1 • An overview

To the monetary economist, the period 1870–1914 was a golden age, in more than one sense. Most obviously and literally, in those years the Gold Standard developed from something close to an exclusively British institution into an international monetary system which even today is held up as a model of stability. But this was also the period in which the quantity theory of money, conceived of as a theory of the general price level, reached the peak of its development. In the years before World War I, both well-known formulations of that theory – the transactions approach mainly associated with Irving Fisher, and the stock supply and demand for money approach of Alfred Marshall and his pupils – were brought to full fruition by their exponents. This fact, and the then ruling idea that it was the principal business of monetary economics to explain the behaviour of the general price level, combined to give the quantity theory a more central position in monetary economics than it has enjoyed at any other time, whether before or since.

During the period in question the quantity theory was deployed, as it had been in earlier years, to deal with policy issues, prominent among which were, in the case of the controversy about bimetallism, those involving the choice of monetary standard. However the analytic precision which the quantity theory acquired after 1870 owed more to a concern on the part of its exponents to eliminate a certain logical incompleteness in the body of knowledge which they had inherited from classical economics, than it did to any immediate desire on their part to contribute to contemporary policy debates. In the years before World War I, the literature of monetary economics became much less a series of *ad hoc* responses to questions posed by current events than it had been before, and began consistently to display that internal dynamic which is the basic characteristic of a mature branch of economic science. In this sense too, then, the phrase 'golden age' seems an appropriate characterisation of the period.

There is nevertheless an element of irony implicit in this book's title. The spread of the Gold Standard between 1870 and 1914 had much to do with the growing international influence of what Frank Fetter (1965) called 'British monetary orthodoxy'. This orthodoxy had developed over the preceding century, and the quantity theory too was part and parcel of it. But the refinement of the quantity theory after 1870 did not strengthen the intellectual foundations of the Gold Standard. On the contrary, it was an important element in bringing about its eventual destruction. I hasten to add that I am aware that World War I happened, and that the monetary upheavals associated with it and its aftermath were undoubtedly the immediate causes of the Gold Standard's final collapse in the 1930s. However, the notion of a managed money, available to be deployed in the cause of macroeconomic stability and capable of producing a better economic environment than one tied to gold, was not an intellectual response to the monetary instability of the post-war period. The idea appeared in a variety of guises in the pre-war literature as a corollary of the quantity theory there expounded.

Whether the idea of managed money would have triumphed over tradition and practice to destroy the Gold Standard had World War I not happened is hard to say. My own instinct is to doubt it: exponents of the quantity theory were, on the whole, more satisfied with the monetary status quo on the eve of the war than they had been twenty years earlier. Though they did not give up arguing the theoretical superiority of other ways of organising matters, they did recognise that the Gold Standard, or to be more precise the Gold Exchange Standard, seemed to be working, and working rather well at that. At the same time, I find it even less likely that notions of managed money would have attracted so much support so quickly in the 1920s and 1930s, had their intellectual foundations not been so firmly developed in the preceding forty years or so.

This book does not pretend to offer a comprehensive account of what is to be found in the literature of monetary economics between 1870 and 1914. It concentrates on the development of the quantity theory of money, and discusses alternative approaches to the extent that they seem to throw light on that development, making no attempt to weight the latter by the relative frequency with which they were discussed in contemporary literature. Two major themes are developed in the following pages, as I have already hinted: namely, that the evolution of monetary economics owed more to its own internal dynamics than to outside events, and that the logic of the quantity theory subverted the intellectual authority of the Gold Standard. These themes are explicit in many of the details of the exposition that follows. More importantly, though less obviously, they are implicit in the order in which topics are taken up in the following chapters. In particular, the nature of the quantity theory as it evolved after 1870 is dealt with before its application to policy questions is discussed in any detail.

There is some justification for my chosen order of exposition: Marshall's (1871) manuscript on 'Money', unpublished (until 1975), which contains an essentially complete account of the Cambridge version of the quantity theory, was indeed a product of the early 1870s, and hence antedates its author's involvement in the bimetallic controversy of the 1880s and 1890s; but this defence cannot be pushed too far. Irving Fisher's work, not to mention that of Knut Wicksell, did not even begin to see print until the debate in question was more or less over, and both of them were well aware of, and commented extensively on, the issues that had been raised during its course. My main reason for treating topics in the order that I do stems, however, not from chronological but from theoretical considerations. The chronology of the development of monetary economics during this period, as indeed during any other, is capriciously untidy. The logical relationships which exist among theoretical ideas that were developed then, and between those ideas and the policy problems to which they were relevant, have an altogether clearer shape. My perception of that shape has, as I have already remarked, determined the design of my narrative, which I shall now outline.

The main purpose of Chapter 2 is to give an account of the 'monetary orthodoxy' of the early 1870s, an account which stresses the following three weaknesses in its structure. First, that orthodoxy distinguished between the short and long run when it discussed price level determination under commodity convertibility, espousing the quantity theory for the short run and the classical cost of production theory of value for the long run; but, because it treated mining as a rising marginal cost activity, while simultaneously lacking the theoretical tools to analyse precisely the influence upon that marginal cost of the monetary demand for the precious metals, its treatment of these matters was logically incomplete, or at least unclear.[1] Second, that orthodoxy treated the cycle as being mainly a phenomenon of short-run price level fluctuations, but did not satisfactorily explain the speculative behaviour which drove them; nor did it integrate output and employment fluctuations into the corpus of facts with which cycle theory was expected to deal. Finally, classical economists often had difficulty distinguishing systematically between money and credit, and hence in integrating their analysis of banking with their theory of the price level.

These three flaws in classical monetary economics are precisely those which the neoclassical quantity theorists, notably, but not exclusively, Fisher, Marshall and Wicksell, attempted to repair. As I show in Chapters 3 and 5, they carefully analysed the influence of the monetary demand for the precious metals on their value. In the process they demoted the metals' cost of production from the status of a major, and in some treatments unique, determinant of money's 'natural' value to that of a secondary and remote influence on its quantity. They simultaneously promoted the quantity theory to the status of general theory of the price level, valid in both the short and long run. As to the cycle, Chapter 4 shows that the idea of expected inflation and its corollary the nominal–real interest rate distinction, and the notion of money wage stickiness, taken together led most quantity theorists (though not, as is shown in Chapter 5, Wicksell) to give pride of place to price level fluctuations in its analysis. Though not all of them regarded monetary shocks as being the major impulse leading to cyclical fluctuations, all of them emphasised the interaction of money and prices in explaining how the consequences of initial shocks were propagated and amplified. Wicksell's unique role in the development of the quantity theory is described in Chapter 5, where it is shown to have involved tackling the third of the above-mentioned problems implicit in classical monetary economics. Wicksell integrated an already well articulated classical account of the role of interest rates in the transmission mechanism with contemporary capital theory, and went on to expand the analysis of credit market effects in that mechanism. In doing so, he laid the groundwork for the later abandonment of the quantity theory by his disciples.

Chapter 6 describes how the theoretical developments just outlined affected thinking about policy. Specifically it is argued: that the destruction of the idea that a commodity money has some natural value independent of its monetary use removed an important theoretical support from the Gold Standard, whose victory over bimetallism, therefore, occurred despite, rather than because of, developments in monetary theory; and that the quantity theorists' insistence on price fluctuations as a key factor driving the cycle naturally led them to look for monetary arrangements that would either eliminate such fluctuations or render them harmless. Marshall, early in his career, wanted to replace the Gold Standard with a form of bimetallism and advocated indexed contracts; Fisher argued for indexing money itself; and as early as 1898 Wicksell was urging the abandonment of any kind of metallic money and its replacement by an international paper standard. None of those proposals attracted support from contemporary policy-makers. Their effect was less direct and more subtle, but in the longer run no less important. They helped to change the political status of the Gold Standard from that of an unquestioned constraint on choices about monetary arrangements to that of one object of choice among several. That change of status was, I believe, crucial once the monetary instability associated with World War I put the choice of monetary arrangements back on the political agenda.

Now the foregoing is a summary of this book's major thrust, but many other subsidiary, yet important, topics are taken up along the way: the relationship between Fisher's version of the quantity theory and the Cambridge formulation; Ralph Hawtrey's use of Marshallian ideas to construct a thoroughgoing monetary theory of the cycle; Wicksell's failure to integrate inflation expectations into the heart of his cumulative process analysis; Francis Y. Edgeworth's important contribution to banking theory to name but a few. Nor should this very broad brush summary lead anyone to believe that, by the outbreak of World War I, the edifice of neoclassical monetary economics, built around the quantity theory, was any more complete than the classical orthodoxy, from which it developed, had been in the early 1870s. It contained gaps and inconsistencies of its own, and the development of monetary economics continued after World War I in response to those gaps and inconsistencies just as it had earlier. The scientific maturity which marked monetary economics during the period 1870–1914, persisted into the post-war period. The final chapter of this book, therefore, briefly discusses the deficiencies of neoclassical monetary theory as it stood in 1914, and how subsequent attempts to cope with them were to evolve.

Note

1. I do not mean to suggest here that classical monetary theorists always neglected demand side effects. Thus one important factor motivating David Ricardo's (1816) *Proposal for an Economical and Secure Currency*, which would have replaced gold coin with paper convertible into bullion, was his fear of the deflationary consequences of re-introducing gold coinage into Britain in the wake of the preceding inflation. On this, see Samuel Hollander (1979), Chapter 8.