the two departments are treated as one. Moreover, new laws put into force since the war give the Bank the right to issue notes without metallic cover in excess of the amount legally laid down whenever the need should arise. The unissued note reserve which the Bank of England uses for granting credits, that is to say its "margin of issue," formerly wholly inelastic, has now become as elastic as that of any other bank.[1]

The Bank of England has thus regained that elasticity of issue which Tooke advocated so warmly. The controversy is ended. Peel's Act is nothing but a memory. To-day it is clear (and many writers said so at the time) that the organisation laid down in the Act was one of the most irrational that has ever been devised: it required all the sound common sense of the English to make it work, all the ability of its governors, and sometimes the co-operation of continental banks. It is unnecessary to discuss the question further; but—for the sake of completeness—it is as well to summarise the ideas which guided the promoters of the Act, in particular Lord Overstone.

Starting out from the erroneous idea that bank-notes are money,

[1] The reader is referred to the series of Acts which have, since the war, changed the legal position of the Bank of England. Here I would refer only to the fact that the Bank is no longer obliged in emergencies to consult the Chancellor of the Exchequer before increasing its note issue, and that the consent of the Treasury is assured in all circumstances.

whereas other credit instruments are not money, and that rises in prices (even when notes are convertible) are the result of an excessive issue of bank-notes (which are mistakenly regarded as paper money), and that, finally, crises are the consequence of excessive issues—all of them ideas which Tooke and Fullarton shewed to be false—Lord Overstone concluded that the way to avoid crises was to *limit the paper in circulation to the amount that a purely metallic currency would have been* (as though crises were avoided in countries with a purely metallic currency). If there is an excessive amount of coin in circulation, gold will leave the country and the exchange rate of the currency will fall. The same symptoms will be manifest with "mixed" currencies, consisting of both coins and bank-notes. (This conception of a "mixed" currency is also absurd since, even in the absence of bank-notes, coin is never the sole circulating medium.) Once these symptoms appear, the number of bank-notes must be reduced. This will be achieved if the quantity of notes is strictly limited and if gold can only be obtained in exchange for bank-notes. To get gold, the public will have to use the notes in circulation, and thus their quantity will be automatically reduced.

This was Lord Overstone's theory. It met with every kind of objection, of which the most important may be summarised as follows: In a country such as England, with a highly developed credit system, the notes which the banks use to obtain gold are *not drawn from the notes in circulation*, but from the re-discounting of their bills at the central bank. The process envisaged by the Currency School, based on the idea of notes coming in from those already in circulation, does not in fact operate. As we shall see in Chapter Nine, Lord Overstone misunderstood the function of a central bank, assumed henceforth by the Bank of England. The only way to reduce the circulation, or rather to *rectify an excess of credit*, is to make credit dearer, that is to say to raise the discount rate.

Tooke maintained that the raising of the discount rate, coupled with a strong cash position, would enable the Bank of England to mitigate the effects of a crisis and to prevent it from developing. Mere limitation of notes will only make the crisis *more acute*, for it is the function of notes to provide additional temporary currency in times of crisis, which will make it possible to avoid bankruptcies and collapses. This concept of the necessity of elasticity in a credit system is one to which Tooke attached great importance. It was to be fully confirmed by the crisis of 1847, when the bank was compelled to ask the Treasury to authorise the issue of notes in excess of the legal maximum. Three years after it was passed, events proved the worthlessness of the Peel Act.