1. INTRODUCTION

1.1. Was Smith a chartalist?

1.1.1. In his recent book L. Randall Wray, re-examining the development of the chartalist approach\(^1\) to monetary theory, unexpectedly includes Adam Smith among the modern authors who have made an important contribution to this doctrine together with Knapp, Keynes (Treatise on money), Schumpeter and other economists who argue in favour of the endogenous nature of money (such as the followers of the Banking School and Marx or, more recently, Kaldor, Lerner, Boulding, Minsky and the monetary circuit theorists).\(^2\)

1.1.2. Wray analyses Smith’s explanation of the process through which “the bank creation of money” and “the determination of the value of an inconvertible currency”\(^3\) occur. In particular – he argues – Smith recognizes that the value of paper money does not derive from its convertibility nor from the fact that it is regarded as legal tender, but simply from the fact that the government accepts it in payment of taxes and from the ratio between the amount issued to finance government expenditure and the amount required by the public to meet its fiscal needs.\(^4\) He underlines that Smith acknowledges (though not explicitly) the fundamental role of tax levy in maintaining the monetary stability, a role resembling that performed by the law of reflux in a convertible paper currency system.\(^5\) For these reasons, in his opinion, Smith can be listed among the economists who have contributed to the construction of a chartalist theory of money.

1.2. A preliminary look

1.2.1. Is this reconstruction of Smith’s thought acceptable? To answer this question it is necessary to re-examine thoroughly how money is treated in The Wealth of Nations. Smith develops his theory of money through the analysis of three monetary systems. The first is an updated version of the barter system based on the use of gold and silver and can be called a pure commodity money system. The second is a system where, besides gold and silver, promissory notes issued by private banks in connection with lending also circulate. It can be termed a convertible paper currency system. The third is a system that only makes use of an inconvertible paper currency issued by public banks within the limits fixed by the government. It can be called a pure fiat money system.

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1 A definition of chartalism as the contrary of metallism is advanced by Schumpeter (1963, pp. 288-289) who, moreover, distinguishes both chartalism and metallism as theoretical and practical.


1.2.2. Section 2 (The pure metallic currency system) is devoted to the analysis of a barter system that represents Smith’s theoretical paradigm. The basic hypothesis is that money is a commodity selected by traders in order to solve the so-called problem of the double coincidence of needs that arises from barter. As an instrument to make trade easier, money is a means of production and hence must be included among the items of capital. Moreover, like all capital goods, a commodity money is submitted to a continuous innovatory process triggered by the pursuit of ever more efficient solutions to reduce the costs of operating “the great wheel of circulation.”

Section 3 (The convertible paper currency system) is devoted to the analysis of the conditions that allow the regular operation of a system in which money consists of convertible banknotes. Smith examines the transactions whereby banks input paper credit into the economy and the problems they face as a result of incorrect behaviour by their customers or of their own decisions to fund capital formation by firms. Shifting from a descriptive to a prescriptive level, he describes the rules that banks must follow in order to avoid bankruptcy and ensure an efficient employment of economic resources.

Section 4 (The inconvertible paper currency system) examines Smith’s account of the fiat money regime introduced by the English colonies of North America during the eighteenth century. Within the limits of this particular context he salvages (though in a more sophisticated version, which foreruns recent developments) the quantity theory of money that he previously rejected, and singles out fiscal policy as the means by which the value of an inconvertible paper currency can be regulated.

Section 5 (Conclusion), contrary to Wray’s interpretation, argues the thesis that Smith is neither a metallist nor a chartalist nor either one of two. In fact, his conception of money as a means of exchange, whose value must be stabilized in order to assure the correct working of the economy, explains the two-sided nature of his theory, namely his adherence to a commodity money theory with reference to a barter system and to the quantity theory with reference to a convertible or inconvertible paper currency system.

2. THE PURE METALLIC CURRENCY SYSTEM

2.1. The barter paradigm

2.1.1. The analysis of what has been defined a pure metallic currency system has a key role in Smith’s theory, since only in this case will money behave according to the value-cost law on which a market economy is based.

In his analysis Smith proceeds step by step. Firstly, he attempts to define the nature of money by studying its origin. Once established that money originates as a commodity through exchanges, he specifies that it is an element of capital and he draws attention to the repercussions of this fact on the development of money economies.

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7 According to Santiago-Valiente (1988, pp. 44-47), Smith elaborates his theory on money starting from the analysis of a “pure commodity money economy”; subsequently, the idea whereby the value of money is based on the cost of production was also dealt by Senior and developed by Laughlin.
8 Schumpeter (1963, pp. 289-290, footnote 5) stigmatises the “confusion between the historical origin of money (…) and its nature or logic” and observes that “primitive forms of social institutions may be more complex than modern ones and that they may hide (…) the logical essentials”. Assuming that the “nature or logic” of money overlaps its proper function, this means that analysis must be focused on the current function rather than the original form.
2.1.2. In Book I, Chapter IV, of The Wealth of Nations, entitled Of the origin and use of money, Smith advances a hypothesis according to which the division of labour generates trade which, in turn, generates money. “When the division of labour has been once thoroughly established – he observes – (…) every man thus lives by exchanging (…) and the society itself grows to be what is properly a commercial society”. However, when trying to exchange goods, traders meet many difficulties and obstacles. “One man, we shall suppose, – Smith continues – has more of a certain commodity than he himself has occasion for, while another has less. The former consequently would be glad to dispose of, and the latter to purchase, a part of his superfluity. But, if this latter should chance to have nothing that the former stands in need of, no exchange can be made between them”. It’s precisely at this point that Smith introduces a hypothesis which can be called the “barter paradigm”: “In order to avoid the inconveniency of such situations, – he states – every prudent man in every period of society (…) must naturally have endeavoured to manage his affairs in such a manner, as to have at all times by him (…) a certain quantity of some one commodity or other, such as he imagined few people would be likely to refuse in exchange for the produce of their industry”.9

Smith, leaving undefined the historical context, draws up a list of several commodities utilized for this purpose in different times and places: cattle, salt, shells, dried cod, sugar, tobacco, hides or dressed leather, etc.. However – he adds – “men seem at last to have been determined by irresistible reasons to give the reference, for this employment, to metals above every other commodity”. Such reasons, though different, all concern lower exchange costs for traders using metals as they “can not only be kept with as little loss as any other commodity (…) but they can likewise (…) be divided into any number of parts, as by fusion those parts can easily be re-united again”. In this way metals have established themselves as “the instruments of commerce and circulation”.10 The same reasons of economic advantage led, over time, to the substitution of iron with copper and then of copper with gold and silver. In sum, according to Smith, money is a product of trade which, in turn, is a product of the division of labour. This “is the necessary, though very slow and gradual consequence of a certain propensity in human nature (…) the propensity to truck, barter, and exchange one thing with another”.11 In support of this hypothesis Smith calls upon the fact that the propensity to exchange is “to be found in no other race of animals” while “it is common to all men”. If one then asks what this propensity comes from, the most “probable” answer is that it is “the necessary consequence of the faculties of reason and speech”.12 In other words, trade – in Smith’s opinion – is an institution deeply rooted in human nature. This is the primitive proposition or axiom in the face of which justifications cease to regress. Therefore, it is the starting point for explaining all other aspects of the economy and of money in particular.

2.1.3. This clarifies the role Smith assigns to the state in the introduction of money. In his opinion, coinage represents the mere acknowledgement of a reality that developed autonomously in the economic sphere. The intervention of the state is only needed to certify the quality and weight of metal in order to prevent misuse and fraud to the prejudice of creditors as this would discourage “all sorts of industry and commerce”.13

The practices of debasement he meticulously enumerates reveal the systematic violation of creditors’ rights perpetrated by governments which, “abusing the confidence of their subjects, have by degrees diminished the real quantity of metal, which had been originally contained in their coins”. As “all other debtors” too “were allowed the same privilege” such operations – he adds – “have sometimes produced a greater and more universal revolution in the fortunes of private persons, than could have been occasioned by a very great publick calamity.”

It is through such a process (i.e. the selection of a particular commodity by traders and the subsequent intervention of the state to certify its quality and weight) that – according to Smith – money has acquired “in all civilized nations” its role of “universal instrument of commerce” by means of which “goods of all kinds are bought and sold, or exchanged for one another”.

2.2. The role of money

2.2.1. Thus, Smith's preliminary result is that money is a commodity and that, for reasons of convenience, in all developed economies such a commodity consists in precious metals. In a country where gold and silver circulate, the value of money cannot be different from the cost of production of these metals for a long time since variations in the supply will adjust the bulk of currency to demand by equalling market to natural prices.

This conclusion is based on the hypothesis that the market for gold and silver has world-wide dimensions. If, in a given country, the cost of mining gold or silver decreases because new mines are more productive or technical improvements have been introduced, production in excess of domestic demand will be sent abroad where the price of gold and silver is higher. This process continues as long as there is a gap between production costs in the country and the world price of gold and silver.

On the basis of this argument Smith implicitly criticizes the current explanation of the so-called revolution of prices that took place in Europe after the discovery of America. He replaces the relationship between money and prices supported by the quantity theory with the opposite relationship between the cost of production of the commodity money (and therefore the price level) and its quantity.

At this point, Smith interrupts his discourse on money and in the following chapters of Book I – from Chapter V to Chapter XI – he focuses on the analysis of the exchange value of commodities and on income distribution and concludes his Book with a long Digression on the value of silver.

2.2.2. Smith resumes his discourse on money in Book II (Of the nature, accumulation and employment of stock) devoted to analysing the role performed by capital in the working of the economy.

The introduction defines the concept of capital as a set of intermediate goods, which must be stored in advance to allow the producer to live and work until his products have been sold. This
stock – Smith points out – is supplied by saving and at the same time bound to its amount.\footnote{Cf. Smith (1981, p. 337, ll. 9-28).} Fixed and circulating capital are two of the three shares in which Smith divides the “general stock of any country or society”, the third one being the stock of commodities which “have been purchased by the proper consumers, but which have not yet entirely consumed”.\footnote{Smith (1981, pp. 281, 279, passim).} Smith includes money among the items of the circulating capital together with provisions, materials and finished products which are still in the hands of merchants or manufacturers and he states that it is thanks to money that “all the other three [parts of circulating capital] are circulated and distributed to their proper consumers”.\footnote{Smith (1981, pp. 282).}

Assimilating money to circulating capital has an important spin-off at a theoretical level as it confirms the role of money as a simple means of exchange. “A man – Smith observes – must be perfectly crazy who, where there is tolerable security, does not employ all the stock which he commands, whether it be his own or borrowed of other people”, in procuring “either present enjoyment or future profit”. Only where the safety of life, personal freedom and property is uncertain, recourse to hoarding becomes rational behaviour. Smith relates the opinion according to which hoarding is a “common practice (…) in Turkey, in Indostan and (…) in most other governments of Asia” as it was in England “during the violence of the feudal government”.\footnote{Smith (1981, pp. 285, passim).} Reference to examples, which are very remote in time and place, hints \textit{a contrario} that at present entrepreneurs enjoy “tolerable security” and hence the use of money as a store of wealth has no right to exist.

2.2.3. As previously seen, money is one of the four parts comprising circulating capital together with provisions, materials and finished products. However, it closely resembles fixed capital whose aim is “to increase the productive powers of labour”.\footnote{Smith (1981, p. 287).} Smith compares “the stock of money which circulates in any country” to “those machines and instruments of trade” which “require a certain expence, first to erect them, and afterwards to support them”.\footnote{Smith (1981, pp. 289, 288, passim).}

Moreover money resembles fixed capital since it does not belong to the revenue of individuals nor to that of society. As Smith points out, “the great wheel of circulation is altogether different from the goods which are circulated by means of it” and, on the other hand, “the revenue of the society consists altogether in those goods and not in the wheel which circulates them”.\footnote{Smith (1981, p. 289).}

A third similarity between money and fixed capital is that “every saving in the expence of erecting and supporting those machines” can be assimilated to that realized “in the expence of collecting and supporting that part of the circulating capital that consists in money”. In effect, if such saving “does not diminish the productive powers of labour”, it causes “an improvement of the neat revenue of the society” as it allows “to increase the fund which puts industry into motion” and consequently “the annual produce of land and labour”.\footnote{Smith (1981, pp. 291-292, passim).}

The similarity between money and fixed capital is particularly relevant in Smith’s eyes as it supports his attempt to reconstruct the history of money as the incessant pursuit of technical solutions to increase the efficiency of the economic system. He believes that gold and silver are
extremely expensive as means of circulation and that the introduction of paper money helps to economize on precious resources that are allocated to increasing capital and production.  

However, there were those, like Hume, who considered banks and credit a source of inflation and therefore of distortion of economic relations. Smith disagrees with this opinion and intends to prove how economies where convertible banknotes circulate together with gold and silver – or even non convertible notes only – may well, with appropriate adjustments, replace economies based on metallic money. In other words, Smith believes that it is possible to obtain the advantages of using a cheap means of circulation such as paper money without necessarily violating the law of value on which exchange economies are based. The two following sections will focus on the arguments he develops to support his opinion.

3. THE CONVERTIBLE PAPER CURRENCY SYSTEM

3.1. Bank money

3.1.1. Owing to the introduction of paper money, the circulation of commodities – Smith observes – comes to be carried on by a new wheel, which costs less both to erect and to maintain than the old one”. There are “several different sorts of paper money”, but “the circulating notes of banks and bankers are the species which is best known”, and moreover which seems “best adapted” for the purpose of realizing a saving in circulation costs.

To be able to do his job the banker must, in the first place, gain the public’s confidence. When, rightly or wrongly, “the people of any particular country” believe that the banker, thanks to his fortune, probity and prudence, “is always ready to pay upon demand [i.e. to convert into gold and silver money] such of his promissory notes as are likely to be at any time presented to him”, these notes “come to have the same currency as gold and silver money.” The source of the banker’s gain is the interest that borrowers pay on loans. Given the public’s confidence that the banker enjoys, the most of his notes “continue to circulate for months and years together”, without being presented for collection, so that in the face of “a hundred thousand pounds, twenty thousand pounds in gold and silver may frequently be a sufficient provision for answering occasional demands”. And if the same operation should, at the same time, be carried on by many different bankers, “the whole circulation (…) may be conducted with a fifth part only of the gold and silver which would otherwise have been requisite.”

Supposing that, before the establishing of the banks, the annual product of a country had required “only one million [sterling] to circulate and distribute it to its proper consumers”, the same sum will also be sufficient after the bank’s operations, as “it cannot be immediately augmented by

\[29\] Cf. the essay On money in Hume (1955).
\[30\] This idea is already clearly stated in his Lectures on Jurisprudence [cf. Smith (1982, pp. 503-504)], where he upholds “the beneficial effects of the erection of banks and paper credit” and rejects price-specie-flow mechanisms by means of an example that is reproduced in almost the same words in The Wealth of Nations: cf. the passages relating to footnotes (54)-(57).
\[31\] If an intrinsically worthless substitute for a commodity were to circulate, the value-cost law would be replaced by the value-shortage law and it would be up to those issuing the substitute to apply the new law so that the supply of money would constantly adjust to demand: cf., on this point, Sections 3.2 and 4.1.
\[34\] Smith (1981, pp. 292-293, passim).
those operations”. As a consequence, the economic system comes to have an excess of money of eight hundred thousand pounds sterling. Though “this sum cannot be employed at home”, it is “too valuable, to be allowed to lie idle”. It will, therefore, “be sent abroad, in order to seek that profitable employment which it cannot find at home”. But paper money “cannot go abroad” because “at a distance from the banks which issue it, and from the country in which payment of it can be exacted by law, it will not be received in common payments”. Gold and silver, therefore, will be sent abroad, leaving a million pounds sterling for the needs of domestic circulation.

The money sent abroad will be used to purchase foreign goods in order to supply the carrying trade or domestic consumption, both productive and unproductive. According to Smith, it seems not only “probable”, but “almost unavoidable” that it be employed in purchasing goods of the first kind, as “the revenue of idle people, considered as a class or order, cannot, in the smallest degree, be increased by those operations of banking”. As a consequence, the circulating capital of the economy “may be increased by the whole value of gold and silver which used to be employed in purchasing them”. The relevance of such operation cannot be underrated. Though, in effect, “the proportion which the circulating money of any country bears to the whole value of the annual produce” can be computed at hardly a thirtieth part of that value, since capital is a small part of that produce, “the circulating money (...) must always bear a very considerable proportion to that part”. When, therefore, as a result of the introduction of paper money “the gold and silver necessary for circulation is reduced to (...) a fifth part of the former quantity”, if the value of the other four-fifths “be added to the funds which are destined for the maintenance of industry”, there will be “a very considerable addition to the quantity of that industry” and, consequently, “to the value of the annual produce of land and labour”.

To conclude, if there is an increase in a country’s money supply due to the intervention of banks, that money will be transferred abroad and domestic prices will remain the same. Apparently, Smith considers a mechanism similar to the so-called “monetary approach to the balance of payments” whereby in a small scale economy dealing with foreign markets under a fixed exchange rate system (as happens with a gold standard) commodity prices are set at world level and are therefore an exogenous variable. Consequently, when international (and therefore domestic) prices rise, economic operators try to adjust money balances by exporting commodities and accumulating money, while importing commodities from abroad in exchange for money when prices fall. In such an economy, therefore, the introduction of banks and credit will not produce the effects imagined by Hume, namely inflation, but only the replacement of specie with banknotes. Gold and silver will be sent abroad in exchange for commodities, and if most of these commodities are a production input – as Smith assumes – the final result will be a recapitalization of the system.

37 This result allows to solve what Viner (1937, p. 87) has described as “one of the mysteries of the history of economic thought” i.e. Smith’s rejection of Hume’s price-specie-flow mechanism. Among the several solutions of this “mystery” advanced by the scholars [cf., for example, Low (1952), Petrella (1968), Eagly (1970)] the simplest one – as Glasner (1989, pp. 208-209) observes – is that Smith rejected price-specie-flow mechanism “because it incorrectly applied the quantity theory to determine the price level of a country with a metallic currency”. Actually, he adds: “a national price level depends on the international value of the metal used as money, not the quantity of money in the country”.
38 As Humphrey (1981, p. 3) states, “That approach denies the validity of both the quantity theory of money and the price-specie-flow mechanism (...). It rejects the price-specie-flow concept on the grounds that prices in the small open economy are determined in the world markets and cannot deviate from foreign (i.e. world) prices. Likewise, it rejects the quantity theory on the grounds that since money flows in through the balance of payments to support the pre-determined price level, causation necessarily runs from prices to money rather than from money to prices, contrary to the predictions of the quantity theory.”
3.1.2. During his discussion Smith analyses in detail the methods with which banks put paper money in the system. The first, known for many years and widely employed, is the discounting of bills of exchange by means of which the banker advances to the merchant “not gold and silver, but his own promissory notes”, as “he finds by experience” that they are “commonly in circulation” and that only a small proportion of them will be presented for collection. The result is that the banker is enabled “to make his clear gain of interest on so much a larger sum”. The second method of issuing paper money – Smith observes – was recently introduced by the “two first banking companies” of Scotland,39 by granting (…) cash accounts”, that is “by giving credit to the extent of a certain sum” to any individual who could “procure two persons of undoubted credit and good landed estate”. Such persons are to become surety for him so that “whatever money should be advanced to him” within the credit which had been given, “should be repaid upon demand, together with the legal interest”.

Therefore – Smith notes – “all merchants (…), and almost all men of business, find it convenient to keep such cash accounts with them” and are thereby “interested to promote the trade of those companies”, by readily receiving “their notes in all payments” and by encouraging “all those with whom they have any influence to do the same”. In fact, by means of those cash accounts, “every merchant can, without imprudence, carry on a greater trade than he otherwise could do” and hence realize larger profits. In support of his statement, Smith compares the hypothetical situation of two merchants, one working in Edinburgh and the other in London, who, while employing “equal stocks in the same branch of trade”;41 obtain different profits from their business. The reason is that the latter “must always keep by him a considerable sum of money, either in his own coffers, or in those of his banker, who gives him no interest, in order to answer the demands continually coming upon him for payment of the goods which he purchases upon credit”. The merchant in Edinburgh, on the contrary, “keeps no money unemployed” for the purposes of answering the demands of his creditors. He satisfies them “from his cash account with the bank, and gradually replaces the sum borrowed with the money or paper which comes in from the occasional sales of his goods”.42 With the same stock, therefore, he can carry on his trade, give employment and make profit in a greater measure than the London merchant.

3.2. The law of reflux and the real bills doctrine

3.2.1. As stated, David Hume was sceptical about the introduction of banks since, following the quantity theory of money, he feared the effects of credit on inflation. “It seems a maxim almost self evident, that the prices of every thing depend on the proportion between commodities and money (…) Encrease the commodities, they become cheaper; encrease the money, they rise in their value”.43 The existence of banks, by increasing the quantity of circulating money, produces an increase in the prices of commodities, which makes Hume “entertain a doubt concerning the benefit of banks and paper-credit”.44 The practical conclusion that he draws is that banks should by law only deal with deposits and custody and they should not be allowed to grant credit: “no bank could be more

39 As Smith (1981, p. 297) points out, those banks, established in Edinburgh, were public: “the one, called The Bank of Scotland, was established by act of parliament in 1695; the other, called The Royal Bank, by royal charter in 1727”.
43 Hume (1955, pp. 41-42).
44 Hume (1955, p. 35).
advantageous, than such a one as locked up all the money it received, and never augmented the circulating coin, as is usual, by returning part of its treasure into commerce”. “This is the case” – he adds in note – “with the bank of AMSTERDAM”.45

Smith’s opinion of the consequences of banks is completely different. He underlines the fact that the prerequisites for an increase in prices do not exist because the quantity of circulating money does not vary owing to bank credits: “as the quantity of the gold and silver, which is taken from the currency, is always equal to the quantity of paper which is added to it, paper money does not necessarily increase the quantity of the whole currency”.46

In order to support his idea, Smith compares the Scottish situation with that in England and the English situation with the French one, commenting that during the eighteenth century the abundance of paper money in Scotland compared to England, and in England compared to France, did not produce an increase in prices in Scotland compared to prices in England and in England compared to prices in France. He concludes by stating that the increase in food prices in Scotland in 1751-52, which Hume considers, was probably due “to the badness of the seasons, and not to the multiplication of paper money”.47

Still, even if we were to admit that banknotes do not replace metallic money but add to it, according to Smith, it is possible to reject Hume’s conclusion. It is sufficient for banks to be obliged to convert their banknotes into metallic money at the request of bearers. Convertibility anyway prevents banks from issuing an excessive number of banknotes with respect to the demand of entrepreneurs, since they undergo that special process called “law of reflux”, whereby excess paper money would be used immediately by the public to reduce its indebtedness to the banking system or be converted into metallic money.48

In The Wealth of Nations Smith gives one of the first descriptions of this mechanism, which is then later defined by the supporters of the Banking School, especially Fullarton: “Should the circulating paper at any time exceed (…) the value of gold and silver, of which it supplies the place”, then many people “would immediately perceive that they have more of this paper than was necessary for transacting their business at home, and as they could not send it abroad, they would immediately demand payment of it from the banks”. If these showed “any difficulty or backwardness in payment”, then “there would immediately (…) be a run upon the banks (…) to a much greater extent; the alarm, which this would occasion, necessarily increasing the run”.49

3.2.2. However, although excluding the danger for inflation subsequent to the issuing of excess banknotes, Smith clearly understands the liquidity risk commercial banks have to face when discounting bills or granting credits under guarantee. The mention of the real-bills doctrine contained in The Wealth of Nations falls into this framework. It is a rule of behaviour which, in Smith’s mind, forces banks to keep under control fluctuations in their indebtedness caused by changes in the demand for banknotes by the public. With this aim, banks should be supplied with assets that can be liquidated easily in the event of a decrease in the demand for loans. They thus avoid losses during attempts to liquidate their own assets or borrow at high interest rates to satisfy requests for bill conversions.50 Banks achieve this result when they discount “to a merchant a real

45 Hume (1955, p. 36).
48 As Glasner (1989, pp. 204-205, passim) notes, the law of reflux states that “an excess supply of inside money [does not] correspond to an excess demand for goods in the real sector”, as it is offset “by an excess demand for IOUs from the banking system, i.e. a desire by the public to reduce its indebtedness to the banking system”.
50 As Glasner (1992, pp. 890-891, passim) explains, if the public cause banks (through the law of reflux) “to contract their outstanding note and deposit liabilities”, they “could respond only by contracting (…) [their] assets by an equal
bill of exchange drawn by a real creditor upon a real debtor, and which as soon as it becomes due, is really paid by that debtor”. In this way, in effect, the bank “only advances to him a part of the value which he would otherwise be obliged to keep by him unemployed and in ready money” to meet occasional demands.

3.2.3. In sum, Smith’s idea is that banks are “profit-seeking” operators that prefer to issue banknotes not producing any interest in exchange for IOUs by clients that instead yield high interest. He believed that competition would have discouraged banks from issuing excess notes because they would have been promptly cashed by owners and, even before them, by their competitors. In addition, the rule banks have to follow to avoid bankruptcy is to grant short-term loans upon submission of short-term bills issued by debtors of their clients or on real security. Banks must not grant medium- or long-term loans for two reasons. First, this would mean supplying capital to entrepreneurs without any, but who should acquire it by saving or resorting to loans secured by mortgages. Second, they could have to face liquidity problems while clients complete their production cycle or the amortization of equipment with a substantial increase in management costs.

Smith condemns the idea of transforming Scottish banks “into a sort of a general loan office for the whole country”, that is into offices able to provide entrepreneurs with access to the economic resources of society. He does not consider that if an entrepreneur applies to a bank for a loan he does so in order to expand his business over the limit set by his capital. In fact, entrepreneurs seldom own all the capital they need to implement their projects, and often have difficulty finding it. This is why banks were set up to supply entrepreneurs with the capital they need to start business. According to Smith, however, that is what banks should never do: “It is not augmenting the capital of the country, but by rendering a greater part of that capital active and productive than would otherwise be so, that the most judicious operations of banking can increase the industry of the country”.

3.3. The role of banks

3.3.1. From the preceding observations it is easy to infer the role that Smith assigns to the banks in the working of a market economy. He believes that the benefit of paper money does not go beyond the chance offered to entrepreneurs of unfreezing a portion of their circulating capital and devoting it to an increase in production. In other words, the only duty of banks is to provide liquidity for a short time to entrepreneurs (mainly merchants) who, having already started a business with their own funds and sold their products, are waiting to be paid by clients while having to pay suppliers. The accent is on the short-term loan. The coffers of a bank – he notes – resemble a “water pond, from which though a stream is continually running out, yet another is continually running in, fully equal to that which runs out”, so that “the pond keeps always equally, or very near equally, full”. What runs out are the loans, whilst what runs in are the repayments of the customers. The bank, therefore, ought “to observe with great attention, whether in the course of some short period”, which can go from four to eight months, “the sum of the repayments which it commonly receives amount and paying off the liabilities or by incurring additional liabilities to pay off the ones (…) [they are] extinguishing". Thus, “to maintain a flexible asset portfolio, it was necessary for banks to lend short term to borrowers who would be likely to repay their loans at short intervals".

is, or is not, fully equal to that of the advances it commonly makes”. Only in the first case can it “safely continue” to lend money. The need for banks to observe this prudential rule of behaviour explains Smith’s dislike of entrepreneurs’ attempts to finance investment through bank credit. He states that “a bank cannot”, unless it is ready to give up its own interests, “advance to a trader the whole or even the greater part of the circulating capital with which he trades”, the reason being that “the whole of the returns is too distant from the whole of the outgoings” and the intervals surpass “such moderate periods of time as suit the conveniency of a bank”. This argument applies all the more so to fixed capital, whose returns “are in almost all cases much slower than those of the circulating capital”. Smith’s opinion is that capital formation ought not to be financed by bank credit, but ought to be funded upon the “bond or mortgage” of savers, i.e. “of such private people as propose to live upon the interest of their money, without taking the trouble themselves to employ the capital”. 

Actually – Smith observes – the claim of entrepreneurs that banks ought to “provide them with all the capital” they need to realize their production plans was not accepted. This was the reason why some of them “had recourse to an expedient” which, “though at a much greater expence”, enabled them “for a time” to obtain the desired borrowings. This expedient – he points out – “was no other than the well-known shift of drawing and redrawing”. 

The negative judgement Smith gives on this practice is due to the fact that it succeeded, without the banks being aware of it, not only in substituting gold and silver money but in increasing the quantity of currency. In fact, “upon many occasions”, the paper money issued “upon the circulating bills of exchange” amounted “to the whole fund destined for carrying on some vast and extensive project of agriculture, commerce or manufactures” and not merely to “that part of which, had there been no paper money, the projector would have been obliged to keep by him, unemployed and in ready money for answering occasional demands”. The final result – which Smith underlines once more – was that the excess paper money “immediately returned upon the banks in order to be exchanged for gold and silver”, and the banks had to honour their commitment “as they could”. 

Summing up his analysis, Smith calls the entrepreneurs who made recourse to this practice “projectors” who “in their golden dreams” had, no doubt, “the most distinct vision” of the great profits they expected from their undertakings, yet “very seldom (…) had the good fortune to find” them.

3.3.2. “Projectors’” idea of capitalism is the farthest from Smith’s view one could conceive. Though in a rough and early form, it had been stated at the beginning of the eighteenth century by a Scottish economist, John Law, who, during the regency of Louis of Orléans, tried to introduce paper money in France. It is precisely Law’s theories which represent the target of Smith’s criticisms. At the end of his excursus on the Bank of Scotland’s experience, he explicitly recalls the opinion of his “famous” fellow countryman (according to whom “the industry in Scotland languished for want of money to employ it”) and mentions his proposal “to remedy” this want of money “by establishing a bank (…) which (…) might issue paper to the amount of the whole value of all the lands in the country”. He defines “splendid, but visionary” the ideas expounded by Law and advances the hypothesis that they have, perhaps, in part, “contributed to that excess of banking, which has of late been complained of both in Scotland and in other places”.

In the face of these ideas Smith reasserts his opinion on the role of bank credit as a means of converting idle capital into productive capital. He compares the “ready money” that a dealer keeps by him “for answering occasional demands” to “so much dead stock” which “produces nothing either to him or to his country”. Such stock, by means of “judicious operations of banking”, can be converted into “active and productive stock”. With a well chosen metaphor, Smith compares the gold and silver money which circulates in any country to “a highway” and the judicious operations of banking to a “wagon-way through the air” which enables the country to convert the highway “into good pastures and corn fields”, and thereby “to increase very considerably the annual produce of its land and labour”, where emphasis is to be laid on the bank’s good judgement when granting credit to entrepreneurs.

In order to understand Smith’s point of view, it might be helpful to compare his approach with that of the money theorists, according to whom money is the means by which entrepreneurs may start production without having previously earned any income. In an economic world which is ruled by the budget constraint, where every individual can spend only what he has previously earned, bank credit represents a sort of passkey by means of which firms are enabled to force their way into the market, i.e. to take goods and services without having capital at disposal, that is without first having to save. Actually, a market system can be properly defined a monetary economy of production: for it to be able to work regularly, firms must be allowed to spend before having earned a profit, as the revenue from sales will only accrue after production. The amount of credit granted by banks does not necessarily have to obey the saving constraint, since investment expenditure, given the interest rate, finds its natural bounds only in the flows of future net receipts.

Smith rejects this interpretation. He believes that the creation of money by banks and the possibility given to entrepreneurs to invest without having first to save produce destruction rather than increase of social capital. As a consequence, while clearly appreciating the role performed by cash in hand in the working of the economy and while outlining with great accuracy the circuit of paper money from the time it is issued by banks to its destruction when loans are reimbursed by entrepreneurs, he does not succeed in pinpointing the revolutionary implications of bank credit, i.e. the chances it offers to firms of getting capital without earning any income in advance. In Smith’s vision, capitalism is an economic system which is ruled by entrepreneurs who do not bet on the future with the money they have borrowed from the banks, yet they cut down to employ “the money borrowed” from private individuals “in sober undertakings, proportioned to their capitals”, which, having “more of the solid and the profitable”, can repay “with a large profit” whatever has been laid upon them.

4. THE INCONVERTIBLE PAPER CURRENCY SYSTEM


Commenting on the affairs of Ayr bank, whose avowed principle was “to advance, upon any reasonable security, the whole capital which was to be employed in those improvements of which the returns are the most slow and distant” and which was obliged to close down its business after only two years, Smith (1981, pp. 313-314, 316-317) observes: “though this operation had proved not only practicable, but profitable to the bank as a mercantile company; yet the country could have derived no benefit from it; but, on the contrary, must have suffered a very considerable loss by it”. This because: “The success of this operation (…) without increasing in the smallest degree the capital of the country, would only have transferred a great part of it from prudent and profitable, to imprudent and unprofitable undertakings”.


Smith (1981, p. 317). Here Smith resorts to a “petitio principii” in his attempt to bypass the problem of uncertainty which entrepreneurs and bankers are both obliged to face.


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4.1. State money

4.1.1. Promissory notes issued by the banks, however, did not constitute the only type of paper money circulating in the economy at the time of Smith. In order to find a remedy for the scarcity of gold and silver during the eighteenth century, the governments of the English colonies in North America had issued paper money in the form of notes, declaring them to be legal tender. Smith dedicates the final part of Chapter II, Book II of *The Wealth of Nations* to an analysis of this experience.

He starts with the conclusion reached regarding the convertible paper money system, in which banknotes can be considered, in every respect, equal in value to gold or silver money when they can immediately and without any condition be converted into such money. On the contrary, Smith observes that a money which would not be convertible immediately and without any condition “would, no doubt, fall more or less below the value of gold and silver”, according to “the distance and probability of the term of its final discharge and redemption”. Smith gives some examples in support of his statement, one of which introduces the analysis of the inconvertible paper currency system: “The paper currency of North America” – he explains – “consisted not in bank notes payable to the bearer on demand, but in government paper, of which the payment was not exigible till several years after it was issued”. Nonetheless, the governments of the colonies did not pay holders any interest and, moreover, imposed the legal tender of these banknotes for the full nominal value to which they were issued. The consequence of this decision was that sterling’s exchange rate increased in all the colonies, from a minimum of 150% to a maximum of 1100% depending on the case.

Smith observes that the large differences in the value of the various colonies’ paper money with respect to sterling arose not only from the factors mentioned, but also “from the difference in

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63 The economic situation of these countries was featured by a sustained growth of income and by a consequent need of massive imports of commodities (especially production inputs) from the homeland. Exports to the Caribbean area, though substantial, were not enough to restore their balance of trade and that fact was responsible for a continuous outflow of gold and silver which caused a domestic shortage of currency, as proved by the archive material of that period. Cf., on this point, Smith (1981, p. 942, ll. 12-18).
66 Smith (1981, p. 326). As Thayer (1953) explains, the paper currency circulating in the North American colonies was of two types. The first consisted in bills of credit that the governments issued for various maturities against future fiscal revenues and declared they would accept for payments. The second, on the other hand, consisted in notes issued by public land banks in connection with loans granted to private parties on the security of a real estate (land, farms, town houses, etc.). The first bills of credit were issued in 1690 by the government of Massachusetts to fit out an expedition against French Canada. This example was rapidly followed by other colonies. Bills of credit became widespread until the advent of the land banks discouraged their use. Later, during the French and Indian war of the 1750s, the colonial governments were authorised to issue large volumes of bills of credit guaranteed by taxes to pay for military defence. When new issues or renewals of bills of credit were prohibited, the colonies obtained authorisation to issue short term bills of credit each year to finance current government spending. Unlike bills of credit, which were used to finance military spending, the notes issued by the land banks served the needs of private entrepreneurs. According to documents relating to Pennsylvania, of 500 loans granted in 1744 over 75% were to yeomen farmers, while most of the others went to mechanics. Bills of credit became widespread until the advent of the land banks discouraged their use. Later, during the French and Indian war of the 1750s, the colonial governments were authorised to issue large volumes of bills of credit guaranteed by taxes to pay for military defence. When new issues or renewals of bills of credit were prohibited, the colonies obtained authorisation to issue short term notes. Unlike bills of credit, which were used to finance military spending, the notes issued by the land banks served the needs of private entrepreneurs. According to documents relating to Pennsylvania, of 500 loans granted in 1744 over 75% were to yeomen farmers, while most of the others went to mechanics. Farmers gave their farms as collateral, whereas mechanics offered their homes and land in Philadelphia and other colonial towns. Generally speaking, loans could not exceed 50% of the value of the property given as collateral. However, this rule was not always observed and land did not always represent good collateral. A major exception was Pennsylvania, where the amount of loans was well below the legal limit and officials took great care not to overestimate the value of goods offered as collateral. The value of paper money circulating in the colonies depended less on the size of issues and more on that of the collateral. In the case of notes issued by land banks it was the value of the mortgaged property that counted, while for bills of credit it was the size of fiscal revenue and the colonial government’s reputation for effectively trying to observe the terms of repayment in specie.
the quantity of paper emitted in the different colonies”. The link between the quantity of paper money issued by the government and its value in gold and silver is reasserted immediately after in relation to Pennsylvania. This colony – Smith observes – “was always more moderate in its emissions of paper money than any other of our colonies”. This is precisely why, continues Smith, “its paper currency is said…never to have sunk below the value of the gold and silver which was current in the colony before the first emission of its paper money”.

However, in Smith’s opinion, moderation in issues of paper money was not the only reason for Pennsylvania’s success. He calls attention to the fact that all the colonial governments accepted their own paper money “in the payment of the provincial taxes for the full value for which it had been issued”, pointing out that “from this use” paper money “necessarily derived some additional value, over and above what it would have had from the real or supposed distance of the term of its final discharge and redemption”. The added value accruing to the colonies’ paper money was – according to Smith – “greater or less, according as the quantity of paper issued was more or less above what could be employed in the payment of the taxes of the particular colony which issued it”. The government of Pennsylvania managed to keep the exchange rate of the paper money at par with sterling precisely because the quantity was barely above the amount needed to pay taxes, whereas in the other colonies it was “very much above what could be employed in this manner”.

Smith realises that in a system in which the currency is purely a sign, the only way to preserve its value is to establish simultaneously a need and a shortage. A government with a monopoly of issues and the power to levy taxes can make paper money a necessity by announcing it will be accepted in payment of taxes, while at the same time it can use a monetary and fiscal policy mix to ensure there is a shortage, i.e. by making expenditure (which decides the supply of notes) proportionate to taxation (which determines demand) or vice versa. Understanding this fact allowed Smith to apply quantity theory correctly to analyse the inconvertible paper money system, avoiding the error of Hume.

He observes that “a prince, who should enact that a certain proportion of his taxes should be paid in a paper money of a certain kind, might thereby give a certain value to this paper money; even though the term of its final discharge and redemption should depend altogether upon the will of the prince”. In this case, the convertibility of notes into specie would lose importance completely and it would be possible to fix a premium on gold and silver, “if the bank

69 Smith (1981, p. 327). Later, Smith (1981, p. 327, ll. 27-31) explains that the paper money that replaced specie in Pennsylvania kept the same value with respect to sterling. McCusker (1978, pp. 184-186) provides the average annual exchange rate of Pennsylvania currency against English sterling during the years between 1723-1774 where the colonial government issued paper money. After a slight initial rise (from 140.37 to 139.34 per £ sterling) the rate shows a constant, though fluctuating, fall in the following years, reaching the lowest value of 183.78 per £ sterling in 1747 with an average loss of 16.9% during the entire period. While representing an appreciable performance in comparison with the other colonies’ currencies, these data do not fully support Smith’s glowing judgement. On the monetary policy of Pennsylvania during the eighteenth century there is an abundant literature: cf., especially, Lester (1938), Thayer (1953), McCusker (1978), West (1978), Hanson (1979), Hanson (1980), Smith B. D. (1985).
71 Smith (1981, p. 328). When assessing the impact of issues on the value of the paper money it should be kept in mind that the North American colonies of the time also used other types of money. First there were precious metals, gold and silver. Initially, particularly in border zones, special commodities, such as beaver fur, tobacco and rum, were used. Occasionally, warehouse certificates and bills of exchange that were then endorsed circulated in place of goods. Commodity money was gradually abandoned as less costly alternatives became available. But, as West (1978, p. 7) reminds us, “there was another kind of money which was very important in the colonial economy: book of credit”. Of course, we must distinguish between means of payment and means of settlement. With regard to English colonies of North America, warehouse certificates, bills of exchange and books of credit were also means of payment, but to settle debts at their expiry it was necessary to have real money, that is gold and silver coin or paper money.
72 Cf., on this point, Glasner (1985, p. 56).
which issued this paper was careful to keep the quantity of it always somewhat below what could easily be employed in this manner.”

### 4.2. The Pennsylvania case

4.2.1. In Smith’s analysis of the fiat money system the case of Pennsylvania assumes a special importance, being the only colony where the introduction of an inconvertible currency was successful. Smith returns later to a discussion of this case in Chapter II (Of the Sources of the general or publick Revenue of the Society), Book V of *The Wealth of Nations*, and furnishes additional information about the monetary system established in the colony. He first explains that the government’s objective was to provide “to its subjects” a means of payment “without amassing any treasure”; then goes on to state that the method adopted was to set up local public banks with the task “of lending, not money indeed, but what is equivalent to money (…) by advancing to private people, at interest, and upon land security to double the value, paper bills of credit to be redeemed fifteen years after their date.”

Those bills of credit, Smith adds, were “in the mean time made transferable from hand to hand like bank notes” and “declared by act of assembly to be a legal tender in all payments from one inhabitant of the province to another”. From this operation, the government, which Smith defines as “frugal and orderly”, obtained a revenue “which went a considerable way towards defraying an annual expence of 4,500l.” i.e. the whole amount of its ordinary expenses.

Smith ascribes the success of this measure to three factors. The first is the need “for some other instrument of commerce, besides gold and silver money”, required to pay for imports from the motherland. The second is “the great credit of the government which made use of this expedient”. The last is the moderation of issues, borne out by the fact that “the whole value of the paper credit” never exceeded “that of the gold and silver money which would have been necessary for carrying on their circulation, had there been no paper bills of credit”. Smith stresses the importance of this fact by pointing out that it was the lack of moderation in emissions that had caused “much more disorder than conveniency” in most of the other colonies.

Smith concludes his analysis of the inconvertible paper money system in Chapter III (Of publick debts), Book V of *The Wealth of Nations*, with a synopsis. He first recalls that “the Americans…have no gold and silver money; the interior commerce of the country being carried on by a paper currency and the gold and silver which occasionally come among them being all sent to Great Britain in return for the commodities which they receive from us”. He rules out the possibility that this is due to “the poverty of that country, or…the inability of the people there to purchase those metals”, because the inhabitants of the colonies were not without the means to buy gold and

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73 Smith (1981, p. 328, *passim*).
76 Smith (1981, p. 820). Contemporary documents attest to the great need of businessmen for liquidity in a period of rapid economic growth of the colony. This requirement could not be satisfied in the usual way, that is through a trade surplus (there being no mines) because, as Brock (1975, pp. 2-7), West (1978, p. 12) point out, Pennsylvania managed hardly to pay off its debt with Great Britain out of the revenue from exports to the West Indies.
77 Smith (1981, p. 820). This point is also stressed by Galiani (1963, pp. 267-268) who, referring to paper money circulating in the English colonies of North America, attributes the reliability of the Pennsylvania government to Quaker virtues. However, in his opinion, such virtues cannot be imitated by other Christian nations.
silver “if it was either necessary or convenient for them to do so”.

The true reason, according to Smith, lies elsewhere. It is a calculated decision based on the fact that: 1) paper money can perfectly replace gold and silver as a means of payment within a country, at least in times of peace, as the example of Scotland confirms; 2) this replacement is advantageous for the Americans because it allows them to avoid “the expense of so costly an instrument of commerce as gold and silver” and to employ what they save “in purchasing, not dead stock, but active and productive stock”.

According to Smith, the abundance of paper money in the American colonies should be viewed as positive because, like the banknotes in Scotland, it is due to “the entreprizing and projecting spirit of the people, their desire of employing all the stock which they can get as active and productive stock.” As a result gold and silver are used to pay for imports of goods destined for capital formation. Thus, Hume’s price-specie-flow mechanism is again rejected, as it had been by Smith in the case of the convertible paper money system.

4.2.2. Smith’s observations can be summarised as follows:

1) a system of inconvertible paper money is the result of particular historical circumstances such as those occurred in the English colonies of North American, in other words: a) the absence of gold and silver mines; b) rapid economic growth that had to be matched by equally fast capital formation and made trade surpluses impossible. Whereas Scotland, in similar conditions, benefited from a stock of precious metals built up in earlier periods, the American colonies were forced to use all their gold and silver for foreign trade.

2) this type of system can work if the government issuing the paper money: a) declares that it will accept it in payment of taxes; b) takes care to adjust the stock in circulation constantly according to public demand, thus creating widespread expectations that budget balance will be maintained. Since the supply of money is no longer endogenous, as in a system based on commodity money, the government must regulate the quantity of money so that it does not exceed the demand of economic agents. The method Smith suggests to achieve this result is to issue no more notes than are necessary to pay taxes. Careful management, designed to ensure that part of demand is not met, might even allow the paper money to appreciate against gold and silver.

If the quantity of money depends on a decision of the government, public demand is bound to be affected by expectations regarding the future trend of the budget. Distrust of the government’s will or ability to maintain a balance between revenues and outlays over a period of time will prompt economic agents to get rid of paper money for fear of incurring losses. If these expectations spread, the fears will become reality and the currency will devalue. Smith seems to be aware of this fact. He emphasises that Pennsylvania’s success was due not only to the government’s moderation in issues, but more especially to: 1) great frugality, which is borne out by the fact that it was able to cover most of its ordinary expenses from seignorage rights alone; 2) prestige, in other words, credibility with the citizens regarding its intention to fulfil its commitments.

5. CONCLUSION

84 Cf. Smith (1981, p. 941): “The redundancy of paper money necessarily banishes gold and silver from the domestick transactions of the colonies, for the same reason that it has banished those metals from the great parts of the domestick transactions in Scotland”.

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5.1. Smith’s two-fold theory of money

5.1.1. As previously seen, Smith’s discourse on money is well-structured and many-sided. It deals with both the theoretical problem of the role of money and the practical problem of the stability of its value through the analysis of three different monetary systems. However, there is no doubt that it is sustained by a homogeneous vision which rests on two simple ideas, namely that: 1) money is essentially a means that facilitates exchanges; 2) its value must be excluded from any arbitrary change. Regarding the first, Smith defines money as “the great wheel of circulation” and includes it among the items of circulating or fixed capital. Like any element of capital, money is subject to an incessant process of technical innovation aimed at reducing production costs. It is this process that explains the passage from the different kinds of commodities to gold and silver and more recently from the latter to paper money. In principle, any instrument can perform the function of means of exchange and in particular circumstances – as Smith points out – it can prove convenient or even necessary to substitute that instrument with a pure fiat. This fact explains the Janus-faced aspect of Smith’s theory of money. To simplify, we could say that he adopts a commodity money theory when analyzing a barter system while accepting the quantity theory when examining the convertible and inconvertible paper currency systems.

5.1.2. Actually, Smith’s analysis of the convertible paper currency system presents some ambiguities and needs clarification. As already said, he considers banknotes a simple means of reducing the transaction costs whereby firms are able to save on specie and increase their productive capacity. Resting on the assumption that excess gold and silver will be sent abroad to purchase means of production, Smith reaches the conclusion that banknotes are a simple substitute for gold and silver and the entire system a particular version of a commodity money system. However, he cannot fail to recognize that banks, for many reasons, could issue an amount of paper money exceeding the value of gold and silver that circulated before and, consequently, that the problem arises of pegging the value of banknotes to that of specie. Thus, we can conclude that Smith, when interpreting the working of the convertible paper currency system, implicitly adopts the quantity theory of money.

5.1.3. The two faces of Smith’s theory of money show up again in the solution to the problem of the value of money. In the barter system the value of currency naturally adapts to the production costs of the commodity money without the need for external intervention. Problems arise when a convertible or inconvertible paper currency system is considered. Regarding the first, Smith believes that the value of paper money could be effectively pegged to that of gold and silver through adequate measures, namely: 1) the convertibility of banknotes which put into operation the law of reflux; 2) the adherence of the banks to the real bills doctrine, whereby they should grant loans to firms only if secured by bills of exchange issued against commodity sale contracts and, moreover, refuse entrepreneurs’ requests for financing capital, both circulating and fixed, and, in general, all the projects that anticipate a reimbursement of the loan for a long period.

Regarding the second, instead, he advises governments to adopt a fiscal policy designed to achieve a balance between the amount of public expenditure and tax revenue. He is aware of the fact that the law of value-cost which operates in a pure commodity money system is no longer effective and must be substituted by a different law based on scarcity or the proportion between
supply and demand, the task of enforcing the new law falling on the subject with the power to issue money.

5.2. Wray on Smith's theory of money: a critique

5.2.1. On the basis of the foregoing considerations two objections can be made to the reconstruction of Smith’s theory of money advanced by Wray. First, he fails to look at the passages of *The Wealth of Nations* that refer to a pure commodity money system, missing the overall structure of Smith’s theory. Second, he confuses chartalism with a particular version of quantity theory, namely the one advanced by Sargent in order to salvage that theory from several counter-examples signaled by monetary history.

As Sargent observes, in order to explain inflation what matters is not “the current government deficit, but the present value of current and perspective future government deficits”. Indeed, he adds, the government can be viewed “like a firm whose perspective receipts (…) are its future tax collections”. In other words, “the public’s perception of the fiscal regime” influences “the value of government debt through private agents expectations about the present value of the revenue streams backing that debts”.

The chartalist theory advanced by Wray seems to be in line with that approach. “Money – he states – is a creature of the state” and “fiscal policy would be used to increase the stability of the value of currency”. If government decisively pursues a balanced budget policy, economic operators will form no inflationary expectations as the actual value of future final balances will be close to zero. Smith supposedly refers to that fact when citing among the causes of Pennsylvania’s success the low level of its public expense, the moderate issues of money and the good reputation enjoyed by the government.

He seems to think that Pennsylvania’s citizens had formed positive expectations regarding government’s will and ability to honour the commitments undertaken when issuing paper money.

These considerations prompted Wray to state that “Smith’s views on money are quite similar to his own. However, it should be recalled that the quantity theory of money, even in Smith’s version, is only one of the possible formulations of chartalism and, perhaps, the least interesting. In fact, in this approach the most appealing implications get lost. In particular, fiat money is no more an endogenous aggregate whose amount is determined by the joint decisions of firms and banks, but an exogenous aggregate whose quantity is fixed by the government, which, in principle, is chiefly committed to keep its value stable. In sum, this version of chartalism ignores the most important consequence of bank credit, namely the chance it offers entrepreneurs to have access to economic resources without resorting to their own or other’s savings.

5.2.2. In conclusion, in Smith’s eyes money remains a technical means to facilitate the circulation of commodities and it never rises to the role of an essential instrument for production. What he does not succeed in identifying is the correct way of working of an economy in which resource management is assigned to private firms that make use of wage earners to carry out their productive activities. In such an economy firms, which provide the community with goods and services, must

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86 In particular, Sargent (1982) examines four episodes of hyperinflation which occurred during the 1920’s in Austria, Germany, Poland and Hungary.
87 Wray (1998, pp. 18-19, *passim*).
88 Cf. the passages relating to footnotes (75), (77), (78).
be put in a position to spend and, in particular, to pay wages before having cashed money through the sale of commodities. In drawing up and carrying out their projects they cannot be constrained – as Smith would like – by available savings, because in this case there would be a drastic retrenchment of economic undertakings and hence of the production of goods and services, which the welfare of the community depends on. This undesirable outcome is usually prevented by advancing to firms the means of payment created by the banking system, to be reimbursed once the productive processes are complete.

Smith refuses to conceive money as an instrument whereby firms and banks jointly exercise the power to decide the employment of economic resources while the consequences of their decisions fall upon society. For that reason he repeatedly attacks all economic operators, whether merchants, entrepreneurs or bankers, who by their unfair, imprudent or risky behavior are likely to waste the collective resources on hazardous undertakings instead of increasing them.

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