theless, was very important, for it declared that to make bank paper currency stable and tied to gold, it must be regulated to conform to the movements of the gold supply. If the Bank of England were the monopoly issuer of notes, Pennington prophetically counselled, it would be easy for it to control the total supply; in lieu of that, the private banks, London and country, could in some way be totally and immediately controlled by the bank. In either case, the bank could then be compelled to keep its securities (i.e. its earning assets) fixed in total amount; if so, its note issues would move in the same direction, and to the same extent, as its stock of gold. While the bank would not have 100 per cent gold reserves to its notes, the legally fixed gap between them would mean that bank notes (and by extension, the total money supply) would move in the same way and to the same extent as the gold supply – thus arriving at the equivalent of 100 per cent specie money for all *further* operations of the bank. Here was the seed of Peel's great Act of 1844, the embodiment of the currency principle.

But Huskisson could not seize on this point, because of Pennington's hesitations and qualifications; in particular, Pennington, of all people, knew full well that bank deposits are just as much creatures of bank credit as bank notes, and that to 'regulate them [deposits] properly will be no easy task'.

It becomes a mystery that Pennington, the founder of the currency principle, should have been so alert to bank deposits' role as money, while the currency school concentrated with such fierce insistence on bank notes alone. They applied this variant of 100 per cent gold money to notes exclusively, leaving deposits to go unchecked and unregulated on their own. Some historians speculate that the currency school made the conscious decision to avoid applying their principle to deposits, because of an alleged difficulty in practical application, and because they believed that note-holders – presumably being a broader or less wealthy section of the population – were more likely to cash in for gold than deposit-holders.[4] If so, then this 'practical' decision to forget about deposits proved, in the long run, to be the height of *im*practicality – indeed, fatal to the currency, or 100 per cent gold, cause. For Peel's Act's prohibitions on further fractional-reserve note issue simply induced the banking system, led by the Bank of England, to shift their inflationary and expansionary attentions to deposits alone – a condition that still prevails throughout the world.

Currency school myopia on demand deposits scarcely extended to their cousins in the United States. On the contrary, such 100 per cent gold leaders and Jacksonian theorists as Condy Raguet, Amos Kendall and the magnificent Jacksonian William M. Gouge of Philadelphia (1796–1863), were perfectly aware of deposits' equivalent role to notes in the issue of bank money. A Philadelphia editor, Gouge became a treasury official in the 1830s, and remained there from that point on. Gouge held firmly that deposits are in all cases equal to notes, that they may be created by bank lending, and that they have the same inflationary effect on prices as bank notes. He called for a return to the 100 per cent gold reserves backing the deposits of the original banks of Hamburg and Amsterdam. Gouge was also the main theoretician of the Van Buren–Polk independent treasury system, in which the federal government would separate itself totally from banking, first by keeping no deposits in any banks, spending its funds directly in specie, and second, by accepting in taxes only specie and no bank notes or deposits. In that way, the American banking system would be free, not only of a central bank (as ensured by President Jackson in the early 1830s), but also of any link to or support by the federal government.[5]

Other influential expressions of the currency principle emerged from the panic of 1825. The highly influential Sir Henry Drummond (1786–1860)[6], banker and MP, in the fourth edition (1826) of his *Elementary Propositions on the Currency*, was driven by the crisis to the realization that mere specie convertibility was not enough to avoid boom–bust crises in money and in prices. He therefore concluded that the quantity of paper money should be kept constant, so that variations in the money supply would only reflect changes in the stock of specie. In the same year, Richard Page, writing as 'Daniel Hardcastle', state the currency principle in crystal-clear form: 'That only is a sound and well-regulated state of things, when no greater numerical amount of paper is in circulation than would have circulated of the precious metals if no paper had existed'.[7]

After the crisis of 1825, then, a consensus began to form, beginning with James Pennington and spreading through knowledgeable circles in Britain, that the gold standard is not enough; and that bank credit must not be allowed to expand unduly. At the ultimate pole were the currency school, who believed that commercial banks must be restricted to 100 per cent of gold, at least for any further note issues. Most of the school unfortunately left demand deposits out of their reckoning as not part of the money supply. Other established leaders, such as bank governor John Horsley Palmer, developed the far more qualified view advocating more control by the Bank of England: bank money should pyramid on top of a fixed ratio of reserves to liabilities maintained by the Bank of England.

But if bank credit was to be confined to movements of gold, and thereby to end the threat of inflation and the business cycle, *by what mechanism* was this to be accomplished? In most cases, and certainly among virtually all adherents of the currency school, the answer was to be the Bank of England itself: the very institution which bullionists and their successors had long seen to be the central agent of inflation and credit expansion. The idea was that the bank would either ride herd over the private banks, or, in the developing consensus, to assume a monopoly over all issue of bank notes –

leaving banks to issue demand deposits in a way that tied them inexorably to the Bank of England. In short, the modern banking system, with all its deep inflationary flaws, was what was envisioned and brought forth by the currency school. In the name of ultra-hard money, they unwittingly imposed upon Great Britain, and later the world, the modern, centralized inflationary, fractional-reserve and central bank-dominated banking system. The theory was that the bank would control the private banks through monopoly of note issue and other measures, while the government would rigidly control the bank itself.

The other main instrument of bank control over private banks was to centralize gold in the hands of the bank, and to make Bank of England notes legal tender for all citizens and banks. In that way, the banks would be induced to surrender their gold to the Bank, and to happily pyramid their loans and deposits on top of their bank reserves. Their demand deposits at the bank could always be cashed in for legal tender currency. In short, as this proposed structure came to be established in Britain and then elsewhere, the world was saddled with the modern banking system.

It is still a mystery how men so keenly aware and critical of the cartellizing and inflationary role of the Bank of England should have proposed centralizing control into the hands of the very same bank, and all in the name of stopping inflation and tying the monetary system closely and one-to-one to gold. It was truly putting the fox in charge of the proverbial chicken coop. A minority of currency men, it is true, favoured another variant, first recommended by the spiritual father of the currency school, David Ricardo himself. Already, at the end of his 1816 pamphlet on *Economical and Scarce Currency*, Ricardo had hinted at this solution, influenced by an unpublished proposal of J.B. Say in 1814. In his last, posthumous work, published in 1824, *The Plan for the Establishment of a National Bank*, Ricardo put forward and elaborated the new plan: the appointment of a government board to be in charge of a national note issue monopoly, with the Bank of England essentially confined to credit and deposit banking. The idea was that since the bank could not be trusted to be in charge of monopoly note issue, that function should be trusted to the central government. But, surely, here was even more of a fox, if not a wolf, to be placed in command. Government is just as much, if not more, inclined toward monetary and credit inflation as any private central bank. Government can always use inflation to finance the deficits it desires and to subsidize credit to its political allies.

There were other far more effective ways to restrict bank credit expansion. During the Jackson–Van Buren era in the United States (approximately 1828–40s), which roughly coincided with the period of the currency–banking school controversies in Britain, the programme of the hard-money Jacksonian movement was far more thoroughgoing, and ultimately far more realistic, than their spiritual cousins of the currency school. Both groups aimed at achieving hard money, tied very closely to specie, in order to end inflation and the boom–bust cycle. But, instead of maintaining and strengthening the central bank, the Jacksonians, far more logically, made it their first order of business to destroy it. The next step, for Gouge, Kendall, Raguet and their followers, who included Presidents Jackson and Van Buren, was to separate the federal government totally from money, by establishing an independent treasury system, passed by the Van Buren administration in 1840, repealed by the Whigs, and then permanently re-established by the Jacksonian Polk administration in 1846. The idea of the independent treasury was, first for the treasury to keep its own funds, without depositing them in any banks; and second, for the treasury to accept in taxes and other fees only *specie*, and not even notes of specie-redeeming banks. In that way, the federal government would give no encouragement whatever to the circulation of bank notes or deposits. Another plank in the Van Buren programme, considered but never passed, as being too hard-hitting, was a federal bankruptcy law which would have forced any bank to close its doors whenever it failed to meet its contractual obligations to redeem its notes or deposits in specie on demand. Other parts of the Jacksonian programme were state enforcement of bankruptcy the moment a bank should fail to pay in specie, and even the outlawing of all fractional-reserve banking as inherently fraudulent, as promising something that could not possibly be fulfilled: instantaneous redemption of all demand liabilities in specie.[8]

Less thoroughgoing than the Jacksonian proposals but better than the currency school's reliance on the central bank were the proposals of a free banking group that arose after 1825, calling for elimination of the Bank of England. The free banking proponents, however, were scarcely united in their theoretical outlook or in their goals; some wanted free banking in order to eliminate what they considered to be Bank of England restraint on bank credit expansion; while others wanted it for the opposite reason: to approach the currency school goal of pure specie money.

In the former category, for example, was the veteran inflationist and anti-bullionist, Sir John Sinclair. On the other hand, a particularly important example of the latter, hard-money, category was the long-time bullionist and clerk at the Royal Mint, Robert Mushet. In his substantial book, *An Attempt to Explain from Facts the Effect of the Issues of the Bank of England...* (1826), Mushet set forth a currency principle type of business cycle theory. The Bank of England, he pointed out, set into motion an expansionary policy that created an inflationary boom, and that later had to be reversed into a contractionary depression. Like the later currency school, Mushet's aim was to arrive at a purely metallic currency or its equivalent, but he saw that free banking rather than central banking was a better way to achieve it. Thus, Mushet hailed the act of 1826, allowing joint-stock banking outside of the environs of London, as an improvement on the previous system, but still leaving intact the 'main evil', 'because they do not take the power from the Bank of England of adding extensively to the currency'. But 'when the monopoly of the Bank expires [in 1833], and the trade in money is perfectly free, a better order of things may arise'. The better order included stability, a currency not suffering from over-expansion, and an end to the boom–bust cycle.[9]

But by far the most important hard-money free banking advocate was the veteran bullionist Sir Henry Brooke Parnell, a leading MP who had taken the bullionist side in the Irish money question in 1804, was a prominent member of the bullion committee, and had supported resumption in 1819. As early as 1824, Parnell had moved in Parliament for an investigation of the Bank of England's charter. In 1826, he denounced the bank's 'exclusive and mischievous privilege'. In 1826 and again the following year, Parnell organized a discussion at the Political Economy Club, on the theme, 'Might not a proper Currency be secured by leaving the business of Banking wholly free from legislative interference?' He left no doubt that his own answer was, Yes.

Parnell set forth his free banking views in his 1827 tract *Observations on Paper Money, Banking, and Overtrading* (1827, 2nd ed., 1829). He began, following Mushet, by placing the blame for the panic of 1825 on the Bank of England's over-issues of 1824–25. The problem was that the law had taken away from the bank 'the great check over abuses in issuing paper money, namely, the competition of rival banks'. Going beyond Mushet, Parnell was not willing to wait for the bank's charter to expire in six years; no, the power of the bank over money, and thereby over prices and the general state of business, was 'so entirely repugnant...that it ought not be tolerated any longer'. Parnell concluded that the remedy was 'a free system of banking', and, overlooking a few pages at the end of Mushet's work, proclaimed that he himself was the first man in England to raise the banner of free banking.[10]

It is hardly surprising, on the other hand, that George Poulett Scrope, the inveterate underconsumptionist, should also have been an inflationist advocate of free banking in this period. In several books and in an article in the *Quarterly Review*, heralded by articles of other like-minded men in that leading Tory journal, Scrope called for the legalizing of small bank notes and an end to the London note issue monopoly of the Bank of England. His programme was designed to fit inflationist ends. Thus the competing banks would be able to redeem their notes in bullion rather than coin. The proclaimed goal of this banking programme was, in Scrope's words, to 'everywhere lower the values of the metals, and with them that of money'.[11]

7.3 Rechartering the Bank of England

The Bank of England's charter expired in 1833, and this seemed to offer critics of the existing system a golden opportunity to effect a fundamental reform. A bank charter committee was selected by the House of Commons in 1832 to engage in a detailed enquiry into the banking system, focusing on the question of the bank's existing monopoly of bank note issue in London and environs. The committee's hearings and inquiry was the most thorough examination of British banking to date, but Parnell, the only member of the committee to vote against rechartering the bank, complained with some justice that the roster of witnesses was stacked against the proponents of free banking by the manoeuvres of the chancellor of the exchequer in Lord Grey's Whig government, the Viscount Althorp.[12]

It was clear that a consensus of witnesses was building towards centralizing note issue in the hands of a strengthened Bank of England, a policy both the currency school, in its misguided way, and the moderately inflationist Establishment, could support. Only a few witnesses favoured bank competition in note issue in London, and only one, the Manchester merchant and joint-stock banker Joseph Chesborough Dyer, opposed the fateful proposal to invest Bank of England notes with legal tender power.

Based on the committee inquiry, Viscount Althorp presented Parliament in 1833 with his legislative programme: to keep the status quo of bank charter and bank note-issue monopoly in London and a 65-mile radius, and to centralize banking further by granting bank notes legal tender power. This meant that, from then on, private and joint-stock banks need not keep any of their reserves in gold, since depositors and note-holders would be compelled by law to accept bank notes in payment; and that only the Bank of England itself would have to meet its contractual obligations to redeem its notes or deposits in gold. This measure of 1833 went a long way to reduce the role of gold coin in everyday life, and to encourage its replacement by bank notes and bank deposits. In presenting his programme, Althorp noted that since the committee hearings, 'the public have been more inclined to look favourably on the management of the Bank of England…'. In short, the loaded committee had done its work well. He further provided a harbinger of the future by stating that his goal was to have all bank notes issued by the Bank of England – which of course is the modern centralized banking system.

The powerful country banking lobby, however, rose up in high dudgeon at this threat to its note-issue privileges, and the Cabinet was forced to back down on its goal of note-issue monopoly for the Bank of England. Lord Althorp was so chagrined at this successful pressure that he almost resigned from the government.

Although there was only one witness against it, the legal tender provision for Bank of England notes only carried in Commons by virtue of support from arch-inflationists opposed to the gold standard; the vote for legal tender was 214 to 156, with hard-money stalwarts Sir Henry Parnell and Sir Robert Peel, the leader of the Tory opposition, voting against.

Outrage against the legal tender law among the public was led, as might be expected, by the country bankers. The committee of country bankers, led by Henry William Hobhouse, pointed out that the law would 'violate private rights, and secure to the Bank of England an unjust and perpetual monopoly'. The committee's memorial justly pointed out that the government had taken measures against the expansionary tendencies of the country banks, but had ignored the 'operation of the same principle' at work in the Bank of England, in its case unchecked by the competition of other banks.

Leading the public reaction against legal tender was the prolific free banking advocate, the Scottish attorney Alexander Mundell. Mundell warned that the 1833 law would lead to the centralization of specie reserves in the country into the hands of the Bank of England. He charged that 'Your [English] industry, which has been already taxed by the exclusive privileges of the Bank of England as it now exists, is thus to be taxed still more by extension of it'.[13]

7.4 The crisis of 1837 and the currency school controversy

For the first time, the law of 1826 had allowed joint-stock banking (except for the Bank of England) to exist in England. But various remaining restrictions had held the number of joint-stock banks down to 14; the act of 1833 had removed these restrictions, and the result was a veritable orgy of joint-stock banks formed in England. Forty-four new banks were added from 1831 to 1835, topped by no less than 59 in 1836 alone, 15 of them established between 1 May and 15 June of that year. A powerful joint-stock bank, the London and Westminster Bank, was even established in London itself in 1834, although of course it was banned from issuing notes.

Along with the increase in the number of banks came an expansion in bank money. Thus the circulation of country bank notes rose from £10 million at the end of 1833 to over £12 million in mid-1836. Of this growth, almost all came from the issue of the new joint-stock banks: from £1.3 million to £3.6 million in the same period.

Although the Bank of England and the private country banks complained at the new competition, the expansion of credit by the bank fuelled this new burgeoning of banks and bank notes. Discounts of the bank expanded from £1.0 million in April 1833 to £3.4 million in July 1835, and rose to over £11 million by the end of the latter year. Total bank credit, in turn, rose from £24 million in 1833 to over £35 million at the beginning of 1837. This expansion took place in the teeth of the bank's loss of specie reserves from £11 million in 1822 to less than £4 million at the end of 1836. So much for the currency principle, and for its modified 'Palmer rule', which the bank's governor, John Horsley Palmer, had explained to the bank charter committee in 1832 that the Bank of England had been following. There is no way that such a practice – of expanding credit while specie reserves were falling – could be tortured into even an approximation of the currency ideal that the money supply should move as if it were the stock of specie in the country.

To top it off, the bank credit expansion led, in what was becoming the usual way, to a financial crisis and panic at the end of 1836 and the beginning of 1837, replete with bank runs, especially in Ireland. There followed the typical signs of recession: contraction of bank credit, decline of production, collapse of stock prices, numerous bankruptcies of banks and other businesses, and a swelling of unemployment.

It is not surprising that the new boom–bust cycle gave rise to parliamentary inquiries – by committees on joint-stock banks in 1836, 1837, and 1838, and even more so to vigorous debates on the banking situation in pamphlets and in the press. Indeed, more than 40 pamphlets were published on the banking system in 1837 alone, and a large number continued the following year.

The pamphlet war was touched off by a remarkable pamphlet by Colonel Robert Torrens,[14] remarkable not only for being the best presentation of the currency school, but also because it signified a sudden conversion of Torrens into the currency ranks. For Torrens, though a distinguished political economist, a friend of Ricardo, and a founder and leading member of the Political Economy Club, had been an ardent, almost wild, inflationist and anti-bullionist during the bullion *Report* struggles. Indeed, Torrens's inflationism had continued at least into 1830.

Then, in the course of confused and bewildering speeches in Parliament in the critical year of 1833, Torrens continued his old bitter anti-deflationist attacks on the resumption act of 1819, but in the midst of them, also inconsistently enunciated the currency principle in clear form:

> Extensive and calamitous experience had established the fact, that a currency, consisting of precious metals, and of paper convertible into these metals on demand, was liable to sudden and very considerable fluctuation, between the extremes of excess and of deficiency...A mixed currency...would suffer a much more considerable contraction...than a purely metallic...Unless our present system of currency were amended by the timely interference of the Legislature, it would go on to occasion periodical and aggravated distress, until, in a national bankruptcy it would find its euthanasia.[15]

In another speech on rechartering the Bank of England, Torrens warned that 'the adoption of the measures proposed by Government for continuing and increasing the exclusive privileges of the Bank of England would inflict upon the country a periodic recurrence in aggravated forms of revulsions of trade, and of panics in the money market...'.

In his notable *Letter to Lord Melbourne*, all hesitation finally fell away, and Colonel Torrens joined the leadership of the currency school ranks. He began by pointing out, in contrast to most of his currency colleagues, that bank deposits were money equally with bank notes, paying tribute to James Pennington for pointing this out. Torrens explained the nature of deposits as money very clearly, showing that a shift of bank liabilities from notes to deposits or vice versa would not change the amount of bank money by which merchants and others can make purchases. He also noted that while most people have learned how an increase in coin and bank notes raises prices and depreciates foreign exchanges, neither the government nor the directors of the Bank of England understand how loans and deposits do the same thing. But tragically, Torrens then inconsistently dismissed deposits as unimportant, apparently on the ground that the bank, not the public, decides whether to keep its liabilities in notes or deposits, and on the further erroneous assumption that country and joint-stock banks pyramid at a fixed ratio upon bank notes as their reserves but not upon bank deposits. From then on, Torrens wrote and acted as if deposits were irrelevant to the money supply.

Torrens also unfortunately conceded that the bank must function as a lender of last resort to banks in distress, but then confined his attack on the bank to its stoking the fires of inflationary credit and not conforming to the currency principle from the beginning. In order to force the currency principle upon the bank, Torrens, for the first time in print, urged that Parliament rigidly separate the bank into an issue department and a banking department. The issue department would be forced to limit its note issues to its actual supply of gold, so that bank notes could only fluctuate to the extent that the bank's stock of gold increases or decreases. In that way, wrote Torrens, 'the circulation [of bank notes] would always remain in the same state, both with respect to amount and to value, in which it would exist were it wholly metallic'.

The problem is that the banking department, in Torrens's and hence the currency plan, would be left totally free and unregulated, on the assumption that the bank could issue credits and deposits, and that those loans and demand deposits would be totally irrelevant to the money supply. The neglect of deposits was the tragic flaw in the currency plan.

Colonel Torrens's assault on the bank was in effect, though not by name, answered in a pamphlet by bank director and former governor John Horsley Palmer.[16] As in the case of bank apologists for decades, Palmer put the blame for the inflation and recession on every institution *but* the bank: on shipments of funds abroad, on bank runs, and on reckless credit expansion by private and joint-stock English and Irish banks. He concluded that the solution – a particular favourite of the bank – was that the bank must have a monopoly of all note issue. Ironically, the currency school, so hostile to the bank, proposed the same plan for different reasons: so that the government could have but one central bank to regulate.

In his *Letter to Lord Melbourne*, Torrens had given credit to the banker Samuel Jones Loyd for originating the idea of the separation of the Bank of England into issue and banking departments. Loyd now weighed in with a pamphlet attack on Palmer, in which he assumed the leadership of the currency camp.[17] Far more simplistic than Torrens, Loyd dogmatically but fatally asserted that notes and deposits are forever absolutely different and therefore can and must be treated totally differently. Professor Fetter offers an amusing and accurate explanation of the triumph of Loyd's simple-minded stance:

> He [Loyd] stated as a fundamental that no man in his right mind could question that note issuing and deposit business were completely separate and that a mixed circulation of coin and notes should fluctuate exactly as would an all-metallic circulation. Despite its theoretical vacuity, there was no denying the effectiveness of Loyd's argument...Loyd's prestige as a successful banker undoubtedly made his words carry conviction to many who...felt that something ought to be done about the Bank of England and that a man who made money in banking must understand banking.[18]

Throughout 1837 and 1838, the currency principle was advocated in highly influential pamphlets – again by Loyd, by David Ricardo's brother Samson, and – in a particularly important pronouncement – by long-time Bank of England director George Warde Norman. Like Loyd, Torrens and Pennington, Norman was a member of the Political Economy Club. His pamphlet of 1838 was a revision of a pamphlet that he had privately printed five years earlier.[19] Norman agreed with Loyd that notes and deposits are totally different, and also suggested granting to the Bank of England a monopoly of all bank notes. Since Norman was a powerful bank director, it would seem that his adoption of the allegedly 'anti-bank' currency principle was akin to B'rer Rabbit urging not to be thrown into the briar patch!

Another economist lending his prestige as one of the last of the Ricardians to the currency principle was the prolific John Ramsay McCulloch, both in a review of some of the year's pamphlets in the *Edinburgh Review* for April 1837, and again in a new edition of Smith's *Wealth of Nations*, which he published the following year. In 1840, at the next stage of the debate, another leading economist joined the fray on behalf of the currency principle: S. Mountifort Longfield, in a notable four-part article, 'Banking and Currency', in *Dublin University Magazine*, an article influenced heavily by McCulloch's writings.

7.5 The crisis of 1839 and the escalation of the currency school controversy

A mild boom in 1837 and 1838 was followed by another economic crisis towards the end of 1838 and during 1839. Bankruptcies and bank runs ensued, and the Bank of England's gold reserve fell from £9.8 million in December 1838 to an extremely low £2.4 million by September 1839. Not only that; but in the teeth of shrinking reserves, the bank, instead of following anything like its own Palmer rule, let alone the more rigorous currency principle, expanded credit still further, thus precipitating an even greater drain of gold from the bank. By July and August 1839, the chancellor of the Exchequer was beginning to contemplate another restriction, another suspension of specie payment on behalf of the bank. The bank was saved only by massive credits from the Bank of France and from Hamburg.

Clearly, the banking situation was becoming intolerable, and something had to be done. Parliament appointed a select committee on banks of issue on 1840 and again in 1841, and massive hearings were held on the question. Disputes in parliamentary testimony and pamphlet controversy were redoubled, and were made more urgent by Horsley Palmer's concession that the bank was finding it almost impossible to adhere to his rule.

Several other groups now arose to challenge the growing currency school consensus. The free banking adherents took a lead from the currency school in lashing out at the Bank of England's responsibility for inflation and for the business cycle. But the force of their opposition to the bank was vitiated by their uniform apologia for the country and joint-stock banks. While it is true that those banks were largely governed by the actions of the bank, it was egregious for them to claim that the private banks were totally passive and blameless in the entire process. The free banking school was particularly discredited by the fact that virtually all of its spokesmen – with the exception of Sir Henry Parnell, who died in 1842, in the middle of the controversy – were themselves joint-stock or country bankers, so that the special pleading in their stance was all too evident. If this group had confined their advocacy of free banking to the largely *political* point that the bank would inevitably be *more* inflationary and dangerous than competitive banking, they would have been far more persuasive. But such restraint is not the usual practice of special pleaders.

The only distinguished economist to take up the free banking cause was Samuel Bailey, the subjective value theorist. But Bailey had founded and was now chairman of the Sheffield Banking Company, and his fervent apologia was all too suspect. Bailey, indeed, was one of the worst offenders in insisting on the passivity of the country and joint-stock banks, and in attacking the very idea that there is something wrong with worrying about changes in the quantity of the money supply. By assuring his readers that competitive banking would always provide 'nice adjustment of the currency to the wants of the people', Bailey overlooked the fundamental Ricardian truth that there is never any social value to increasing the money supply, once the commodity is established, and that inflationary increases in bank credit take place as a process of fraudulent issue of fake warehouse receipts to standard money.

Another school of thought arising in this period was the banking school, at this early point consisting solely of one prominent man, Thomas Tooke. Tooke (1774–1858) was by now an elderly merchant in the Russian trade who, born the son of a chaplain, had started working in St Petersburg at the age of 15, and had become a partner in a mercantile firm in London. Long interested in economic matters, Tooke had been one of the founders of the Political Economy Club, and continued to attend meetings of the club until his death. In the bullion controversy, Tooke was a staunch bullionist, and he strongly supported the resumption of specie payments in 1819. At best, however, Tooke was a confused and inchoate thinker, and whatever theoretical acumen he had was apparently warped beyond repair by decades of immersion in his life-work, a four-volume *History of Prices and of the State of the Circulation from 1792*, published from 1838 to 1848.[20] Inductive play with his statistics was able to convince Tooke, for example, as early as his 1838 volumes, first that high and rising prices during the Napoleonic periods were solely due to bad harvests, lowering the supply of farm products, as well as obstructions of foreign trade, while, second, *falling* prices after the war were caused by better harvests and the resumption of trade. Having concluded that, Tooke was able to press on, in his third volume of the *History of Prices* in 1840, and in his parliamentary testimony the same year, to launch the banking school with the absurd proposition – to quote from a crystal-clear formulation of Tooke four years later – that: 'the prices of commodities do not depend upon the quantity of money indicated by the amount of bank notes, nor upon the amount of the whole of the circulating medium: but that, on the contrary, the amount of the circulating medium is the consequence of prices'.

To be fair to Tooke and his banking school colleagues, they did not mean – or profess to mean – to apply this old fallacy to *inconvertible* currency, as their anti-bullionist forbears had done, but only to convertible currency. But this did not make their analysis or conclusion one whit less absurd. The masterful critique by Torrens deserves to be quoted at some length: Torrens first points out that Tooke has 'the deserved reputation, which even he himself cannot destroy' of having shown by 'an extensive induction from existing and from historical facts...that the value of everything declines as its quantity is increased in relation to the demand'. But then, Torrens notes, Tooke 'turns his back upon himself by affirming that the value of money does not decline, as its quantity is increased in relation to the demand'. Or at least he affirms this for a convertible money standard. But Torrens concludes incisively that the effects of an increase are the same, for convertible or inconvertible currency. The only difference is that there are limits to increases imposed by a convertible currency. Thus: 'Mr. Tooke falls into the misconception of imagining that the limitation to a further decline of value which convertibility imposes, prevents the previous existence of the decline which it subsequently arrests.' Like Adam Smith, the banking school was blithely assuming that the adjustments and restraints of redeemability were instantaneous, and therefore that no problems would be created in the actual processes of the real world.

A particular rapier thrust against Tooke by Torrens four years later cannot be resisted: 'Throughout interminable pages of inconsistent affirmation [in the multi-volume *History of Prices*], he reiterates the inference, that the value of commodities has fluctuated in relation to money and that, therefore, the value of money has not fluctuated in relation to commodities'.

The corollary proposition of the banking school, taken from the anti-bullionists and now brought again to the fore by Tooke, is that the Bank of England *cannot* increase the supply of money (as Tooke put it starkly, 'The Bank of England has not the Power to add to the Circulation'). Even applying this claim only to convertible currency, as the banking school did, it is difficult to hold such a manifest absurdity at length. In practice, therefore, Tooke and the other banking school adherents usually modified this blunt statement to apply only to bank notes issued in loans to private borrowers, and not to purchases of government securities. To the question: what's the difference?, the main contribution to Tooke's doctrine was made in 1844 by John Fullarton: namely, that notes issued in purchase of government securities are 'paid away' and remain permanently in circulation, thus adding to the quantity of money, whereas bank notes 'are only *lent* and *are returnable to the issuers*',[21] and presumably therefore do not add to the money supply. This was what Fullarton dubbed the 'principle of reflux' of notes returning to the banks. Once again, the incisive refutation came from Colonel Torrens, who pointed out that to carry any weight, the 'vaunted principle of reflux' requires *instantaneous* repayment of all loans: 'Allow any interval to elapse between the loan and the repayment and no regularity of reflux can prevent redundancy from being increased to any conceivable extent.'[22]

The same, as well as many other, strictures apply to a variant of Fullarton's and others in the banking school, which, again stemming from the anti-bullionists, held that banks can never over-issue notes provided that their notes are only issued in the course of making short-term, self-liquidating loans matched by inventories of goods in process – the so-called 'real bills' doctrine.

Torrens's role in the currency *vs* banking controversy has a fascinating reverse symmetry with the path taken by Tooke. Whereas Torrens began as an anti-bullionist and apologist for the Bank of England, and now ended as a currency schoolman and opponent of bank credit inflation, Tooke began as a solid bullionist yet ended his days as a pro-bank, anti-bullionist.

Among the various grave inconsistencies in the banking school approach, one particularly stands out: if it is true that banks can do no wrong (at least in a convertible currency), that they cannot over-issue notes or over-expand credit, and that even if they did it could have no effect in raising prices or causing a business cycle, then why not adopt free banking? Why have a privileged monopoly like the Bank of England? Yet the banking school remained a determined enemy of free banking and devoted apologists for the bank. Thomas Tooke's most famous *dictum* was the striking: 'Free trade in banking is synonymous with free trade in swindling.' Fair enough. But, if we analyse this pronouncement logically and we find that banking is synonymous with swindling, then what is the rationale for placing the power of state privilege behind a monopoly 'swindler'? Even if banking is swindling, isn't 'competitive swindling' better than a state-privileged and dominant monopoly swindler? And yet Tooke fiercely fought to preserve the bank and its exclusive privileges in London and environs; his only proposed reform was to induce the bank to hold a higher reserve of specie to liabilities.

The one contribution of the banking school was to continue to emphasize – what Torrens knew but Loyd and Norman did not – that bank notes and bank demand deposits were equal and coordinate parts of the supply of money. Because of their grave error on this point (in Torrens's case to dismiss deposits as always in a fixed ratio to notes), the currency school, and its embodiment in Peel's Act, left deposits as the big hole in their attempt to make the money supply conform to movements in gold. As we have noted, the currency school counterparts in the United States did not make that error.

Free trade and *laissez-faire* thought was growing in dominance in Great Britain during this era, led by the intrepid merchants, manufacturers and publicists from Manchester. But where to stand on the vexed question of banking? Should banking be free or is fractional-reserve banking really 'swindling' and therefore different from normal honest enterprise? Was Chancellor of the Exchequer Thomas Spring Rice correct when he stated in Parliament in 1839 'I deny the applicability of the general principle of freedom of trade to the question of making money?'

Of one thing the men of Manchester were certain: there was no quarter to be given the Bank of England. Thus, John Benjamin Smith, the powerful president of the Manchester Chamber of Commerce, reported to the chamber in 1840 that the crisis of 1839 was caused by the Bank of England's contraction, following inexorably from its own earlier 'undue expansion of the currency'. Smith denounced the 'undue privileges' of the bank as the source of its control over the nation's economic life. Testifying before Parliament that year, Smith endorsed the currency school by criticizing the fluctuations of note issues by all the banks as well as the Bank of England, and went on to state: 'it is desirable in any change in our existing system to approximate as nearly as possible to the operation of a metallic currency; it is desirable also to divest the plan of all mystery, and to make it so plain and simple that it may be easily understood by all.' Not only did he thus endorse the currency principle; he went further to endorse Ricardo's scheme of creating a governmental national bank for the purpose of issuing bank notes.[23]

A similar course was taken by Richard Cobden, the shining prince of the Manchester *laissez-faire* movement. Attacking the Bank of England, and any idea of discretionary control over the currency, Cobden fervently declared:

> I hold all idea of regulating the currency to be an absurdity; the very terms of regulating the currency and managing the currency I look upon to be an absurdity; the currency should regulate itself; it must be regulated by the trade and commerce of the world; I would neither allow the Bank of England nor any private banks to have what is called the management of the currency...I should never contemplate any remedial measure, which left it to the discretion of individuals to regulate the amount of currency by any principle or standard whatever...

Rejecting both private and central bank management, Cobden was perceptive enough to see that the goal was not free banking *per se*, but to have a currency that mirrors genuine market forces of supply and demand: i.e. the fortunes of gold or silver money. He saw that the currency principle aimed to do just that, and hence his endorsement. And while his support for a government national bank of issue was too much like leaping out of the frying pan into the fire, it was understandable in the light of his refusal to trust the Bank of England to cleave to the currency path: 'I should be sorry to trust the Bank of England again, having violated their principle [the Palmer rule]; for I never trust the same parties twice on an affair of such magnitude.'

7.6 The renewed threat to the gold standard

Thus a consensus was building rapidly after the crisis of 1839 on behalf of the currency principle. But perhaps the precipitating factor in bringing Sir Robert Peel and the Establishment to enact the principle was a renewed threat to the gold standard. The gold standard had been the agreed-upon consensus of all parties since the 1820s and since the return to gold the assaults of inveterate statists and inflationists like Birmingham's Attwood brothers had faded away. But now, under the stimulus of economic crisis, fiat paper agitation and other inflationist threats to the gold standard surfaced once again.

If Manchester was the home of *laissez-faire* and sound money, Birmingham, its sister manufacturing town in the North, had long been the home of state-sponsored inflationism. Economic recession struck the Birmingham area in 1841, and Birmingham moved once more to a powerful attack upon gold. Thomas Attwood himself had retired from Parliament two years before, but Birmingham's representatives were more than willing to take up the old cause. Attwood had been replaced by merchant and manufacturer George Frederick Muntz, who agreed with the former's currency views; and Richard Spooner, the Tory whom Muntz had defeated for the seat, was an inflationist and a banking partner of Attwood's.

The following year, the Birmingham Chamber of Commerce, presided over by Richard Spooner, launched a furious campaign pressuring the prime minister, Sir Robert Peel, into going off gold. Muntz put out a new edition of an old anti-gold tract and, roaring back to the wars, Thomas Attwood, as might be expected, published articles and wrote numerous letters on his currency nostrums.

The most influential of this outpouring of Birmingham inflationism was the *Gemini Letters*, published anonymously by Thomas B. Wright and John Harlow of Birmingham, first as 35 letters in a country newspaper during 1843, and then in book form the following year as *The Currency Question: The Gemini Letters*. The *Gemini* plea was straight, proto-Keynesian, inflationism: inconvertible paper money should be issued by the government, in sufficient amount to stimulate consumer purchasing power and ensure full employment. In addition, the public debt should be inflated away. Thus, as Wright and Harlow put it:

> The proper plan, it appears to us, is to raise the capacity of the consumer, by securing high wages and ample profits, and by these means making light the fixed national obligations of the people...The only limit they would affix to the issue of paper money would be the degrees of prosperity which the different amount of issues would produce...

There is every reason to believe that the *Gemini Letters* and the Birmingham agitation were influential throughout the country. Henry Burgess and his committee of country bankers used the interchanges between the Birmingham Chamber and Robert Peel to denounce the gold standard. Both the *Times* and the new weekly *Economist* were forced to expend a great deal of energy in defending the gold standard from its 'unsound' enemies. At any rate, it is known that Peel owned a copy of *The Currency Question* and marked key passages in the book.

The threat to gold was reinforced by a renewed agitation to dump gold for a bimetallic gold–silver standard. Heedless of the fact that bimetallism never works in practice (since Gresham's law pushes the undervalued metal out of circulation and encourages the overvalued), the pro-silver forces found in bimetallism a way to support monetary inflation while remaining respectably in favour of precious metals as money. Silver supporters therefore began with