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An Economic Crisis In Perspective: The Currency Debate and Uncertainty

Joakim Book Jönsson

Uncertainty is a powerful concept in many ways, particularly so for economic ideas. The convictions before the financial crisis in 2007-8 that business cycles had been tamed was not the first time neglect of uncertainty proved devastating. This essay discusses the famous Currency controversy in mid-19th century Britain and the failure to take uncertainty into consideration, which ultimately lead to the banking crisis of 1847. The unintended consequences of the Bank Act of 1844 revealed themselves spectacularly in 1847, in the same way convictions about the Great Moderation fell apart in 2007-8.

The financial crisis of 2007-8 raised much criticism against economists from a plethora of perspectives. Some argued that the fault lay with formal economic models unable to explain the crisis[1], others that their emphasis on mathematics and static analysis were particularly to blame.[2] Many attacked economists' institutions and incentives, and economists across the ideological spectrum were quickly

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[1] P. Romer 'The trouble with macroeconomics', *The American Economist (Forthcoming)* accessed Oct 2016 via https://paulromer.net/wp-content/uploads/2016/09/WP-Trouble.pdf; M. Lavoie 'Rethinking macroeconomic theory before the next crisis', Institute for New Economic Thinking (2016): https://www.ineteconomics.org/perspectives/blog/rethinking-macro-theory; D. Colander, M. Goldberg, A. Haas, K. Juselius, A. Kirman, T. Lux, and B. Sloth, 'The financial crisis and the systemic failure of the economics profession', *Critical Review*, 21 (2009).

[2] G. Gorton, *Misunderstanding Crisis: Why We Don't See Them Coming,* Oxford: Oxford University Press (2012); R. Frydman and M.D. Goldberg, *Beyond Mechanical Markets: Asset Price Swings, Risk and the Role of the State.* Princeton, N.J.: Princeton University Press (2011).

pointing fingers at their typical villains.[3] Even the Queen briefly joined the ranks of unwavering critics, asking the profession why nobody saw the crisis coming.[4]

In his book about the financial crisis, the former Governor of the Bank of England ('The Bank'), Mervyn King takes a step back and introduces a slightly different analysis: uncertainty in economic life matters. For a period between the mid-1980s and 2007 often referred to as 'The Great Moderation'[5], private-sector agents and policy-makers alike took the recent past for granted, forgetting about uncertainty since the problem of depressions and business cycles had seemed conquered. King blames the crisis itself on this idealistic development: [6]

> 'Economists have brought the problem upon themselves by pretending that they can forecast. No one can easily predict an unknowable future, and economists are no exception'[7]
>
> 'At the heart of modern macroeconomics is the same illusion that uncertainty can be confined to the mathematical manipulation of known probabilities.'[8]

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[3] B. S. Bernanke, 'Implications of the financial crisis for economics', *Federal Reserve Board*, conference by the Center for Economic Policy Studies and Bendheim Center for Finance, Princeton University, Sept 24, 2010: https://www.federalreserve.gov/newsevents/speech/bernanke20100924a.htm; D. Colander 'The economics profession, the financial crisis, and method', *Journal of Economic Methodology*, 17 (2010); J. Taylor,'Causes of the financial crisis and the slow recovery: a 10-year perspective', SIEPR Discussion Paper No.13-026: http://siepr.stanford.edu/sites/default/files/publications/Causes_of_the_Financial_Crisis_2.pdf;
A.M. Shaikh, *Capitalism: Competition, Conflict, Crises.* New York: Oxford University Press (2016); A.M. Shaikh 'The first great depression of the 21st century', *Socialist Register*, 47 (2011); J.T. Salerno, 'A reformulation of the Austrian Business Cycle Theory in light of the financial crisis', *Quarterly Journal of Austrian Economics*, 15 (2012).

[4] *Financial Times*, 'The economic forecasters' failing vision', Nov 25 (2008): https://www.ft.com/content/50007754-ca35-11dd-93e5-000077b07658

[5] B. S. Bernanke, , 'The Great Moderation', *Federal Reserve Board*, at the meeting of the Eastern Economic Association Feb 20, 2004: https://www.federalreserve.gov/boarddocs/speeches/2004/20040220/.

[6] M. King, *The End of Alchemy: Money, Banking and the Future of the Global Economy.* London: Little, Brown.

[7] King, *Alchemy*, 4.

[8] King, *Alchemy*, 121.

Economic actions are much less reliable than are predictions for scientific phenomena, King asserts, for the simple reason that they depend on human behaviour, that sometimes changes when acquiring new information, as opposed to inanimate objects that generally do not internalise information. He concludes forcefully: 'Uncertainty – radical uncertainty – is the spice of life'[9]. There is a long tradition in economic thinking regarding the concept of uncertainty, with notable proponents including Frank Knight, John Maynard Keynes and Joseph Schumpeter.[10]

Much like the crisis of 2007-8, the very same failure to appreciate uncertainty in the domain of economics occurred in Britain 160 years before the run on Northern Rock.[11] Leading up to the banking crisis of 1847, similar convictions of conquering uncertainty were present. The early 1840s were dominated by famous debates in the realm of economic ideas, in which the Currency School prevailed over the Banking School. Their victory was enclosed in the Peel Banking Charter Act of 1844, which would govern the Bank of England's operations until the World War I.[12] The failure to appreciate uncertainty and the unintended consequences following the legislation are vital puzzle pieces in explaining the crisis of 1847[13]; in the very same way, the uncanny convictions before the financial crisis in 2007-8

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[9] King, *Alchemy*, 129.

[10] For more on their respective positions and its implication for economic theory, see J.A. Schumpeter J.A, *The Theory of Economic Development*, London: Transaction Publishers (1983); P. Krugman, 'Mr Keynes and the moderns'; Centre for Economic Policy Research, VOXeu.org, accessed April 25, 2017: http://voxeu.org/article/mr-keynes-and-moderns; H. Hoppe, 'The limits of numerical probability: Frank H. Knight and Ludwig von Mises and the frequency interpretation', *Quarterly Journal of Austrian Economics*, 10 (2007); L. Mises, *Human Action: A Treatise on Economics*, Scholar's edition. Auburn, Alabama: Ludwig von Mises Institute (1998). P. Dizikes, 'Explained: Knightian Uncertainty', *MIT News,* June 2, 2010: http://news.mit.edu/2010/explained-knightian-0602.

[11] H.S. Shin, 'Reflections on Northern Rock: the bank run that heralded the global financial crisis', *Journal of Economic Perspectives*, 23 (2009), 101-119.

[12] V. C. Smith, *The Rationale of Central Banking and the Free Banking Alternative.* Indianapolis: Liberty Fund Press (1936), 21; J.D. Turner, *Banking in Crisis: the Rise and Fall of British Banking Stability 1800 to the Present.* Cambridge: Cambridge University Press (2014), 75-77; M. Daugherty, 'The Currency-Banking controversy: part 1', *Southern Economic Journal*, 9 (1942), 140.

[13] G. Campbell, 'Government policy during the British railway mania and the 1847 commercial crisis', in Dimsdale, N. and Hotson, A., eds., *British Financial Crises Since 1825.* Oxford: Oxford University Press (2014), 73; F. Capie, S. Fischer, and C. Goodhart, 'Central Banking', in F. Capie, S. Fischer, and C. Goodhart and N. Schnadt, eds, *The Future of Central Banking: The Tercentenary Symposium of the Bank of England.* Cambridge: Cambridge University Press (1994), 83-84.

that business cycles had been tamed and depressions banished to the dustbins of history, inform us how dangerous neglect of uncertainty can be.[14]

By looking into the debates surrounding Peel's Act of 1844, this essay simultaneously achieves two purposes: first, refreshing knowledge of the Currency debates has a value in itself since the debate is among the most important in the history of economics and the ideas raised then had bearing on economic thinking until our days[15]; second, it provides us with another example of a financial crisis, beyond the commonly-mentioned parallel to the Great Depression, where neglecting uncertainty was fundamental to the development of that crisis.[16] Below the core points of the controversy are described, followed by a more detailed explanation of either side and the Bank legislation of 1844, before concluding with a brief discussing with regards to uncertainty and the 2007-8 financial crisis.

THE MID-1840S: CURRENCY, BANKING AND THE 1847 CRISIS

The mid-19th century Currency debates developed from the Bullionist debates earlier in the century, and can reasonably be said to have begun with Robert Torrens's 66-page pamphlet in 1837.[17] In that year alone more pamphlets were published on the topic of the currency than in over a decade, and during the following years journals, books and even more pamphlets as well as parliamentary enquiries were dedicated to the topic. The background for their writing was the many banking crises of the 1820s and 1830s, and a sense that price inflation from

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[14] On this, see infamous pre-crisis work by Bernanke 'Great Moderation'; O.J. Blanchard 'The state of macro', NBER Working Paper 14259: http://www.nber.org/papers/w14259.pdf 2008; R. Lucas 'Macroeconomic priorities', presidential address delivered at the one-hundred and fifteenth meeting of the American Economic Association, Jan 4, 2003: http://pages.stern.nyu.edu/~dbackus/Taxes/Lucas%20priorities%20AER%2003.pdf. More on this below.

[15] Capie *et al*, 'Central banking',80-85; Smith, *Rationale*, 21; Daugherty, 'Controversy: part 1',140; F. Fetter, *Development of British Monetary Orthodoxy*. Cambridge, MA: Harvard University Press, vii.

[16] On the parallel between the Great Recession of 2007-8 and the Great Depression of the 1930s, see B. Eichengreen *Hall of Mirrors: The Great Depression, the Great Recession and the Uses – and Misuses – of History*, New York: Oxford University Press (2015).

[17] R. Torrens, *A Letter to the Right Honourable Lord Viscount Melbourne, on the Causes of the Recent Derangement in the Money Market and on Bank Reform*. London: Longman, Rees, Orme, Brown & Green (1837).

the Napoleonic wars and the rate at which gold convertibility was eventually re-established had something to do with it.[18]

TABLE 1: A Schedule of the Currency and Banking Controversy		
CURRENCY SCHOOL	CLASH	BANKING SCHOOL
Notable contributors: Robert Torrens Samuel Jones Loyd George Warde Norman James McCulloch		*Notable contributors:* Thomas Tooke John Fullarton John Stuart Mill James Wilson
It did not, but it *should*.	**(1)** Metallic Currency: whether the monetary system *did* and *should* behave as if it were consisted entirely of gold.	It *did* not, and *should* not. Trying to, would produce financial crises.
Strict rules laid down by parliament to ensure (1).	**(2)** Bank of England decision with regards to the currency steered by Discretion of the Governors or by strict Parliamentary decree.	Discretion, flexibility. Some gold drains should not contract the outstanding notes.
Fundamentally different. Distinct concepts, business and functions. The Bank of England is ultimately in charge of the money supply.	**(3)** Whether notes and deposits were the same. Whether the Bank of England could control the money supply.	Same thing, same economic function, that could be instantly translated into one another. No bank could effectively control the supply of money.
Note issuance, all notes in circulation, quantity theory of money (QTM).	**(4)** Price formation; what governed prices and the price level in the economy	*Real factors*: incomes, shortages, availability and preferences.

Sources: see text.

[18] Fetter, *Orthodoxy*, 167-73; L. H. White, *Clash of Economic Ideas: the Great Policy Debates and Experiments of the Last Hundred Years*. Cambridge: Cambridge University Press (2012), 88-90.

The contributors on either side of the dispute broadly disagreed in four major ways with regards to money, bank notes and Bank of England policy, as seen in Table 1: first, whether the currency system did or did not act as a currency based on a metal (gold or silver) would, and whether that was desirable; second, whether Bank of England decisions with regards to the metallic currency should be placed at the discretion of the Governors, or limited by strict parliamentary decree; third, the relationship between notes and deposits, and their economic function; fourth, as a spin-off to the third, how prices were established in the market and the influence acting upon them by notes and deposits respectively.[19]

The impetus for Torrens and other Currency School writers such as Samuel Jones Loyd (banker and politician), George Warde Norman (Bank of England Governor) and James McCulloch (journalist, professor of political economy) came out of concerns about note convertibility into gold, and a disapproval with how the Bank had let its reserves fall in the 1820s and 1830s. Under the gold standard, the Bank of England ensured note convertibility by paying out gold on demand when presented with Bank of England notes. In order to uphold the convertibility, a sufficient reserve of gold at the Bank was vital; an international drain of gold undermined outstanding notes and could threaten the convertibility and the economy, through a mechanism referred to as the 'price-specie-flow' mechanism. This mechanism, commonly first attributed to David Hume, describes how higher domestic prices due to note-issuing reduces international competitiveness, which creates a trade deficit settled by gold flowing out of the country. That causes a pressure on prices to fall in the home economy, and to increase in the receiving country, re-establishing the relative international competitiveness and correcting the gold flows. The flow of gold could also be influenced by the relative interest rates between countries; increasing (decreasing) the Bank interest rate, attracted (discouraged) speculative gold flows.[20] Excessive domestic note-issuing could thus threaten the gold reserve of the Bank.

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[19] Daugherty, 'Controversy: part 1', 145-152; M. Daugherty, 'The Currency-Banking Controversy: II', *Southern Economic Journal*, vol. 9 (1943), 245-47; Fetter, *Orthodoxy*, 165-201; Morgan, V.E., *The Theory and Practice of Central Banking*. Cambridge: Cambridge University Press (1943), 120-164; Smith, *Rationale,* 22, 75-81; Capie *et al*, 'Central banking', 80-85.

[20] Fetter, *Orthodoxy*, 167-70; Daugherty, 'Controversy: Part 1', 142-46; Morgan, *Theory*, 127; Collins, M., *Money and Banking in the UK: a History*. London: Croom Helm (1988), 173-74; Library of Economics and Liberty, 'David Hume', *The Concise Encyclopedia of Economics,* accessed April 25, 2017: http://www.econlib.org/library/Enc/bios/Hume.html. In the 19th century 'interest rate' was also referred to as 'discount rate'; the two terms are used interchangeably throughout the essay.

To protect the note convertibility the Bank, in accordance with the price-specie-flow mechanism, had to raise its discount rates quickly to attract gold, which, according to the Currency School writers caused commercial crises and instability in the money markets.[21] Torrens wrote:

> when, at the same time, the Bank directors do not draw in their notes, as their treasure is withdrawn, the drain upon their coffers is continued until the Bank is in danger of stopping payment. To avert this danger, the Bank directors resort to a late and violent action on the circulation; they disregard the rule of keeping their securities even; they raise the rate of interest; they refuse bills of unquestionable character; they sell exchequer bills; and thus create alarm and distrust [...].[22]

Since outstanding notes did not fluctuate as they would have done under an all-metallic currency system, the pre-1844 monetary system was considered a disaster that had to be corrected by making notes properly vary with gold holdings.[23] If they did, the Currency School's proponents argued, the problems of gold drains would be much less severe, and the recurrent panics in the financial markets would end.[24]

As for the second dispute, regarding discretionary Bank action, they considered monetary problems exacerbated by Bank actions, and thus suggested imposing strict limitations in Bank note-issuing behaviour.[25] Capie *et al* considers this dispute to be an intellectual forerunner of the Monetarist vs. Keynesian clash over central bank policies and monetary targets in the 1980s, in Britain mostly associated with the reasoning behind Margaret Thatcher's economic policies.[26]

Regarding the third point of controversy, the relationship between notes and deposits, what united the Currency School writers was their passionate claims that notes and deposits were completely separate business activities and even different economic concepts. For instance, economic historian Frank Fetter describes Loyd's

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[21] Torrens, *Letter*, 40-42; Daugherty, 'Controversy: Part 1', 141, 145-46; Smith, *Rationale*, 20.
[22] Torrens, *Letter*, 41.
[23] J. Clapham, J., *Bank of England: a History*, volume II 1797-1914. Cambridge: Cambridge University Press (1944), 172, 182.
[24] N.T. Skaggs, N.T 'Banking and Currency Schools', in G. Faccarello, and D.K. Kurz, eds, *Handbook on the History of Economic Analysis Volume II: Schools of Thought in Economics*. Cheltenham, UK: Edward Elgar (2016), 185; Daugherty, 'Controversy: Part 1', 146.
[25] Daugherty, 'Controversy: Part 1', 142-46; Fetter, *Orthodoxy*, 167-172; Smith, *Rationale*, 75.
[26] Capie *et al*, 80-83; White, *Clash*, 321-28.

conviction that 'no man in his right mind could question that note issuing and deposit business were completely separate', similarly stated by other Currency School writers.[27] Daugherty qualifies their position somewhat in pointing out that only *some* Currency School writers completely denied that deposits were money, whereas others regarded deposits as the top of a structure where gold and notes were the base; the impact on deposits would strictly follow the impact on notes, and so only notes needed to be regulated and made to fluctuate with gold. Hence, deposits were secondary to notes in every aspect.[28]

Lastly, on the fourth point concerning how prices were established, the Currency School relied almost entirely on a version of what later became known as the Quantity Theory of Money (QTM). Building on earlier work by Henry Thornton and David Ricardo[29], they concluded that the 'overissue' of notes was chiefly responsible for high price inflation, and that there was a proportional relation between the quantity of notes in the economy and the prices of goods and commodities.[30]

The legislation Prime Minister Robert Peel proposed in May 1844 (and Parliament subsequently passed in August) was almost entirely based on Currency School ideas since Robert Peel was 'of their persuasion'.[31] He nevertheless seemed to have had very little connection with the proponents of the Currency School, and the bill can truly be referred to as 'Peel's Act'; it is an indication either of his skill as a politician

[27] Fetter, *Orthodoxy*, 169-73, quote from p. 171; G. W. Norman, *Remarks Upon Some Prevalent Errors, With Respect to Currency and Banking.* London: Pelham Richardson (1838), 96-7; Daugherty, 'Controversy: part 1', 145-50.

[28] Daugherty, 'Controversy: part 1', 146-47.

[29] H. Thornton, *An Enquiry Into the Nature and Effects of the Paper Credit of Great Britain.* London: J. Hatchard (1802); D. Ricardo, *On the Principles of Political Economy and Taxation.* London: John Murray (1821); Library of Economics and Liberty, 'David Ricardo', *Concise Encyclopedia of Economics*, 2008. Accessed Dec 20, 2016: http://www.econlib.org/library/Enc/bios/Ricardo.html.

[30] Daugherty, 'Controversy: Part 1', 141, 145-7, 152; Capie *et al*, 'Central banking', 81; Fetter, *Orthodoxy,* 189-91; House of Commons, Thomas Tooke's testimony, Q.5301-Q.5493, pp. 410-433, *First report from the Secret Committee on Commercial Distress; with the Minutes of Evidence,* No. 395. London: (1848), Q. 5395-5397.

[31] Capie *et al*, 'Central banking, 83; Skaggs, 'Banking'; C. P. Kindleberger and R. Z. Aliber, *Manias, Panics and Crashes: a History of Financial Crises.* New York: Palgrave Macmillan (2011), 215-6.

or the dominance of the Currency School ideas in Britain that the legislation so 'faithfully produced the main proposals of the Currency School'.[32]

There were three main parts of the law. First, the Bank was separated into an Issue Department charged with upholding convertibility, and a Banking department, acting as any other profit-seeking commercial bank, which had to honour its liabilities by holding sufficient reserves to cover its deposits. Second, the Issue Department's first £14 million were backed against government securities, after which any additional note issuing had to vary one-for-one with gold bullion, allegedly making the currency behave as if it were gold. Third, any then-issuing bank could not exceed their current levels of issued notes, and newly created banks did not have the right to issue.[33] Campbell describes the key feature as follows:

> Under the system prior to the Bank Charter Act, the Bank had to retain sufficient total reserves to ensure *both* the convertibility of notes to gold, and to cover its deposits. Under the new system the reserve in the Issue Department ensured convertibility, and the reserve in the Banking Department covered deposits. The reserve of one department could not be used to meet the needs of the other.[34]

Although the writings of the Currency School were vastly influential and considered the 'approved doctrine of the day'[35], there was no scarcity of critics. The best of them, considered leaders of the Banking School, include Thomas Tooke, John Fullarton and John Stuart Mill.[36] Their opposing opinions initially came out of pamphlets in the late-1830s and testimonies to the parliamentary committees in 1840 and 1841, but more vigorously in publications in 1844 before and after Peel's Act was made into law. The most reasoned arguments come out of Thomas Tooke's

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[32] Quote found in Capie *et al*, 'Central banking, 83; Fetter, *Orthodoxy*, 182-84; Daugherty, 'Controversy: Part 1', 148, 155; Smith, *Rationale*, 21; Clapham, *Bank*, 177-78; Collins, *Money*, 172-73.

[33] Clapham, *Bank*, 183, 188-89; Fetter, *Orthodoxy*, 184-186.

[34] Campbell, 'Government', 72-3, emphasis added.

[35] Daugherty, 'Controversy: II', 245.

[36] White, *Clash,* 89; Smith, M., 'Tooke, Thomas, and Ricardo' in Heinz D. K. and Salvadori, N., eds., *The Elgar Companion to David Ricardo.* Cheltenham: Edward Elgar (2015), 559-561.

An Inquiry into the Currency Principle and John Fullarton's *On the Regulation of Currencies* as well as John Stuart Mill's article in the *Westminster Review*.[37]

Their arguments were, at once, more intertwined and less consistent than the Currency School, which Fetter attributes to a strategic desire of attacking the Currency School and Peel's Act by every means possible rather than constructing a coherent monetary theory.[38] Their opposition fundamentally stemmed from considering notes and deposits to have 'the same economic function'[39], the distinction attributed to them by the Currency School invalid.[40] Fullarton's vicious attack is, by modern standards, both correct and very amusing:

> the same action on prices which you attribute to the occasional excesses of a circulation of notes [...] must be exercised in a far greater degree by the excessive use of other forms of credit, which perform precisely the same offices in exchange that are performed by the notes, but probably to ten times the extent. [...]
>
> Nothing so preposterous can ever be maintained, as that the same payment, which contributes to a rise of the market, when made through the instrumentality of banknotes, will have no such consequence if effected by the transfer of a bill of exchange or by an adjustment of set-off in a banker's books; or, to put the absurdity at once in its most glaring light, that the action of any given facility of credit on price depends not at all on the *essential nature and tendency of the transaction, but simply on the particular piece of paper on which the amount of credit may happen to be inscribed*.[41]

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[37] Fetter, *Orthodoxy*, pp. 172-74, 186-87.

[38] Although Smith points out that Tooke's monetary theory was as consistent and complete as Ricardo's, Smith, M., 'Tooke, Thomas, and Ricardo' in Heinz D.K. and Salvadori, N., eds., *The Elgar Companion to David Ricardo.* Cheltenham: Edward Elgar (2015), 561; Schumpeter holds Tooke's and Fullarton's contributions as the most systematically presented cases, J. A. Schumpeter, J.A., *History of Economic Analysis.* New York: Oxford University Press (1954), 726. See also Skaggs, 'Banking', 182 for the same point.

[39] Fetter, *Orthodoxy*, 172-73,191.

[40] Fetter, *Orthodoxy*, 188-92.

[41] J. Fullarton, *On the Regulation of Currencies; Being an Examination of the Principles, on Which it is Proposed to Restrict, Within Certain Fixed Limits, the Future Issues of Credit of the Bank of England, and of the Other Banking Establishments Throughout the Country.* London: John Murray (1844), 40-41, emphasis added.

He concluded that the entirety of deposits could be instantly turned into notes or all notes into checkable accounts, with no real economic consequences whatsoever.[42] Basing their arguments on similar remarks, the Banking School rejected the entire idea of making notes vary with gold holdings, since they neither believed it possible for any bank to control money, nor that Peel's Act was particularly relevant since the alleged harms coming from overissuing of notes must be equally applicable to deposits, which the legislation took no consideration of.[43] The Banking School proponents went even further and denied the proto-QTM, embracing the Real Bills doctrine stemming from Adam Smith, and concluded that prices are governed by real rather than monetary factors. They sometimes even reversed the causality of the QTM, arguing that the amount of notes and deposits depended on prices; because of what they called the Law of Reflux, "excess" money would be returned to the banking sector and fail to produce any effect on prices.[44] The intellectual importance and rigour of this reversal is questionable, and hence Schumpeter calls it 'downright silly'[45] before qualifying it as a strategic overshot in the context of the Currency School's religious objection to anything but a stable proportionate relation. Hence, in regard to the third and fourth points discussed above, the Banking School took the exact opposite positions from the Currency School, arguing that notes and deposits are essentially the same thing, and that note issuance did not govern prices, but real factors did.

In regard to the first dispute, over the need for notes to act as a metallic currency would, the Banking School writers peculiarly enough accepted the need for a gold standard and note convertibility (as opposed to their Anti-Bullionist intellectual predecessors[46]), but denied the Currency School's assertions that the pre-1844 system did not act as that currency standard. In fact, the previous systems where notes had not varied proportionately with bullion holdings was a necessary outcome of the inability for the Bank of England to control deposits and the fact that reserves could swamp the movement of bullion. Since the Banking School writers

[42] Fullarton, *Regulation*, 40-41.
[43] Tooke, Tooke, T., *An Inquiry Into the Currency Principle: the Connection of the Currency with Prices and the Expediency of a Separation of Issue from Banking*. London: Longman, Rees, Orme, Brown & Green (1844), 122-23; Tooke's testimony to the *Secret Committee*, Q. 5377, Q. 5381-82, Q. 5400; Fetter, *Orthodoxy*, 188-92; Smith, *Rationale*, 89; Morgan, *The Theory*, 126.
[44] Tooke, *Inquiry*, 123-24; Fetter, *Orthodoxy*, 193; Tooke's testimony to the *Secret Committee*, Q. 5429-30, 5460; N.T. Skaggs, 'John Fullarton's Law of Reflux and central bank policy', *History of Political Economy*, 23 (1991), 458-59; G.A. Selgin, 'The analytical framework of the Real-Bills doctrine', *Journal of Institutional and Theoretical* Economics, 489-93.
[45] Schumpeter, *History*, 709.
[46] Skaggs, 'Fullarton', 462-64.

believed that most international flows of gold 'would end spontaneously' with no 'corrective action on the part of the Bank' required, they advocated a less strict approach where the Bank facing a gold drain should exercise caution and use its good judgement until they were certain of its 'deep-seated causes'[47].

The Currency School put their trust in the international equilibration of gold bullion through the price-specie-flow mechanism; by attempting to connect the outstanding notes with the Bank gold bullion, they believed that the mechanism was ensured, preventing inflation and moderating crises. What they failed to recognize was that the reserve holdings of the Bank also mattered for the total money in circulation; if, while the Issue department redeemed notes in face of an external gold flow, the Banking department reduced its reserves, the total money in circulation in the British economy would not shrink, and so the price-specie-flow mechanism would be disrupted. What became clear during the crisis of 1847 was how changes in reserves in fact *did* overshadow the flow of bullion, taking many Currency School writers by complete surprise. The economic historian John Clapham discussed a speech by Francis Baring in the House of Commons in 1847 shortly after the crisis had begun where he expressed this confusion very well; that '£7m of gold should run off, and yet the notes in the hands of the public should rather increase than diminish'[48] was completely unfathomable to most observers, save perhaps the Banking School writers. In his 2014 article Campbell showed that despite large-scale redemption of notes, the Issue department's actions were sterilised by the falling reserve in the Banking department, maintaining the money in circulation fairly stable.[49]

After having constructed a monetary system that policy-makers and Currency School writers believed would prevent large-scale financial crises and overissuing of notes, they saw 'to their sorrow'[50] the Banking department reverse their efforts when its reserve fell by similar amounts; because they misjudged that possibility, they mistakenly believed that the problem of financial crises was solved, or at least greatly reduced. As Capie *et al* concluded, the Currency School won the intellectual

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[47] Quotes from Daugherty, 'Controversy: Part 1', 154; Selgin 'Analytical Framework', 492; Fullarton, *Regulation*, 40, 50-51; Tooke, *Inquiry*, 121-22; Morgan, *The Theory*, 140; Fetter, *Orthodoxy*, 189.
[48] Clapham, *Bank*, 195.
[49] Clapham, *Bank*, 196; Campbell, 'Government', 71-3. See also
R. Dornbusch, and J.A. Frenkel, 'The gold standard crisis of 1847', *Journal of International Economics*, 16 (1984), 11-12; Collins, *Money*, 175-77.
[50] Skaggs, 'Banking', 186.

battle of the 1840s, with the passing of the Banking Act of 1844.[51] Yet in many ways they lost the war, failing to prevent the recurrence of crises or diminish their impact.[52] Campbell points to the 'unintended consequences' of Peel's Act, and concludes that 'the automatic stabilization which it was intended to provide was nullified by the management of the Banking reserve.'[53]

THE GREAT RECESSION OF 2007-8

The over-reliance shown by economists and policy-makers in 1844 of the nature of a metallic money standard, combined with the stabilising workings of the price-specie-flow mechanism illustrates very well the problem of real-world uncertainty in economic policy-making. It is all too tempting for economic actors and policy-makers to downplay risks on account of some major change to the financial system. In the run-up to the 2007-8 crisis, policy-makers and economists confidently believed that they had conquered the problem of business cycles, not unlike what Currency School writers imagined in the 1840s, or economists did during the "roaring 1920s"[54]:

> Above all, there was the naïve belief that policy had tamed the cycle. In the 1920s it was said that the world had entered a "New Era" of economic stability with the establishment of the Federal Reserve System and independent central banks in other countries. The period leading up to the Great Recession was similarly thought to constitute a 'Great Moderation' in which business cycle volatility was diminished by advances in central banking.[55]

A belief spreads that this time is somehow different, on account of completely different circumstances; in the late-2000s, globalisation, securitised debt or technological advanced were commonly given as reasons.[56] The role this conviction plays in financial manias or business cycle is well-described in economic

[51] Smith, *Rationale*, p. 21; Daugherty, 'Controversy: Part 1', p. 140
[52] Capie *et al*, 'Central banking', 83-84.
[53] Campbell, 'Government', 73.
[54] White, *Clash*, chapter 3.
[55] Eichengreen, *Hall of Mirrors*, 3. See also 20-21, 85-87.
[56] C.M Reinhart, and K.S. Rogoff, *This Time is Difference: Eight Centuries of Financial Folly*. Princeton and Oxford: Princeton University Press (2009), 15-20; Eichengreen, *Hall of Mirrors*, 88.

literature.[57] In particular for the 2007-8 crisis, serious incentive problems up and down the "mortgage origination-extension-securitization chain"[58] were caused by a combination of government subsidies, programs geared towards "affordable housing"[59], regulatory capture, the illusion of safety from diversification, financial innovation and opaque products, a mentality of too-big-to-fail fostered by accommodative central banks and over-confident politicians and regulators.[60] This is how Eichengreen, for instance, describes the role of ratings agencies:

> Investors should have known better than to rely on gatekeepers with such dubious incentives. But the complexity of the securities in question made it difficult to independently evaluate the risks. As in any boom period, the rising share of naive investors in the market [...] made it even less likely that the ratings agencies would be caught out.[61]

Of course, this false sense of security and prosperity was hardly limited to shady bankers, financial firms or governments faced with political incentives, but stemmed from an honest belief that this time was different.[62] Ben Bernanke in 2004, while a member of the governing body of the Federal Reserve, were among those who believed that the 2000s was meaningfully different. He described the macroeconomic stability of the preceding decades as a success of monetary policy as well structural changes in the international economy:

> The reduction in the volatility of output is also closely associated with the fact that recessions have become

[57] See for instance Kindleberger and Aliber, *Manias*, or H. Minsky, H. P *Stabilizing an Unstable Economy*. New Haven: Yale University Press (1986).
[58] Eichengreen, *Hall of Mirrors*, 78.
[59] Eichengreen, *Hall of Mirrors*, 80-83.
[60] For overviews and timeline of the crisis, see Shin 'Northern Rock'; M. K. Brunnermeier, 'Deciphering the liquidity and credit crunch 2007-2008', *Journal of Economic Perspectives*, 23 (2009); G. Gorton, and A. Metrick 'Getting up to speed on the financial crisis: a one-weekend reader's guide', NBER working paper 17778, (2012), accessible via http://www.nber.org/papers/w17778.
[61] Eichengreen, *Hall of Mirrors,* 79.
[62] Reinhart and Rogoff, *This Time*, pp. xxxiv-xxxv, says that "this time is different" is almost never the case, and that those four words are "most expensive investment advice ever given". They write in their preface "Financial professionals and, all too often, government leaders explain that we are doing things better than before, we are smart, and we have learned from past mistakes."

> less frequent and less severe. [...]Few disagree that monetary policy has played a large part in stabilizing inflation, and so the fact that output volatility has declined in parallel with inflation volatility, both in the United States and abroad, suggests that monetary policy may have helped moderate the variability of output as well.[63]

Computation, communication, and business practices mattered too, Bernanke argued, but the 'Great Moderation' primarily came from improved monetary policy.[64] In academic circles similar voices were heard. Oliver Blanchard, at the time professor of economics at MIT and soon to become the IMF's chief economist, in what has become an iconic representation of the extent to which economists neglected uncertainty, explained that the 'State of macro is good'[65] about a month before the collapse of Lehman Brothers. Reflecting on the (at that point in time rather mild)[66] ongoing financial crisis, a somewhat surprised Blanchard concluded that liquidity shocks to large financial institutions 'appear to have potentially large macroeconomic effects'[67]. But the most striking example of hubris came from Nobel laureate Robert Lucas, who in his presidential address to American Economic Association in 2003 argued the following: 'macroeconomics in [its] original sense has succeeded: its central problem of depression prevention has been solved, for all practical purposes, and has in fact been solved for many decades'[68]. In his autobiography, Bernanke attributed his mistake to forgetting the intricate financial ties between the entire financial system, and the threat posed to the overall financial stability.[69] One is tempted to add Mervyn King's emphasis on neglecting uncertainty.[70]

CONCLUSION

Drawing analogies between the Great Recession of 2007-8 and past financial crises is hardly a novel endeavour, the most striking example being the Great Depression.[71] While the parallel here considered between the 2007-8 crisis and the

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[63] Bernanke, 'Great Moderation'.
[64] Ibid; see also Eichengreen, *Hall of Mirrors*, 85-88, 169-70.
[65] Blanchard, 'Macro', 2.
[66] Gorton and Metrick, 'Getting up to Speed', 3-17.
[67] Blanchard, 'Macro', 14.
[68] Lucas, 'Macroeconomic', 1.
[69] B.S. Bernanke, *Courage to Act: A Memoir of a Crisis and its Aftermath*. New York: W.W. Norton & Company (2015), 113, 136, 162.
[70] King, *Alchemy*, 129
[71] See for instance Eichengreen, *Hall of Mirrors*.

crisis of 1847 concerning the disregard for uncertainty and the belief that the problem of business cycles had been conquered can be found in many other crises, the 1840s provide a particularly important era because of its intellectual disputes.[72] The clash between the Currency School and the Banking School is a scholarly conflict that has re-emerged in various shapes time and again in the history of economic ideas, most prevalently perhaps between Monetarists and Keynesians in the 1980s. The crisis neatly illustrates the failure to take uncertainty into consideration, to which Mervyn King's discussion of the Great Recession equally applies, revealing how ideas dominating economic doctrines more than a century-and-a-half ago can have relevance to modern times; uncertainty in economic life is real, and failing to appreciate that proved costly, not only in the 2000s but in the 1840s as well.

[72] Kindleberger and Aliber, *Manias.*

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