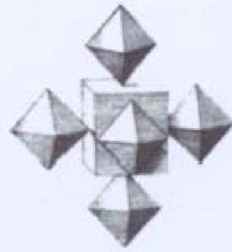

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MARX' CRITIQUE OF THE CURRENCY PRINCIPLE

by

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ABSTRACT

The goal of this paper is to rescue the critique of Marx of the Currency Principle from its current oblivion. The ideas of Marx are extraordinarily interesting both from a theoretical and from a practical standpoint, as the theory of the Currency Principle remains right up today the theoretical basis of the restrictive monetary policies periodically applied by central banks in order to "stabilize the economy", "contain inflation" and correct "excessive money creation". The core of the Currency Principle was the principle that the central bank had to contract the circulation of banknotes "*pari passu*" with the contractions of the gold reserve. Marx contends, in agreement with the Banking School, that such a principle rests on a defective monetary theory and that it creates an artificial scarcity of means of payment; this drives up the interest rate to a level that is higher than that naturally required to liquidate the periodic overproduction brought about by the capitalist system.

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Key words: currency principle, 100% reserve rule, money supply, monetary stabilization, crises

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Introduction

Marx sees in the 1844 Bank Charter Act a strategic maneuver of the British financial interest against, mainly, the British industrial interest. I say "mainly" because, as Marx sees it, though the 1844 Act and its Currency Principle are directed first and foremost against the British industrial interest, they are also directed against the foreign industry, against the landed interest, British and foreign, and against the working class, British and foreign[1]. The erection of the Currency Principle into law in the 1844 Bank Charter Act represents thus a significant demonstration of power on the part of the British financial industry. Not only was Marx aware of the strategic significance of the Currency Principle; as a monetary theorist, he undertook to critically analyze its basis in detail on the grounds provided by his monetary theory. As a result, Marx provided a theoretical critique of the Currency Principle like no one has ever produced in the History of Economics.

The critique of Marx of the Currency Principle is a part of his monetary theory. Unfortunately, however, the monetary theory of Marx might very well be the least known chapter of Marx' thought these days. This is very unfortunate, because Marx' monetary theory has no rival in the History of Economic Thought. It provides a unique point of departure to correct the current superficial monetary theory and, thus, to open the road to a real monetary theory. The rescue of the critique of Marx of the Currency Principle which constitutes the subject of this paper is, thus, the first step in a wider project that aims at rescuing the monetary thought of Marx.

The critique of the Currency Principle provides a good starting point for such an endeavor because it obliges us to distinguish and characterize each of the functions of money. In particular, Marx is free from the erroneous thesis that the essence of

[1] "The Bank Act of 1844 thus directly induces the entire commercial world forthwith to hoard a reserve fund of bank-notes at the outbreak of a crisis; in other words, to accelerate and intensify the crisis. By such artificial intensification of demand for money accommodation, that is, for means of payment at the decisive moment, and the simultaneous restriction of the supply the Bank Act drives the rate of interest to a hitherto unknown height during a crisis. Hence, instead of eliminating crises, the Act, on the contrary, intensifies them to a point where either the entire industrial world must go to pieces, or else the Bank Act. Both on October 25, 1847, and on November 12, 1857, the crisis reached such a point; the government then lifted the restriction for the Bank in issuing notes by suspending the Act of 1844, and this sufficed in both cases to overcome the crisis. In 1847, the assurance that bank-notes would again be issued for first-class securities sufficed to bring to light the £4 to £5 million of hoarded notes and put them back into circulation; in 1857, the issue of notes exceeding the legal amount reached almost one million, but this lasted only for a very short time." (Marx, 1894 [1991], 689)
Here is another passage which Marx takes from the Parliamentary Committee on "the commercial distress":
"4488. How do you think that the Act of 1844 has operated? -If I were to answer you as a banker, I should say that it has operated exceedingly well, for it has afforded a rich harvest to bankers and [money-]capitalists of all kinds. But it has operated very badly to the honest industrious trades-man who requires steadiness in the rate of discount, that he may be enabled to make his arrangements with confidence... It has made money-lending a most profitable pursuit". –4489. "It [the Bank Act,] enables the London joint-stock banks to return from 20 to 22% to their proprietors? -The other day one of them was paying 18% and I think another 20%; they ought to support the Act of 1844 very strongly". -4490. "The little tradesmen and respectable merchants, who have not a large capital ... it pinches them very much indeed ... The only means that I have of knowing is that I observe such an amazing quantity of their acceptances unpaid. They are always small, perhaps ranging from £20 to £400, a great many of them are unpaid and go back unpaid to all parts of the country, which is always an indication of suffering amongst ... little shopkeepers"." (Marx, 1894 [1991], 694)

money is to be the means of circulation. Marx explains how money arises from the process of circulation, but he carefully stresses that the fundamental function of money is to be the measure of value[2]. Money serves as means of payment because the process of circulation makes it, first of all, measure of value. To put it in an alternative way: if money has the ability to discharge debts and, accordingly, acts as means of payment is because, previously, all commodities have been reduced to money. Money is, first of all, the objective manifestation of the identity of commodities as objectified labor. This means that the essence of money is not to be an instrument that mediates the exchange of commodities, an instrument that can be issued at will and should be issued in the least costly possible way. This severely limited conception of money undermines much of current monetary theory[3].

Apart from the theoretical elaborations required, there is a second reason to choose the critique of Marx of the Currency Principle as entry point to the study of monetary theory, namely: the theoretical justification offered by the supporters of the Currency Principle back in the first half o the 19th century for their austerity policies has remained alive and kicking right up today and, in fact, the reader will find it at work in the current plans to overcome the current "crisis". As we can see in the critique of Marx of the Currency Principle, the austerity demanded by the periodically recurring plans to "stabilize the economy", correct the "disequilibria" caused by the reckless credit policies of the financial system and bring "the economy" back to the path of growth and happiness for all is but the modern version of the old view of the Currency School that the origin of the capitalist crises lies in the excessive creation of money, the only remedy for which is the restriction of credit –not for big business, of course, which, for the benefit of all, must have easy access to money, but for the commoners.

1. The Currency Principle

The declared aim of the Currency Principle is to stem gold drains. That gold drains are to be stemmed is the undisputed and first premise of the Currency Principle, as well as of the Banking Principle, as we will see below. We will also see how Marx makes explicit the conception of wealth implicit in this first premise. The main difference between the Currency and the Banking Principles, which is not a trifling one, neither in theory nor in practice, is that the Currency School intended to erect a rule for

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[2] "The first chief function of money is to supply commodities with the material for the expression of their values, or to represent their values as magnitudes of the same denomination, qualitatively equal, and quantitatively comparable. It thus serves as a *universal measure of value*. And only by virtue of this function does gold, the equivalent commodity *par excellence*, become money." (Marx, 1867 [1971], 66). Marx adds a bit later an interesting comment: "With English writers the confusion between measure of value and standard of price (standard of value) is indescribable. Their functions, as well as their names, are constantly interchanged." (Marx, 1867 [1971], 70 n6)

[3] See, for instance: "What is Money? If money is viewed simply as a tool used to facilitate transactions, only those media that are readily accepted in exchange for goods, services, and other assets need to be considered. Many things -from stones to baseball cards- have served this monetary function through the ages." (Federal Reserve Bank of Chicago, 1992, 1). There is no mention of money as measure of value. Moreover: the report goes on like this: "What Makes Money Valuable? In the United States neither paper currency nor deposits have value as commodities. Intrinsically, a dollar bill is just a piece of paper, deposits merely book entries. Coins do have some intrinsic value as metal, but generally far less than their face value. What, then, makes these instruments -checks, paper money, and coins- acceptable at face value in payment of all debts and for other monetary uses? Mainly, it is the confidence people have that they will be able to exchange such money for other financial assets and for real goods and services whenever they choose to do so." (Federal Reserve Bank of Chicago, 1992, 2).

the issue of banknotes by the Bank of England into law, whereas the Banking Principle opposed the management of monetary policy on the bass of rules. The rule that the Currency School succeeded in passing into law, which is known as the Currency Principle, is the rule that the Bank of England should regulate the circulation of banknotes "*pari passu*" with the fluctuations in the gold reserve. The most important and disputed consequence of such a rule is that it requires the Bank of England to *contract*, not to *expand*, the circulation of banknotes in times of gold drain[4].

The contraction of the banknote issue in times of gold drain implies the restriction in the supply of means of payment at exactly the time when the supply of means of payments is restricted. Was it not more reasonable not to cut, but to expand the supply of banknotes in times of gold drain, in order to make up for the increased scarcity of gold and prevent the rise in the price of money, which is hurtful for industry? The Currency School replied that, unfortunately, such a policy would cause inflation and would not alleviate the rise in the interest rate; moreover: it would make it worse in the near future. According to the Currency Principle, the interest rate must rise in the face of a gold drain, but this rise is not caused by the application of the Currency Principle, but by the increased scarcity of real capital, of which the gold drain is but a consequence. The expansion of the issue of banknotes in times of gold drain, as proposed by the Banking Principle, cannot prevent the rise in the interest rate because the interest rate is regulated by the equilibrium between the supply and demand of *real* capital. The expansion in the note issue of the Bank of England can never make up for the rise in the scarcity of real capital[5].

According to the Currency School, the Banking School was wrong to hold that the expansion in the issue of banknotes against good security would contain the rise in the interest rate in times of gold drain. Perhaps the Banking Principle might provide some relief and contain for a while the rise in the interest rate, but this would be temporary, and the final effect of the accommodative monetary policy of the Banking Principle would be inflation, a higher rate of interest and a further fall in the gold reserve. For the Currency School, the gold drain shows that money creation has gone too far, and the only remedy to such an excess is to purge the economy of the excess money –by restricting the circulation of banknotes "*pari passu*" with the fall in the gold reserve.

The Banking School replied that there is no reason why the increase in the issue of banknotes by the Bank of England in times of gold drain should be inflationary

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[4] "Metallic currency has its remedy in the import and export of precious metal, which immediately enters circulation as coin and thus, by its inflow or outflow, causes commodity-prices to fall or rise. The same effect on prices must now be exerted artificially by banks through imitating the laws of metallic currency. If gold is coming in from abroad it proves that currency is in under-supply, that the value of money is too high and commodity-prices too low, and, consequently, that bank-notes must be put into circulation in proportion to the newly imported gold. On the other hand, notes must be withdrawn from circulation in proportion to the gold exported from the country. The issue of bank-notes, in other words, must be regulated by the import and export of precious metal or by the rate of exchange. Ricardo's false assumption that gold is only coin, and, therefore, all imported gold swells the currency, causing prices to rise, while all exported gold reduces the currency, leading to a fall in prices — this theoretical assumption is here turned *into the practical experiment of putting an amount of coin in circulation equal in every case to the amount of gold available*." (Marx, 1894 [1981], 682-3)

[5] "The contention that commodity-prices are regulated by fluctuations in the quantity of currency is now concealed by the phrase that discount rate fluctuations express fluctuations in the demand for actual material capital, as distinct from money-capital." (Marx, 1894 [1981], 683)

or make worse the gold drain. According to this school, the expansion in the issue of banknotes against good security in times of gold drain is the only available means to contain the rise in the scarcity of means of payment and deprives the economy of the only alternative means of payment to gold. This is nonsense. The application of the Currency Principle just raises the interest rate in an unnecessary way and forces a liquidation of industrial capital well in excess of what is necessary to stem the gold drain. The Banking School challenged the Quantity Theory upon which the Currency School grounded his principle and claimed that the proportion between commodities and means of payment does not determine the value of the means of payment. The expansion in the issue of banknotes ion times of gold drain against good security just provides an economical expedient that makes it possible to increase the velocity of circulation of the available gold and thereby, to contain the unnecessary and artificial rise in the interest rate that the application of the Currency Principle would bring about.

Marx challenged the Quantity Theory of money and, therefrom, the Currency Principle. On monetary policy, he took sides with the Banking School and advocated the expansion in the issue of banknotes in times of gold drain in order to contain, as long as possible, the rise in the rate of interest, the liquidation of commodity capital and the rise of unemployment. However, he went beyond both schools and did not take for granted the premise that gold drains are to be stemmed. Marx questioned it and explained how such a premise is the consequence of the conception of wealth as money, and, in particular, as gold: the old and vituperated Mercantilist conception of wealth. However much modern Economics may vituperate Mercantilism, the fact is that it agrees with Mercantilism that money is the primary form of wealth. The Mercantilists had a limited comprehension of the nature of the capitalist system; true, says Marx, but the comprehension of the moderns is equally limited and, however vehemently they deny it, they share the Mercantilist view that the primary form of wealth is money.

As Marx views it, the requirement of the capitalist system of liquidating some fraction of the commodities of the economy in order to stem gold drains makes it manifest that gold is more important than commodities, and that commodities and, therefore, consumption and employment are to be sacrificed to money. The forced transformation of the value of commodities into money represents a *recession of commodity capital*, that is, a diminution of the fraction of total capital existing as commodities; hence the fall in production and employment. The liquidation of commodity capital, that is, its conversion into money, must go on until the "nation" has got rid of the excess commodity capital –where the point of reference for excess is the maintenance and growth of the gold (in the end, money) reserve.

It is to be noted that the recession or decumulation of commodity capital need not involve a parallel recession of money capital. It does so when the cause of the deficit in the balance of payments (of the gold drain) is the excessive expansion of foreign investment in relation to the state of the current account, but it does not when the cause of the deficit in the balance of payments lies in a trade depression. In this latter case, the reason that demands the liquidation of commodity capital is not the *expansion* of money capital, but the *reconstitution* of it. The recession of commodity capital is accompanied by a recession of money capital, as the interest coming to the money business from commodity capital falls as commercial activity falls. The banking system then partakes on the general scarcity of liquidity (which is but the other side of the coin of over-production) and has to liquidate valuable assets which, suddenly,

become not so valuable, in a process that tends to the general elimination of credit and, thereby, to the immediate presence of value as money, that is, of gold.

According to Marx, the fundamental premise shared by both the Currency and the Banking Schools that commodities are at the service of the gold reserve and not the other way round, shows that in the capitalist system the existence of value as money is preeminent over its existence as commodities; indeed, what forces the liquidation of commodity capital is the imperative to maintain and, eventually, increase money, the objective index of which is given by the evolution of the gold reserve. The capitalist system demands the transformation of the value of commodities into money, despite the obvious fact that this demands the sacrifice of consumption and welfare. Far from being a servant of trade, in capitalism money becomes the master of trade and imposes the sacrifice of consumption whenever demanded by the accumulation of money.

Accordingly, money rules over the rest of commodities in a capitalist system, and we never see the contrary process, that is, forced transformation of money into commodities. Of course, the money form of capital is not a "stable" form of existence of capital; "not stable" in the sense that the process of capitalization demands either the continuous exchange of money for commodities or the continuous lending of money. The same ought to be said about the commodity form of capital: it does not represent a stable form of existence of capital because the value of commodity capital must take on the form of money as soon as possible in order to complete the cycle of turnover of capital and objectify surplus value as money. These immanent characteristics of capitalism notwithstanding, the point that I am trying to make is that in capitalism we will never see any reserve (stock) of commodity capital imposing upon money the requirement to become that particular form of commodity capital, whereas the growth in the reserve of money imposes such a constraint on commodity capital in general.

2. The Currency Principle and its Theoretical Basis

The Currency School, on the grounds of the Quantity Theory of money of Hume, inherited via Ricardo, contended that there is an automatic mechanism that automatically establishes the same proportion of commodities to money in all the countries engaged in free trade; in other words: this mechanism tends to equalize the value of money worldwide because it tends to equalize the relative quantity of money existing in all the countries engaged in free trade. Gold flows are the result of different values of money because of excessive abundance or scarcity of money; in other words: gold flows reveal that the purchasing power of money in two countries was not at the parity point, and a commodity (in this case, money) cannot have two different prices under competitive conditions. Accordingly, the key to a sound monetary policy and, in particular, to a sound management of the circulation of paper money is to follow the operations of this automatic mechanism. Any other policy must upset the operation of the mechanism and, therefore, must put unnecessary pressure on the gold reserve and, thereby, on the value of the currency. Here is how Marx describes the automatic mechanism of flow of gold, first enunciated by Hume, on the basis of which the Currency Principle contends that gold drains are to be combated by restricting the supply of banknotes:

"According to Ricardo, the value of metallic money is determined by the labour-time incorporated in it, but only as long as the quantity of money stands in correct relationship to the amount and price of commodities to be exchanged. If the quantity of money rises above this ratio, its value falls

and commodity prices rise; if it falls below the correct ratio, its value rises and commodity prices fall - assuming all other conditions equal. In the first case, the country in which this excess gold exists will export the gold whose value has depreciated and import commodities; in the second case, gold will flow to those countries in which it is assessed above its value, while the under-assessed commodities flow from these countries to other markets, where they command normal prices. Since under these circumstances "gold itself may become, either as coin or bullion, a token of metallic value of greater or smaller magnitude than its own value, it is self-evident that convertible bank-notes in circulation must share the same fate. Although banknotes are convertible, and therefore their real value corresponds to their nominal value, the aggregate currency consisting of metal and of convertible notes may appreciate or depreciate in accordance with its aggregate quantity, for reasons already stated, rising above or falling below the level determined by the exchange-value of circulating commodities and the metallic value of gold.... This depreciation, not of paper as compared with gold, but of gold and paper taken together, or of the aggregate currency of a country, is one of Ricardo's principal discoveries which Lord Overstone and Co. pressed into their service and made a fundamental principle of Sir Robert Peel's bank legislation of 1844 and 1845." (Marx, 1894 [1991])

Accordingly, the issue of paper money should not be left at the discretion of the issuing concerns; there should be a rule that the issuing concerns must follow despite their expectations or experience. The rule must be to follow the automatically adjusting operations of gold flows as described by Ricardo. On this basis, the Currency School contended that the circulation of banknotes should be regulated so as to mimic the fluctuations in the gold reserve; therefore, the monetary authority should contract or expand the circulation of paper notes "*pari passu*" with the contraction or expansion of the gold reserve.

Any other criterion for the issue of paper notes must be unsound. To get closer to the exact problem at issue, let us restrict the domain of the problem to the issue of paper money by the Bank of England. Incidentally, it should be observed that the 1844 Bank Charter Act greatly reduced the power of issue of the British provincial banks and established the paper money of the Bank of England as legal tender. How should that legal tender be issued? According to the Currency School, the refusal to acknowledge Hume's automatic mechanism of adjustment of the balance of payments would inevitably lead the whole economy to baseless contractions and expansions which would be sheer monetary illusions –or perhaps we should say *delusions*. If the gold reserve is increasing, the market is revealing that money was too scarce in England; then, why should the Bank of England refuse to issue more paper? But more importantly: if the gold reserve decreased and, thus, the market told us that money was too abundant in England: why should the Bank of England try to compensate for the diminution of money? Why should the Bank of England try to avoid the unavoidable and pretend that the abundance of money can be prolonged? In view of Hume's automatic mechanism of adjustment of the balance of payments via prices, there is no reason to oppose the regulation of the issue of notes by the Bank of England in accordance with the fluctuations of the gold reserve. This criterion is but the Currency Principle.

The reason why the Currency Principle puts forward the destruction or hoard of the notes returned to the bank in times of gold drain is to collaborate with the gold drain in order to bring over the supposedly required deflation of commodity prices that would bring the gold back. According to the Currency School, the gold reserve fluctuates according to the relative level of international commodity prices, which is the inverse of the international value of money. Money must have the same value in all the countries that take part in trade. If a country faces a trade deficit and, therefore, exports gold, it is because its prices are too high, which amounts to saying that its money is too cheap,

that the value of its money has fallen below the value of gold: money represents less value that its value in gold, and it is accordingly exported in exchange for commodities. The fall in the gold reserve is supposed to automatically trigger a mechanism that operates against itself, namely, general price deflation. The hoard of the notes returned to the central bank in search for gold to export collaborates to suppress the redundancy of money at home and, thereby, to raising its value (to depress prices).

In order to defend itself against the accusation of maneuvering to artificially raise the interest rate, the Currency Principle contends, to put it in modern language, that the interest rate is by "real", not by "monetary" forces. According to Overstone, the high price of money during the crises is the inevitable expression of the scarcity of "real", that is, commodity capital that causes the crises and cannot be remedied (but can be worsened) by any monetary policy. Marx replies that what becomes scarce in the crises is not commodity capital, but specifically money (not money-capital, but money as such); moreover, money becomes scarce to the same extent as commodity-capital becomes *redundant*. The crisis violently does away with the present over-production in order to clear the way for the next over-production.

To formulate the question at issue between the Currency and Banking Schools, let us assume that the deficit in the balance of payments demands the export of gold and, thereby, involves a diminution in the gold reserve. As the gold reserve of the Bank of England falls, their reserve of notes must increase "*pari passu*". The question is: are those increased reserves of notes used to discount commercial paper? Should the rising balances of paper notes in times of gold drain be laid to rest in the vaults of the Bank of England or could they be used to supply the economy with means of payment now that gold was becoming scarcer?

The Currency School held that the paper notes returned to the Bank of England in times of gold drain should not be used to discount commercial paper. The Bank of England should refuse to lend that paper to the private banks and to discount bills. The reason is that if the Bank of England should use these notes, they would thereby increase the money supply and cause inflation. To understand the position of the Currency School, it is to be remembered that, fort this school, a gold drain reveals that too much paper had been issued in relation to the gold reserve. The only reason why a country may be faced with a gold drain and a deficit in the balance of payments is domestic inflation. The only way to stem the loss of gold is to restore the equality between exports and imports, and the only way to do this is to let prices fall at home. Inflation by an excessive supply of money is the explanation not only of gold drains and balance of payments deficits, but more in general of crises.

The proposal of the Currency School was to manage the issue of paper in accordance with the fluctuations in the gold reserve. According to the Currency School, the fluctuations in the gold reserve were determined by the tendency to converge to the purchasing power parity and, therefore, the circulation of paper was to mimic the fluctuations in the gold reserve. This principle for the management of the issue of paper by the central bank is known as the Currency Principle; it also goes by the names "orthodox gold standard" and "rules of the game". According to the Currency Principle, the Bank of England was allowed to increase the issue of paper when the gold reserve increased, but never at a faster pace; that would be inflationary and would lead to a contractive adjustment. Also in accordance with the Currency Principle, the Bank of

England should refuse to re-issue the paper notes that returned to their vaults in times of net export of gold. The reason is that the Bank of England should not stand in the way of the export of money that the market is showing to be necessary. Both the expansion of the supply of paper at a faster rate than the growth of the gold reserve and the re-issue of the paper notes in times of net export of gold would be inflationary and, therefore, would make the recession worse.

To criticize the Currency Principle Marx attacks what he believes to be its theoretical basis, namely, the quantity theory of money. Basically, he holds that the value of money in capitalism is the interest rate, not its purchasing power. Money is not a *sign of value*, despite the possibility of an inconvertible paper currency (accordingly, inconvertible money paper is not a *sign of value*, but a *sign of money*). The Currency Principle is a corollary of the Quantity theory of money in so far as its aim is to keep constant the proportion of money to commodities by adjusting the circulation of paper money to the fluctuations of the metallic reserve of the central bank (fluctuations which are thus taken to be "correct"): paper is to be issued as the metallic reserve increases and it is to be withdrawn from circulation as the metallic reserve falls. With this policy about paper issues, the central bank is pushing in the same way as the market forces towards the stabilization of the value of money.

As Marx correctly notes, the Currency Principle takes it for granted that the metallic reserve fluctuates so as to keep constant the value of money: the export of gold (deficit in the trade balance) reveals that money has become too abundant and the import of gold (superavit) that money has become too scarce. To the extent that there is no monetary noise, the net trade surplus has to be zero because, to the extent that the purchasing power parity of gold is attained, the exports of any country must equal its imports. The disruption in the proportion money-commodities has to manifest itself in the corresponding international flows of gold which, in turn, obey to alterations in the international relative prices of commodities. The superavit reveals that money has a market value in excess of its real value, that is, that money has been made too scarce; on the contrary, the deficit reveals that excessive money creation has driven the market value of money to a level which is lower than its real value.

The key to distinguishing changes in the value of commodities from monetary noise is productivity. The value of money will be held constant if the supply of money grows at the same rate as productivity, for, in such case, the proportion of money to commodities remains constant and, therefore, the value of money remains constant and monetary noise is suppressed. The Currency Principle took as control variable to keep constant the relative quantity of money the supply of notes by the central bank because it deemed the flows of gold as induced by the different values of money in the different countries, and, thus, as an automatic adjusting factor. In contrast to modern practice, the Currency Principle did not choose to manipulate the prime rate so as to keep constant the relative quantity of money, though this is a practical rather than a theoretical matter. However, it is convenient to note that the application of the Currency Principle necessitates of the existence of a free international gold market.

3. Marx' Version of the Banking Principle

The Banking School challenged both the Currency Principle and its theoretical foundations, which basically consist in the Quantity Theory of money. The Banking

School claimed that the supply of paper need not mimic the fluctuations in the gold reserve; moreover: the regulation of the issue of paper in accordance with the fluctuations in the gold reserve was an unwise monetary policy that would only aggravate the recessions of commodity capital because it would bring about excessively high interest rates: the application of the Currency Principle would just make money artificially and needlessly dear in times of gold drain. In particular, the refusal of the Currency School to use the paper returned to the Bank of England in exchange for gold for export represents an artificial cut in the supply of a monetary instrument (notes) to the market at a time when the supply of money (rather, of monetary instruments in general) falls sort of the demand because the demand for money rises when sales fall.

Marx supports the contention of the Banking School that the paper notes returned to the Bank of England in times of gold drain could be used to discount commercial paper if the quality of this commercial paper was good. A necessary though not sufficient condition that bills of exchange must meet to be "good" is not to be *fictitious*. Together with the Banking School, Marx claims that the re-issue of the notes returned to the Issue Department of the Bank of England in times of gold drain to discount good bills is not inflationary. Far from being inflationary, it stands on the way of the rise in the interest rate; more exactly, on the way of the artificial rise in the price of money (that is, of means of payment) that the application of the Currency Principle will necessarily bring about -and which it deliberately intends to bring about. Accordingly, the Banking Principle prevents the excessive liquidation of commodity capital implicitly demanded by the Currency Principle.

Marx agrees with the Banking School that a financial system where paper is convertible into gold on demand will not issue paper money in excess, as the excess issues will automatically return to the issuer. This principle is known in the standard literature as the Law of Reflux. The use of the notes returned to the Bank of England in times of gold drain for the discount of good bills is not inflationary because it does not represent any increase in the demand for commodities. According to Marx, it just satisfies an increase demand not for commodities, but for means of payment. Marx points out that an increased demand for means of payment (or better, for means of payment alternative to gold) does not in any way represent an increased demand for capital, not even for money capital. Marx points out very carefully that the desperate demand for liquidity in times of trade depression represents just an increased demand for means of payment, for money simple or money as such, as he says, but in no way a demand for capital

In times of gold drain, the price of use of gold rises: the supply of gold coins to the money markets falls as the demand for liquidity rises because of the general fall in sales. However, gold coins were not the only monetary instrument existing in England; there also were the notes of the provincial banks and of the Bank of England. Let us leave aside the notes issued by provincial banks, as the 1844 Act strongly restricted the issuing ability of the provincial banks; therefore, let us focus ourselves on the issues of legal tender of the Bank of England. Why not expand the supply of notes to the money markets when the price of use of gold is rising because of a gold drain? The answer of the Currency School is that the use of paper notes in order to make up for the contraction in the supply of gold is inflationary and will put further pressure on the gold reserve. According to the Currency School, if the gold reserve is already under pressure is just because the issue of paper had gone too far and the Bank of England had issued

too may notes in relation to the state of the gold reserve: the extra notes enter circulation and drive prices up. This price rise does not result from any rise in the value of goods, but simply from the fall in the value of money consequent upon the excessive creation of money by the Bank of England.

It should be noted that the Currency School takes it for granted that all the paper issued by the Bank of England will enter circulation. It does not consider the possibility that the issues of the Bank of England may not be met by a corresponding demand of banknotes. Marx sees here a fatal flow in the Currency Principle. From the gratuitous premise that every note issue should enter circulation, the Currency School concludes that the notes issued in excess in relation to the outstanding gold reserve will be used to increase the demand for goods.

We can reconstruct the logic of the position of the Currency School as follows: if the balance of payments becomes unfavorable and there is a gold drain, the cause is that domestic prices have become too high in relation to foreign prices. This can alternatively stated saying that the only cause of an unfavorable balance of payments and a gold drain is the depreciation of money at home. The only reason why money may fall in value is excessive abundance, that is, excessive money creation. Since the flow of gold between countries is regulated by a mechanism that automatically tends to equal the value of money in all countries, the only reason why the value of money may remain too low and give rise to a gold drain is the excessive issue of banknotes. The banknotes issued in excess of the gold reserve, the size of which at any moment is determined by market forces, will not remain ideal, but will enter circulation, which means that they will increase the demand for goods. The excess demand for goods resulting from the excess supply of money leads to a rise in prices which is genuinely inflationary, in that what rise is not the value of goods, but the value of the measuring rod of the value of goods, which is money.

This is why the Bank of England should reduce the circulation of notes when the gold reserve falls. However, it is clear that the Bank cannot “dis-issue” notes, so to speak. Thus, the only way they can curtail the circulation of banknotes is by refusing to reemploy the notes returned in exchange for gold for export in times of gold drain. Another alternative way would be to “repurchase” the excess mass of notes that is depreciating the currency by selling assets to the holders of notes, be it bills or bonds. With such an operation the Bank would mop up the excess liquidity that they injected into the system (to put it in modern terminology) and, thereby, forcing the required deflationary adjustment by diminishing the supply of money.

The Banking School and Marx challenge this view and deny that the re-issue of the paper returned to the Bank of England in times of gold drain and a depression of trade should be inflationary: it is not inflationary because it does not give rise to any excess demand for goods. Nor does it provide accommodation to any previous excess demand for goods financed on an excessive credit –excessive in the sense that the borrower could never repay the loan out of its possible revenue or in the sense that the lender was in a similar situation and was borrowing money from a third party in excess of its ability to earn money. The employment of the notes returned to the Bank in times of gold drain in commercial trade, in the discount of bills of exchange that are not fictitious, does not create any excess demand for goods because all that those notes do is *contain the rise in the price of money*. The notes are simply a means to transfer the

property of gold from hand to hand, as debts fall due. The Currency School mistakes convertible for inconvertible paper money and takes it for granted that every banknote will be forced into circulation (this point is very well made in Tooke, 1844). According to the Banking School and Marx, the refusal to re-issue the notes returned to the Bank of England in times of gold drain just restricts unnecessarily the supply of means of payment and, thereby, artificially drives up the price of all of them –of "money".

In contrast to the Banking School, Marx duly observes that this does not mean that crises can be avoided by the issue of paper in accordance with the need of liquidity of trade. Capitalist crises are the natural result of over-production, and the capitalist system tends to over produce by nature, not by miscalculation:

> "It is clear that there is a shortage of means of payment during a period of crisis. The convertibility of bills of exchange replaces the metamorphosis of commodities themselves, and so much more so exactly at such times the more a portion of the firms operates on pure credit. Ignorant and mistaken bank legislation, such as that of 1844-45, can intensify this money crisis. But no kind of bank legislation can eliminate a crisis." (Marx, 1894 [1991], 620-1)

As long as the credit of the notes of the Bank of England is good because there is confidence in the maintenance of convertibility, the growth in the circulation of notes in times of gold drain does not perpetuate the gold drain or depreciate the purchasing power of the currency. The increased circulation of notes just contributes to making up for the scarcity of money resulting from the over-production of commodities and the over-extension of commodity-capital. Accordingly, the employment of the notes returned to the Issue Department in exchange for gold for the discount of good bills will not give rise to any rise in the demand for goods and will just contain the rise in the interest rate that must inevitably accompany the gold drain that, in turn, must sometime take place because of over-production.

The Banking School has a further argument to contend that the issue of notes does not need of any rule and that it is best left to the discretion of the issuer, whose motive is the most reliable of all, namely, profit maximization. This argument is known in the standard literature as the Law of Reflux: a *convertible* paper currency cannot be issued in excess; the notes issued in excess of the demand for them cannot fail to *reflux* to the issuer. The notes issued in excess of the demand for means of payment alternative to gold will not enter circulation and will be returned at once to the issuer. Only the notes demanded by the need to discharge debts, that is, by the need to transfer the property of the hoards of gold deposited by the entire financial system with the Bank of England, will remain in circulation.

Marx does not mean to claim that the value existing as commodity is as good as the value existing as gold. Accordingly, the reason why he supports the plan of the Banking School of letting the circulation of paper grow when the amount of bills presented for discount rises in times of gold drain does not rest on the view that the re-issue of paper is not deflationary because the notes are "backed" by the equivalent value in commodities. If Marx held this view, he would be implying that the mode of existence of value is indifferent and, tacitly, he would be admitting the central tenet of the Quantity Theory that the value of money is determined by the proportion between commodities and money. The reason why Marx lends his support to the discretional issue of paper advocated by the Banking School is that he views banknotes as a means to transfer the property of money, that is, of gold. A larger amount of notes in

circulation means more money in circulation only in so far as it makes possible a *higher velocity of circulation* for the existing amount of gold.

Of course industrial capital over-invested during the previous phase of boom: over-investment is in the DNA of capitalism. Of course credit grew during the phase of boom. Of course the financial system embarked itself in progressively more risky adventures. Of course industrial capital expanded the facilities of production regardless the future levels of demand. All this is in the DNA of capitalism. Capitalism expands the productive power not in accordance to the needs or in accordance with the evolution of the money funds that are to sustain demand; it expands production to the limit of the existing productive power because the production of goods is the only means to increase the production of surplus value. The capitalist system pursues the accumulation of money, because money is the abstract form of wealth. The capitalist system does not pursue the accumulation of commodities, that is, of particular forms of wealth. The immanent contradiction of a system the end of which is the accumulation of money is that money has no use outside exchange, and this implies that the only way to accumulate money is to get rid of the money already accumulated by re-investing it. Thus, we can properly say that the capitalist system wants neither commodities nor money: both are hot potatoes that are to be got rid of as soon as possible –but not in order to get something "final", as it were, but in order to keep the movement of accumulation going on. Accordingly, the system lacks any criterion that could determine something like an "equilibrium" between money and commodities.

At times there are too little commodities and too much money: this is the phase of expansion or boom. On the contrary, at other times there are too many commodities and too little money. Wanting neither money nor commodities, the capitalist system is bound to have too much money (too few commodities) at times, and too little money (too may commodities) at some other times. While the system is laying the basis for over-production, money looks plenty and commodities scarce; when that over-production manifests itself as a general fall in demand, money looks scarce and commodities redundant.

In fact, the system carries within it the contradiction between production and consumption which is inevitable in any economic system based on the principle that money is the primary form of wealth. The capitalist system does not expand production in order to expand consumption, but in order to produce more surplus value, the proper objective expression of which is money. Accordingly, at the same time that it demands the expansion of production and of productivity, the capitalist system demands the reduction of wages and the withdrawal of profits from consumption –if profits are devoted to consumption, capital is destroying the only basis on which it can grow. Thus, the capitalist system demands the expansion of production and the same time that it demands: a) the reduction of consumption in relation to production and b) the increment in the consumption of the goods that yield most surplus value (not the goods the need for which is the highest). According to Marx, this contradiction takes on an objective form in the crises.

Employment falls during the crises because the demand for productive factors falls –commodity capital and, hence, the productive facilities are to be transformed into money and their value cannot exist any longer under commodity form. Thus, we are faced with the paradox that growing masses of unemployed workers are deprived of

goods to the same extent that the stocks of unsaleable goods grow. We are faced with the paradox that the general standard of living falls not because too little goods have been produced, but because too many goods have been produced. Society becomes poorer not because scarcity has set in, but because abundance has set in.

4. Marx and the "Real Bills Doctrine"

The Real Bills Doctrine is said to be the thesis that the issue of notes against the security of bills generated in trade is not inflationary. The "real bills" would be the "reserve asset" against which the notes are issued and which guarantee the maintenance of the value of the notes. The denial of the RBD by the Currency School implies that the Currency School held, against the Banking School, that only gold constitutes a good reserve asset and, therefore, that notes should be issued only on the security of gold. The issue of notes against the lesser security of the "real bills" is inflationary because neither the real bills nor the commodities the value of which is what is expressed in the real bills provide the issuer with sufficient liquidity to guarantee the convertibility of the notes and, thereby, their value. The Currency School concludes that the issue of notes against the security of real bills in times of tight money does not relieve the pressure in the money market. The issue of notes against real bills in times of gold drain might contain the rise in the interest rate for a while, but in the not too long run it cannot fail to lead to the devaluation of the notes, that is, to inflation, because of excessive abundance of money (KMO: which here means "means of payment")

The reason why, according to the Banking School, the issue of banknotes in order to discount good bills in times of gold drain is not inflationary is not that such an issue of notes does not alter the proportion of commodities to money; of course it does. For the Banking School, the purchasing power of money or, to put it better, what maintains the ability of banknotes to circulate at par, is not determined by that proportion; this is the contention of the Quantity Theory and of its follower, the Currency School. According to the Banking School and Marx, the proportion between the supply of means of payment and the aggregate value of the debts to be discharged does not determine the ability of banknotes to circulate at par. If the notes are convertible and are not issued against Treasury Bills or fictitious commodities, the relation or proportion between the supply of notes and the demand for them determines the *amount* of notes that will be required in order to settle the debts, but not their *value*, or to put it properly, the ability of the notes to circulate at par.

Here Marx goes way beyond the Currency and the Banking Schools. The ability of notes to circulate at par does not depend on the value (in money!) of the reserve assets against which those notes are issued. Even this way of putting the question is misled. To circulate at par, the amount of notes in circulation at any given time does not have to be the mirror of the value (in money!) of the "reserve assets". Marx tells how once, in Scotland, it became very difficult by noon to come by notes in order to make payments because it happened that many debts had to be discharged at the same time. Once the payments were made, the demand for notes ceased. The notes "refluxed" to their issuers once the debts had been discharged. The high circulation of notes by noon did not inflate prices; it did not have any effect on the ability of notes to circulate at par. The proportion between the amount of notes in circulation and the gold reserve just tells us how fast this gold reserve is changing hands and, thereby, discharging debts. Notes circulate below par (inflation) when they are issued in excess in relation to the demand for them.

But is not right the Currency School to claim against the Banking School that gold is a much better reserve asset than real bills? Gold is a much better asset than real bills because the *liquidity* of gold is much higher than that of bills. According to Marx, neither gold nor bills "back up" the "value" of notes. Notes have no value and, therefore, the value of notes needs no back, and cannot possibly have one. Banknotes are means to transfer the property of money. They may circulate at par, below par or above par, according to the confidence deposited in their ability to carry out their function, but they have no value and their nature is to be representatives of money in the process of circulation.

The view underlying standard monetary theory is that notes circulate at par as long as the "value" of the notes in circulation is equal to the value of the reserve assets that "back up" the value of the notes. And we always have the problem about the *liquidity* of the reserve asset; that is to say: the asses held in reserve may have a definite value, but if there are doubts about the value of the asset in case of liquidation of the asset, the problem arises that the reserve asset might be supporting too much liquidity. Of course, this is a pseudo-problem which arises from a poor comprehension of the nature of money. According to some authors, the Currency School was right to hold that the only way to have notes circulating at par was to have in reserve the same value in the shape of gold, as the liquidity of the reserve asset "gold" is total. These authors accuse the Banking School of overlooking the fact that the liquidity of bills is lower than that of gold and, to make things worse, than that of banknotes. This is why there is no reason to guarantee that the issue of notes according to the RBD will not be inflationary; unless very exceptional circumstances concur, the difference between the (total) liquidity of the notes and the (limited) liquidity of the bills will manifest itself in the depreciation of the notes, which will circulate below par by a margin determined by the nominal of the notes and the liquidity of the bills that "back up" the notes (the nominal of which must be the same as the nominal of the notes).

According to this view, the only way to maintain the "value" of a paper currency is to keep the velocity of circulation equal to "one". As they see it, a velocity of circulation higher than one represents an excessive creation of money which must devalue it. If, instead of challenging the basic idea that the money in circulation is but the mirror image of the value (in money!) held in reserve, one replies reply that real bills are as liquid as gold if their payment is certain, one is missing the point: the money in circulation is not the mirror image of the money in reserve; more in general: the circulation of money, the liquidity of the system, is not the "dynamic" form of the value held in a "static" situation in the reserve assets . Marx does not formulate the problem in these terms, as this formulation rests on a defective system of categories. In contrast to it, Marx takes good care to distinguish money as measure of value and money as means of payment, and, on this premise, he does not think of banknotes as the value of gold freed from its static form and set in movement.

5. The Mercantilist Foundations of Both the Currency and the Banking Principles

"We have also omitted from consideration the function of the metal reserve as a security for bank-note convertibility and as the pivot of the entire credit system. The central bank is the pivot of the credit system. And the metal reserve, in turn, is the pivot of the bank. It is inevitable that the credit system should collapse into the monetary system, as I have already shown in volume 1 chapter 3, in connection with means of payment. That the greatest sacrifices of real wealth are necessary to maintain the metallic basis in a critical moment has been admitted by both Tooke and Loyd-Overstone. The controversy revolves merely round a plus or a minus, and round the more or less rational treatment of the inevitable. A certain quantity of metal, insignificant compared with the total production, is admitted to be the pivotal

point of the system. Hence the superb theoretical dualism, aside from the appalling manifestation of this characteristic that it possesses as the pivotal point during crises. So long as enlightened economy treats "of capital" *ex professo,* it looks down upon gold and silver with the greatest disdain, considering them as the most indifferent and useless form of capital. But as soon as it treats of the banking system, everything is reversed, and gold and silver become capital *par excellence,* for whose preservation every other form of capital and labour is to be sacrificed." (Marx, 1894 [1991], 706-7)

Marx puts the same idea in a more succinct way when he writes:

"In the crisis, the demand is made that all bills of exchange, securities and commodities shall be simultaneously convertible into bank money, and all this bank money, in turn, into gold." (Marx, 1894 [1991], 708)

Being the abstract form of existence of value or the universal commodity, money rules over the rest of the particular commodities; the reserves of money cease to be a means to supplement consumption when needed and become an end in themselves. The reserves of money have to grow which, among other things implies that any diminution in the reserves of money must be made up for at he expense of commodities. Marx notices what both the Currency and Banking School were overlooking, namely, that, in the end, the capitalist system must agree with the Mercantile system that true wealth consists in money.

Marx points this out when he notes that the ultimate purpose of the Currency and the Banking Schools was to "protect" the gold reserve at the expense of production and employment. Neither school has noticed that it is viewing money as the only true form of wealth. Neither school has noticed the radical change in the character of the money reserves; neither school has noticed that the whole point of a reserve of money in a non-capitalist economy is to provide for consumption in times of scarcity of goods, whereas in a capitalist economy the growth of money is the very end of the system. Both the Currency and the Banking School debate on the tacit and unchallenged premise that the gold reserve cannot diminish beyond certain lower bound and that the very process of diminution must be reversed at all costs, as dictated by the need to "protect" the reserve.

Both the Currency and the Banking Schools overlook the fundamental opposition between money and commodities that gives rise first to the abundance and then to the scarcity of money. In the end, the difference between the two schools is that the Banking School imposes a weaker sacrifice of production and consumption than the Currency School by supporting the re-issue of the notes returned to the Bank in times of gold drain, a re-issue that to some extent makes up for the scarcity of money and contains the rise in the interest rate. The interest rate reached unsustainable heights in 1847, 1857 and 1866, years in which the Government had to suspend the 1844 Act and allow the Bank to re-issue the notes returned for gold that were sitting idle in the vaults of the Issue Department of the Bank. The result of the regular suspensions of the 1844 Act wherever a crisis was to happen was not inflation, as the Currency School had predicted, but the contention in the rise of the price of money and the diminution in the amount of bankruptcies. Thus, the regular suspensions of the Peel Law contained the liquidation of the British industry. However, and this is a sign of the power of the City, as soon as the danger was gone, the 1844 Act was reenacted; no wonder, then, that the crises of 1857 and 1866 led again, by the hand of the Currency Principle, to a dramatic and unsustainable high price of money that was ended, in both years, by corresponding letters of the Government to the Bank suspending the 1844 Act and allowing the Bank

to follow the Banking Principle. A remarkable success story. And the 1844 Bank Charter Act was not been derogated until 1968…

Indeed, the derogation of the Act in 1968 does not have much importance if the monetary theory that inspired it is retained, as it is the case. By 1968, the view that crises had their origin in a previous excessive inflation resulting from an excessive extension of credit ("excessive money creation") and that the solution of crises required to tighten monetary policy was so firmly embedded in theory and practice that there was no longer a need for a "law" to periodically rip off industry and labor in benefit of the banking industry.

The standard literature on the Banking School sums up its position in two principles: first, the Real Bills Doctrine; secondly, the Law of Reflux. Interestingly enough, Marx does not make any mention of these principles in his writings. Indeed, the term "Real Bills Doctrine" does not appear in the classics of Tooke and Fullarton of 1844; only Fullarton uses the term "Law of Reflux".

According to the Banking School, the Bank of England should reissue the notes returned in times of gold drain as long as the security given in exchange for them is good: this is the essence of the Real Bills Doctrine. As long as the banks issue notes in order to discount real bills, there is no reason why the market price of gold should deviate from the mint-parity or why there should follow a depreciation of the currency. Let us specify that a bill is "real" to the extent that it is what it is, that is, a promise of deferred payment for a really existing good or service. A bill is not "real" when it is "fictitious". Fictitious bills are a circuitous means to get bank credit by giving the appearance of transaction where there has been none. It should be noted that the reason why the issue of notes in discount of good bills cannot be inflationary is not that it does not alter the proportion money-commodities; indeed, *it does alter this proportion*. According to the Banking School, the reason why the issue of notes against real bills cannot depreciate the currency is that it does not have any effect on demand. The eventual alteration of the proportion between commodities and money is not inflationary because the notes issued in discount of real bills do not give rise to any "fresh" demand for commodities. Moreover; an eventual rise of the market price of gold over the mint-parity would reveal that *fictitious bills* have been discounted with good Sterling paper. Convertibility sets the limit of the issue of notes because the notes issued in excess of the needs of trade will immediately return to the issuer. The maintenance of the convertibility of paper notes is, thus, the cornerstone of the Banking School's defense of the gold reserve of the Bank of England.

6. Money "Creation" and the Cycle

The capitalist system does not over-produce because there comes a time when it becomes the interest of the banking system to "create" more money in order to make it cheaper, boost production and seize on a larger gain out of this increased production. When the banking system creates more money it expands the supply and this is supposed to bring down the interest rate. The fall in the interest rate represents a fall in production cost that industry will not miss to increase production and make larger profits. As a result of the expansion of production, industrial capital makes a higher profit and the financial system makes a larger interest because of the expansion of the money business. However, the friendship between the financial and the industrial

capital comes to an end as soon as the financial system notes that the expansion of production has made goods too abundant and, thereby, too cheap. At that point, the gain that the financial system can squeeze out of production is so low that it pays to undo the excessive productive capacity induced by the initial expansion in the supply of money. The financial system then turns off the tap; money creation falls; the interest rate rises as a consequence in the restriction in the supply of money and this forces the liquidation of the redundant industrial capacity –"redundant" in the sense that it makes good too abundant and, thereby, too cheap.

In contrast to this view on the etiology of the crises (and booms), Marx claims that it is not the diminution in the interest charges (which is viewed as a reduction in production cost) what sets in motion over-production. No; the capitalist system over-produces by immanent necessity. It not only over-produces commodities; it also produces the "abundance" of money that, according to the previously sketched theory sets in motion the expansion of production (which, let us not forget, does not make goods abundant, but just less scarce). The upward phase of the cycle is not started when the financial system decides to "open the spigots", that is, to create more money in order to make money cheap. As Marx sees it, the financial system can of course create means of payment, but not money. By the manipulation of the issue of means of payment the financial system can *allocate the money existing at any moment* in accordance with its interest, but the financial system cannot create money anymore than it cannot create exchange value. According to Marx, money is abundant in the upward phase of the cycle (and the interest rate low) not because the banking cartel undertakes to print more money in order to squeeze a larger gain from the economy, but because labor has become more productive, which means that it produces more surplus value.

Money looks abundant at the beginning of the cycle when the liquidation of overproduction has been just finished. As labor becomes employed again in new businesses, the demand for money grows and, with it, the interest rate. This rise in the interest rate can be enhanced by the market power of the banking cartel, but it is inevitable. The expansion of production goes on not in accordance with needs or the growth of the incomes that buy production, but in accordance with productive capacity only. The inevitable result is overproduction. The time at which overproduction becomes manifest and sales plummet is the time at which the pressure on the money market is at its highest and the interest rate reaches its maximum level. Everybody is desperate for liquidity but money is nowhere to be found. Commodity capital is liquidated at bargain money prices. As this process goes on, the demand for money gets weaker and the pressure on the money market is relieved: the interest rate starts to fall, not because the supply of money is abundant, but because the demand for it is falling. The liquidation of overproduction and overcapacity lays down the basis for the next overproduction.

The banking system goes with the system as a whole; it does not drive it. This is seen in the "quality" of the assets of the banks. When overproduction becomes manifest and sales fall, defaults grow; as a consequence, the "value" of the assets of the banking system falls, and the banking system finds itself in trouble when it comes to the settlement of inter-bank debts. The affirmation of the supremacy of money over commodities, this immanent feature of the capitalist system which manifests itself empirically in the crises, can be seen not only in the liquidation of commodity capital at bargain prices, but also in the liquidation of financial assets at bargain prices in times of recession. The successive layers of credit fall one after each other as the claim for the

presence of money grows and the ability of her representatives in the process of circulation falls.

7. The Currency-Banking Controversy and the so-called "Monetization" of the National Debt

The Banking Principle, as well as the Law of Reflux, rest on the premise that banknotes are issued for commerce purposes, that is, that they are issued in order to facilitate the transfer of gold. Hence the sharp distinction that Tooke and Fullarton draw between a convertible paper issued on demand of merchants and an inconvertible paper money of forced acceptance issued by the State in order to discharge its debts without having the money. We see, thus, that the controversy between the Currency and the Banking School, as well as the secondary literature on it, does not pay sufficient attention to the issue of legal tender in order to purchase national debt. Today, quantitatively at least, the issue of legal tender in exchange for Treasury Bills occupies such a prominent position in the workings of the financial system that it is considered that the money consists in debt and that the national debt is the source of our money; look, for instance, at Federal Reserve Bank of Chicago, 1992, or at Macroeconomics textbooks, where the Treasuries "purchased" by the central banks are included within the otherwise funny category of "high-powered money".

Marx was fully aware of the dramatic change in the economic system brought about by the birth of the national banks and the system of the public debt:

> "At their birth the great banks, decorated with national titles, were only associations of private speculators, who placed themselves by the side of governments, and, thanks to the privileges they received, were in a position to advance money to the State." (Marx, 1867,)

National banks were in a position to lend money to State not in virtue of the privileges received from the State, but in virtue of the money that they had previously accumulated. Because of the size of their money reserves, the lending capacity of the new national banks was far greater than that of the goldsmiths, and so the new national banks displaced the goldsmiths from the business of the national debt. The new national banks were able to lend money to the State at more "competitive" rates than the goldsmiths, but, at the same time, the new national banks wanted to secure their business. Thus, they agreed to finance the expenses of the State at a price lower than that charged by the goldsmiths but, at the same time, they demanded the monopoly of ending to the State. We can observe this in the first national bank of Western Europe, namely, the Bank of England. Note how the gang of goldsmiths has been replaced by a single lending body; here we have a movement of concentration.

> "Hence the accumulation of the national debt has no more infallible measure than the successive rise in the stock of these banks, whose full development dates from the founding of the Bank of England in 1694. The Bank of England began with lending its money to the Government at 8%; at the same time it was empowered by Parliament to coin money out of the same capital [KO: that is: out of the gold hoards that they were lending to the crown], by lending it again to the public in the form of banknotes." (Marx, 1867,)

This is a very clever employment of the gold reserve: it is lent out to the Government at the same time that the Bank issues notes against the security of the gold reserve. This way, the Bank of England manages to lend twice the same money and, in consequence, to make interest twice.

"It was allowed to use these notes for discounting bills [KO: Rather, the merchants accepted the notes by their own will, not by government decree], making advances on commodities, and for buying the precious metals. It was not long ere this credit-money [KO: the notes of the Bank of England], made by the bank itself, became the coin in which the Bank of England made its loans to the State [KO: instead of in gold: the banknote invades the circulation of money], and paid, on account of the State, the interest on the public debt. It was not enough that the bank gave with one hand and took back more with the other; it remained, even whilst receiving, the eternal creditor of the nation [KO: rather, of the tax-payers] down to the last shilling advanced. Gradually it became inevitably the receptacle of the metallic hoard of the country, and the centre of gravity of all commercial credit. What effect was produced on their contemporaries by the sudden uprising of this brood of bankocrats, financiers, rentiers, brokers, stock-jobbers, &c., is proved by the writings of that time, *e.g.*, by Bolingbroke's." (Marx, 1867,)

The banknote is certainly a more practical means of transferring the property of gold that handing over gold itself. In this sense, the banknote (paper money in general) represents a more economical form of currency than the coins made of precious metals. This could be labeled as a step forwards and as a development of the system of payments. However, we are dealing with a double edged knife: the reason is that the banknotes, which are an intermediary that make the circulation of gold easier, restrict at the same time the access to gold and, thereby, to money. In other words: the displacement of gold from circulation by the banknote we certainly cut on "transaction costs", but at the same time we are erecting a wall that restricts access to money and leaves the stock of money in the hands of the national bank. This is significant because, having money in its hands, the national bank can allocate the money existing at any time in accordance with its interest, and we are not to forget that the birth of the national bank is but yet another aspect of the birth of the system of the national debt.

Contrary to common usage, I would say that national banks do not have the ability to "create money". Money is created by the economic system. However, what national banks can do is to allocate money as they deem fit; they can do this by creating a very special means of payment which is legal tender, that is, the banknote of forced currency (convertible or not convertible). Central banks can regulate access to money by means of legal tender, but they cannot create gold nor determine the amount of gold that the economic system requires to function as money (more exactly, to be transferred in payments of debts) at any time. We could say, thus, that when a central bank "creates money", it is "destructing money" at other point of the system. This is why, for instance, the prime rate and the inter-bank interest rate are so low these days at the same time that money is very expensive for small businesses.

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