Vanity and the Daedalian Wings of Paper Money in Adam Smith

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George Stigler (1971) claimed that: 'it is uncomfortable to explain Smith's failure by the failure of everyone else, for he is a better man than everyone else' (214). Diverging from Stigler, the problem presented in this chapter is: how can we explain Smith's failure when others did not fail, for Smith is a better man than everyone else?

The failure by Smith diagnosed in this chapter is his lack of vision for the potential uses and/or misuses as policy instruments of paper money in general and of public credit in particular – vision that Smith's contemporaries did not lack. Paper money could be used not only as a cheaper substitute of metallic money, as Smith well realized, but also as a relatively cheaper policy tool to create more money and try to gain control over the economy. Public credit could be used not only to finance wars, as Smith observed, but also to try to fix and stimulate the economy, as some contemporaries known to him as well as many future economists would claim (See among others Albertone 1992, Friedman 1969, Humphrey 1993, 2004, Keynes 1936, Monroe 1966, Pribram 1983 Pocock 1985, Smithin 2003, Viner 1930.) And that paper money may cause hyperinflation, not just more or less beneficial inflation, is recognized among many others by Smith's friend, David Hume, but not by Smith. Why then does not Smith recognize the potential, either positive or negative, of using paper money as a policy instrument to gain control over the economy rather than just as a monetary instrument?

This chapter proposes a *possible* justification for Smith's silence, within the limitations generally associated with all explanations of silences. Smith's contemporaries (and successors) tend to use either benevolence or love of power to justify the positive or negative effects of using paper money as a policy instrument. Smith, on the other hand, considers neither love of power nor benevolence as fundamental motivational forces in human conduct in a commercial society. The downplaying of benevolence as a major motivational force suggests downplaying the possible use of paper money to stimulate the economy; and the downplaying of the love of power suggests downplaying the possible misuse of paper money that causes hyperinflation. A *commercial society* like the one Smith describes is based on forces such as self-centered vanity instead. And vanity, mediated through commerce and market forces, strips paper money of its negative as well as positive potential as a policy instrument: the analysis of paper money as a policy instrument becomes superfluous because money has no motivational basis to become a policy instrument. Money remains simply a unit of account, a means of exchange, and a credit instrument.

The chapter develops as follows. The first section presents a general overview of the eighteenth century debate on money, in which Smith does not participate. The second section presents Smith's analysis of the different forms of paper money. A brief account of his analysis of the benefits and the costs associated with paper money follows. The subsequent sections show how vanity, rather than love of power or benevolence, seems to motivate Smithian human beings, and how, in a commercial society based on self-interested vanity, public credit is neither a threat nor a blessing, as some of Smith's contemporaries thought.

Policy instrument: a new function of money

Before proceeding a clarification is due. While it is true that paper money, paper credit, and public credit are not necessarily equivalent, it is also true that in the eighteenth century these distinctions were not necessarily as well defined as they are today. They were often treated as synonymous.[1] In this chapter there is no attempt to modernize or correct the eighteenth century understanding of money, but simply to report it.

In the eighteenth century the State begins to have the achievement of public happiness as one of its objectives. The State has now the opportunity to be active in the betterment of society and of the economy.[2] The explicit claim of direct control over society, in one form or another, is accompanied by the search for appropriate tools. Money begins to show its potential for being one of these tools.

Money has two traditional functions: unit of account and medium of exchange. In the eighteenth century money debates, a third function is added: money can be a policy instrument to progress toward public happiness. Money could now become a policy instrument to promote economic growth and public happiness, and to pay for it. Paper money, especially when irredeemable, makes money a more malleable and controllable policy instrument than any commodity money. Paper money is generated by both private credit as well as public credit. Control over the economy is achieved by controlling either or, better, both.

Many eighteenth century authors begin their treatises on money declaring that the purpose of their work is to contribute to the achievement of public happiness. Something like this is typical: 'I have the Interest and Advancement of Trade (on which the Welfare and Happiness of Mankind so much depends) really at Heart' (Vanderlint [1734] 1970, dedication). The State is justified to expand its activities to include not only warfare but also welfare[3]: 'what I understand by political oeconomy . . . the object of the art . . . is, to provide food, other necessaries, and employment to every one of the society. . . . To provide a proper employment for all the members of a society is the same as to model and conduct every branch of their concerns' (Steuart [1767] 1966, 28).

Focusing on how to achieve public happiness helps in the analysis of different conceptions of the role of inflation. Traditionally inflation, via debasement, is generated simply to finance an increase in military expenditures. Indeed:

> I am very glad to pursue this matter somewhat further, so that an example will not be made of something that is not one. In the First Punic War the as, which was supposed to be of twelve ounces of copper, weighed only two, and in the Second Punic War, it weighed only one. This retrenching corresponds to what we today call expansion of the currency. . . . The [Roman] republic [inflated because it] was not in a position to pay its debt.
>
> (Montesquieu [1748] 1989, 413)

Debasement, or inflation, is in fact traditionally thought of only as a 'dirty trick' to get rid of debts that were too big to be paid otherwise. No intention to control, regulate, stabilize, fine-tune, or improve the economy is present: only paying off a very large debt. Indeed, calls for inflation are justified either as a backward-looking 'patch'[4] or as the result of vicious behaviors.[5] In Montesquieu's words: '*bad faith or need* makes them withdraw part of the metal from each piece of money, leaving it with the same name' (Montesquieu [1748] 1989, 400, emphasis added).

But in the eighteenth century, starting with John Law, among others, we see calls for inflation based on the idea that increasing the quantity of money would increase wealth and therefore the happiness of the people. Money becomes an important ally of the new order. Money, being required to pay for the re-creation or the improvement of the new social order, and, if controllable and active on the economy, becomes an important policy instrument to be used to construct progress and achieve happiness in a country. But if money has to be a fine-tuning instrument, using metals is not easy. The technology of debasing becomes too complicated and expensive, as shown in the debate on recoinage of the seventeenth century.[6] Paper, issued both through private credit channels and through public credit, is an easier and cheaper technology to produce a more malleable and controllable form of money that better fits its new role of promoter of new advantages, independently of the needs of financing wars.

This eighteenth century debate opens the door to the conception, development, and eventual acceptance of present-day fiat money. But, while most of Smith's contemporaries take part in this debate in one way or the other, Smith's voice is absent. Adam Smith has a meticulous account of money, but only in its traditional functions. Money for Smith is only a unit of account and a means of exchange, and public credit is only a form of paper money, useful to pay for expensive wars. Furthermore, not only is money not a policy instrument to Smith, but he does not even seem to consider it as a conceivable option for others, as he quickly dismisses those who think otherwise. Smith looks at the same phenomena as his contemporaries but sees different things.

What is paper money?

Smith describes the use of different kinds of money in detailed fashion. He has a meticulous account of paper money, which mirrors his contemporaries'. Smith's unique signature is present in his description of the origins of paper money and in his policy prescriptions. But let us start with a brief explanation of the different forms of paper money that Smith observes.

Smith claims that money is an instrument that facilitates trade, decreasing the transaction costs involved in barter (WN I.iv.2, 37–8). Money may take different forms in different times and places (WN I.iv.3–5, 38–9). Precious metals, such as gold and silver, are commonly used as money in the Western world, both within each country and among different countries. But the eighteenth century sees the increasing use of another kind of money: paper. Paper money takes various forms, two of the major forms being receipts and credit. Paper money could be issued, at different times, both privately, by individuals and banks, and by the government.

Paper money in the form of receipts takes place when receipts for bank deposits circulate as money (bank money), while the precious metals are safely kept in a bank. The circulating receipts are the claims on deposits. Banks issuing these papers, in theory, could either be banks with 100 percent reserves or with just fractional reserves. Banks with fractional reserves are banks that accept deposits, giving a paper claim on it to the depositor, and offer loans and lines of credit, lending out a part of the deposits received and therefore keeping only a fraction of their reserves. Borrowers pay interest on the loan, generating revenue for the bank. When the bank issues loans or credit, they could be in metal or in paper notes. Some notes go back to bankers for payment, while others keep circulating. According to Smith, bankers need only about 20 percent of gold as reserve for immediate demands, the economy running on a fifth of the gold and silver otherwise required (WN II.ii.29, 292–3). In practice, all the banks are fractional reserve banks, even if some, like the bank of Amsterdam, claim otherwise. Smith describes the practical difficulties of sustaining a 100 percent reserve: how could the Bank of Amsterdam operate with no revenue? His conclusion is that what the bank claims in words is not present in the facts (WN II.ii.104, 328). On the other hand, other thinkers, such as David Hume, propose an alternative view. Hume, who thinks 100 percent reserve banks are the only acceptable banks, also understands the operational problem of banks with no revenue. But he suggests the introduction of government subsidies to maintain the operations of the banks as a possible way to keep the banks in business (Hume, *Essays*, 285).

Credit takes different forms. It could be backed with collateral (cash accounts) – 'melting' non-liquid assets – or it could be backed not by tangible goods but by the creditworthiness granted to men 'of credit'. The guarantee might come from the creditor's good reputation or from other people's good words vouching for his good reputation. Credit could be granted to individuals or companies, as well as to the government. Public credit is indeed the credit granted to the government, which could also be either backed or unbacked. Backed public credit usually consists of mortgaging future tax revenue. Unbacked credit could be granted on the basis of trust in the current government. The duration of the debt might vary. It might be short-term – with a fund that would allow paying back the interest and the principal – or 'for perpetuity' – with a fund large enough to pay only the interest (WN V.iii.12, 912).

Finally, notes may be traded at a discount if their real value is less than their nominal value, usually due to a decrease in trust in the issuer or due to over-issuing. They could be traded with *agio*, that is, notes may be traded at more than their nominal value because of the extra security offered by a well respected bank (WN II.ii.104, 328).

Benefits of paper money

But why are England, and Europe in general, developing these different forms of money? Are not gold and silver good enough monies?

Smith claims that, with the development of commerce, paper money develops as a cheaper form of money. (For an account of Smith's theory of banking see Gherity 1994.) He describes the benefits of private paper credit in a commercial society in Book II, and the benefits of public paper credit in a commercial society in Book V.

In a commercial society, using gold and silver as domestic currency has a high opportunity cost. Gold and silver in their monetary forms can be used either domestically as currency or can be sent abroad to buy cheaper consumption or investment goods. Given the opportunity to use precious metals, it is natural to observe the emergence of substitutes like paper to be used as domestic currency while the precious metals are sent abroad (WN II.ii.26, 292). Smith indeed explains that money is not part of the revenue of a country, but, due to its function as means of exchange, it is the 'great wheel' on which revenue and goods circulate in society (WN II.ii.14, 289, and WN II.ii.23, 291).

Echoing Hume, Smith considers demand for money constant, given a certain level of economic activity: if money supply is increased via paper, 'whatever is poured into it beyond this sum cannot run in it [in the economy], but must overflow . . . it will, therefore, be sent abroad, in order to seek that profitable employment which it cannot find at home. But the paper 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' (WN II.ii.30, 293) to buy goods and bring home profits (WN II.ii.31–2, 294). When paper substitutes for gold, gold increases funds for maintenance of industry, the quantity of that industry, and the annual product of land and labor. Therefore, wherever cash accounts are used 'every merchant can, without imprudence, carry on a greater trade than he otherwise could' (WN II.ii.46, 299–300).

Smith explains further that using paper rather than gold frees gold from unproductive uses by the following suggestive image of paper money as an aerial highway that frees fertile ground for more productive uses:

> It is not by 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 . . . The part of his capital which a dealer is obliged to keep by him unemployed, and in ready money for answering occasional demands, is so much dead stock, which . . . produces nothing either to him or his country. The judicious operations of banking enable him to convert this dead stock into active and productive stock . . . The judicious operations of banking, by substituting paper in the room of a great part of this gold and silver, enables the country to convert a great part of this dead stock into active and productive stock . . . The gold and silver money which circulated in any country may very properly be compared to a highway, which, while it circulates and carries to market all the grass and corn of the country, produces itself not a single pile of either. The judicious operations of banking, by proving, if I may be allowed so violent a metaphor, a sort of wagon-way through the air; enable the country to convert, as it were, a great part of its highways into good pastures and corn fields, and thereby to increase very considerably the annual produce of its land and labour.
>
> (WN, II.ii.86, 320–1)

When the increase in commerce renders metals expensive as domestic currency, metals will leave an opening for paper, seeking cheaper (more productive) employments. With some caveats to be presented later in this work, paper money is therefore a beneficial consequence of the increased commerce in a commercial society.

In the form of public credit, paper money allows smoothing revenue collection over time, which is useful especially in the case of wars:

> By means of borrowing they are enabled, with a very moderate increase of taxes, to raise, from year to year, money sufficient for carrying on the war, and by the practice of perpetual funding they are enabled, with the smallest possible increase of taxes, to raise annually the largest possible sum of money.
>
> (WN V.iii.37, 919–20)

For the purposes of this chapter, the most interesting part of Smith's account of the benefits of paper money is what Smith does *not* mention. The eighteenth century experiences the first calls to try to manipulate the money supply to stimulate the economy, mostly through easing or tightening private and public credit. Some of these calls were less sophisticated than others. But Smith does not seem to pay much attention either to this potential or to those who claim its relevance.

In the eighteenth century a (not very sophisticated) way to justify money creation is the attempt to fight poverty. Poverty is associated with the lack of money. A way to claim to be fighting poverty is to generate money, something more easily done with paper[7] than with precious metals. (See, for example, Vanderlint [1734] 1970.) Another way to justify money creation is to claim that

> public incumbrances are advantageous, independent of the necessity of contracting them; that any state, even though it were not pressed by a foreign enemy, could not possibly have embraced a wiser expedient for promoting commerce and riches, than to create funds, and debts, and taxes, without limitation.
>
> (Hume, *Essays*, 352; critical of this view)

Money and riches tend to go hand in hand just like lack of money and poverty tend to be observed at the same time. The traditional understanding, to which Smith subscribes, sees wealth generating money, and poverty lack of money. The competing view that makes its way through the eighteenth century reverses the direction of causation, or, according to Hume, it 'mistake[s], as is too usual, a collateral effect for a cause' (Hume, *Essays*, 290). The mechanisms through which an increase in money supply 'quickens' industry are not always clear. Sometimes they are recognized as mysterious, as for example by Isaac de Pinto ([1774] 1969) who claims that 'Circulation and credit are two springs, the play of which is not thoroughly understood' (115). Sometimes they simply sound alchemistic, such as Berkeley's query No. '233. Whether the credit of the public funds be not a mine of gold to England; and whether any step that should lessen this credit, ought not to be dreaded?' (Berkeley [1735] 1979), or de Pinto's explicit reference to magic: 'This mass of wealth has been successively produced with the same specie, by the magic of credit and circulation' (de Pinto [1774] 1969, 20).[8] Nevertheless, many think, 'The more notes the Banks can circulate . . . the more will industry and trade be promoted. Nor can there be any limit' (Wallace [1734] 1969, 19). Smith remains silent instead. His only words[9] are his comments (or lack of thereof) on John Law's 'visionary project', which is dismissed simply as 'the most *extravagant* project both of banking and stock-jobbing that, perhaps, the world ever saw' (WN II.ii.78, 317, emphasis added).

Costs of paper money

Just as Smith deals with some of the common benefits (real or perceived) of paper money, but not all of them, he deals with some of the common costs (real or perceived) of paper money, but not with all of them. Smith tells us that the costs of paper money in a commercial society are associated with the tendency of over-issuing paper money. He does not tell us that using paper money to stimulate the economy can cause hyperinflation. For Smith, creditors tend to like promissory notes more than loans in precious metals because they free idle capital, and because they could pay back a little at a time. The interest on the notes is revenue to the bank. The more notes issued, the more interest collected, the more revenue generated, and most likely, the higher the profits for the bank. And, if banks discount bills of exchange with promissory notes, they could make more profit than with gold (WN II.ii.43, 298–9). Creditors, therefore, are tempted to ask for over-issuing of credit, and banks are tempted to over-issue credit.

In addition, 'over-trading of some bold projectors . . . was the original cause of this excessive circulation of paper money' (WN II.ii.57, 304). Because of their high profits, certain commercial activities attract merchants' attention. Merchants ask for money to participate in these profitable trades. But as more and more merchants enter these markets, profits are eaten away (over-trading) and with them the resources to pay the banks back (over-issuing).

Furthermore, banks should lend 'that part of it [capital] only, which he would otherwise be obliged to keep by him unemployed, and in ready money for answering occasional demands' (WN II.ii.58, 304). 'Fixed capital' pays back only after many years: too much time for a bank. The capital that could be repaid only after years should therefore not be borrowed through banks, but through mortgages and/or bonds from private people (WN II.ii.64, 307). But, when wise banks reject a credit extension, traders use 'shift of drawing and redrawing' to raise the money used to over-trade (WN II.ii.65, 308).

And because, according to Smith, paper and metallic money are substitutes in the domestic market, over-issuing paper generates an oversupply of money. But paper and metals are not substitutes in international markets, as paper cannot be sent abroad. The domestic quantity of money would return to its natural level by reconverting paper into gold and silver, and sending the precious metals abroad. Banks, therefore, have to be ready to convert paper into gold and silver at all times. If they over-issue, they might not be as ready. And if they signal hesitation or difficulties, they might generate bank runs (WN II.ii.48, 300–1).

This intrinsic instability and potential for runs caused Smith to say:

> The commerce and industry of the country, however, it must be acknowledged, though they may be somewhat augmented, cannot be altogether so secure, when they are thus as it were, suspended upon the Daedalian wings of paper money, as when they travel about upon the solid ground of gold and silver.
>
> (WN II.ii.86, 320–1)

As far as costs associated with public credit, Smith seems to believe that public debt may be abundantly issued because paper credit 'is always an obvious and easy expedient for getting out of the present difficulty' (WN V.iii.40, 920–1), the present difficulties being the cost of wars. For Smith, the danger of using public credit is therefore not over-issuing, but the decrease in the cost of wars, which may increase their length (WN V.iii.50, 926).

Smith's apparent lack of concern about the possible over-issuing of public credit 'independent[ly] of the necessity of contracting [it] . . . even though [a state] were not pressed by a foreign enemy', as Hume said, is puzzling, especially in light of the famous attacks his friend Hume makes against public credit ('[E]ither the nation must destroy public credit, or public credit will destroy the nation' (Hume, *Essays*, 360–1)). Hume claims that an economic collapse is near as money manipulations are raising prices. Smith simply and quickly dismisses the higher prices to which Hume refers as due 'probably, to the badness of the seasons' (WN II.2.96, 324).

So, why does Smith seem to close his eyes to what others considered positive as well as negative potentials of paper money?

Blinding vanity

A possible explanation for why Smith seems to stop short in his analysis of paper money may be that his project is to analyze the potential of *commercial* society. As shown below, most of the reflections of Smith's contemporaries base the potential of paper money either on the assumption of benevolence or on the assumption of desire for power. On the other hand, for Smith, in a *commercial* society the most relevant force in its different expressions is a self-interested vanity, not benevolence and not power. Smith may be able to dismiss some theoretical and/or practical effects of paper money as not relevant for an apparatus built on vanity and commerce such as his.

Those who advocate the benefits of increasing money supply (by increasing money to stimulate the economy) generally justify their claims as motivated by what today we call the 'benevolent dictator' assumption:[10] the sovereign wants to act upon the economy because he is moved by benevolence, by genuine care for the well-being of society. So, for example, Bishop Berkeley ([1735] 1979) claims not only that the State should encourage the industry of its members (query 3) but also asks in query No.:

> 346. Whether, therefore, a legislator should be content with a vulgar share of knowledge? Whether he should not be a person of reflexion and thought, who hath made his study to understand the true nature and interest of mankind, how to guide men's humours and passions, how to incite their active powers, how to make their several talents co-operate to the mutual benefit of each other, and the general good of the whole?

The idea of the 'benevolent dictator' is restated, among others, by Sir James Steuart when he combines the interests of the individuals and the interest of the public in the interest of sovereign and says: 'Virtue and justice, when applied to government, mean no more than a tender affection for the whole society, and an exact and impartial regard for the interest of every class' (Book 1, 20).

On the other hand, those who emphasize the perniciousness of paper money, and of its increases, tend to see knavery and desire for power as the motivation for action of the sovereign (for example, Hume, *Essays*). (For an account of knavery in Hume see Farrant and Paganelli 2005.)

Benevolence and love of power may not necessarily be considered as major forces driving human conduct. If they are not, the theories based on them may be quickly dismissed as 'extravagances' or, at worst, short-term problems. And this seems to be what Smith does. To understand this claim, let us walk though Smith's system.

Let us take as a starting point the view that TMS and WN are to be read together and are not in contradiction with each other. One of the most convincing accounts of this view comes from James Otteson (2002). Otteson describes the moral system of TMS as similar to the market system of WN. This communality is based on the fact that the Smithian man is a man hard-wired to desire the attention and approbation of others. The same self-interest (or desire for approbation) that drives every man to better his material conditions drives every man to better his moral conditions.

> From whence, then, arises that emulation which runs through all the different ranks of men, and what are the advantages which we propose by that great purpose of human life which we call *bettering our*

> *condition*? To be observed, to be attended to, to be taken notice of with sympathy, complacency, and approbation, are all the advantages which we can propose to derive from it. It is the *vanity*, not the ease, or the pleasure, which interests us. But *vanity* is always founded upon the belief of our being the object of attention and approbation.
>
> (TMS I.iii.2.1, 50, emphasis added)

Similarly, man's moral development depends on the presence of the impartial spectator, whose approbation human vanity wants:

> We endeavour to examine our own conduct as we imagine any other fair and impartial spectator would examine it. If upon placing ourselves in his situation, we thoroughly enter into all the passions and motives which influence it, we approve of it, by sympathy with the approbation of this supposed equitable judge.
>
> (TMS III.i.2, 110)[11]

The entire Smithian apparatus seems therefore to revolve (or collapse?) around the innate human vain desire to attract the attention of other people.[12] The desire of power boils down to vanity, and public benevolence boils down to vanity as well. The desire to pursue 'power and preheminence . . . [is motivated by the same human desire] to be observed, to be attended to, to be taken notice of with sympathy, complacency, and approbation . . . It is the vanity . . . which interest us' (TMS I.iii.2.1, 50). The alleged 'public benevolence' of the sovereign boils down to 'his own interest, his own vanity, the interest and vanity of many of his friends and companions' (TMS VI.ii.2.6, 230; Cf. TMS VI.ii.2.16, 233). In the Smithian system, we are left with only vanity. (On the importance of vanity in Smith, see also Lerner 1999 and Schliesser 2003.)

The analysis of the origins of both private and public paper credit confirms that vanity is the force at its base. In fact, the development of private paper money is linked to human vanity because paper money is an instrument that facilitates commerce. As we just saw, commerce is the instrument through which a man fulfills his hard-wired desire to 'better his condition', which in its turn, Smith claims, is a function of the hard-wired human vanity which is at the very base of all human actions. Furthermore, even the development of public credit is linked to vanity, as dealt with in Book V of the WN.

Smith's most interesting, albeit less explored, characterization of the origins of paper money comes from Book V, where he deals with public credit. There, Smith presents the common explanation that public credit is a product of war financing: 'The want of parsimony in time of peace, imposes the necessity of contracting debt in time of war. When war comes, there is no money in the treasury but what is necessary for carrying on the ordinary expence of the peace establishment' (WN V.iii.4, 909).

What is interesting for our purposes is the reason for 'the want of parsimony in time of peace'. The 'want of parsimony' is, for Smith, caused by the presence of commerce. In non-commercial societies, tastes are unrefined, and luxuries and useless trinkets basically unknown. The natural and unavoidable human vanity and the human desire for ostentation are therefore much constrained:

> The same disposition to save and to hoard prevailed in the sovereign, as well as in the subjects. Among the nations to whom commerce and manufactures are little known, the sovereign, it has already been observed in the fourth book, is in a situation which naturally disposes him to the parsimony requisite for accumulation. In that situation the expence even of a sovereign cannot be directed by that vanity which delights in the gaudy finery of a court. The ignorance of the times affords but few of the trinkets in which that finery consists.
>
> (WN V.iii.2, 908)

The wealth that accompanies commerce allows vanity to bring extravagances so that

> In a commercial country abounding with every sort of expensive luxury, the sovereign, in the same manner as almost all the great proprietors in his dominions, naturally spends a great part of his revenue in purchasing those luxuries. His own and the neighbouring countries supply him abundantly with all the costly trinkets which compose the splendid, but insignificant pageantry of a court.
>
> (WN V.iii.3, 909)

If Smith's account of the origins of paper money could be given in a nutshell, with all the limitations of such brevity, it would go more or less as follows: vanity generates paper money thanks to the development of commerce. The more *commercial* a society is, the more vanity is freed from constraints, the more money is spent on unproductive trinkets, the less cash is left, the more credit and paper is needed. Smith is indeed exploring the potential of (building?) a tight commercial society. To Smith benevolence and love of power are not commercial motivations, but vanity is. Benevolence and love of power do not enter in Smith's commercial picture and as a consequence neither do the sub-systems built on them. On the other hand, for Smith vanity is a driving force of commerce and the sub-systems that he describes are based on it.

Cost–benefit analysis

A commercial society may be a feasible society for Smith, as it possesses not only the seeds for development and prosperity (vanity), but also the mechanisms to persist (mostly[13] free markets). A commercial society generates wealth, in part, through the natural introduction of credit. But, as we saw, paper money may threaten a commercial society because of its intrinsic instability associated with over-issuing. But this instability may not be irremovable, as its cause may eventually be removed. And the processes through which instabilities are removed seem to be built into paper money itself.

Smith implies that neither merchants nor banks should over-issue as it may bring all into bankruptcy. But Smith's recriminations do not prevent banks from over-issuing (WN II.ii.41–87, 297–320). The reason for over-issuing is, for Smith, ignorance – banks do not always understand what is best for them (WN II.ii.53, 302). Indeed, he reiterates more than once, 'every particular banking company has not always understood or attended to its own particular interest, and the circulation has frequently been over-stocked with paper-money' (WN II.2.56, 303).

The ignorance of banks shows in different ways. First, banks fail to understand that paper should be issued only to replace idle reserve money, not to fund entire projects (WN II.ii.71, 311). Projectors fool banks when traders draw and redraw upon one another. If they do it from the same bank, the bank will realize what is going on. But traders use different banks, and may add more projectors in the circle. Distinguishing between a real bill of exchange and a fraudulent one becomes more difficult. And when a banker realizes he is discounting fake bills, it is too late (WN II.ii.72, 311–12). Finally, banks also tend to overestimate the inflow of money and underestimate their outflow (WN II.ii.76, 315–16).

Fortunately, 'nature' takes care of it, as competitive markets are generally good schools.[14] If a bank that had over-issued tried to fulfill its promises to convert paper into metal upon demand, it would face an outflow of precious metal larger than its inflow. The acquisition of precious metals to fulfill its demand might quickly become very expensive. It is therefore in the bank's interest not to over-issue, because what it would gain, if not more, it would have to spend to keep its coffers ready. And the bank, losing profits, would decrease the amount of issuing (WN II.ii.49–51, 301–2).

Moreover, competition among banks brings an additional check on issuing too much paper. And if something goes wrong, the damage is more limited. (For a general account of decentralized systems in Smith, see Paganelli 2005.)

> The late multiplication of banking companies in both part of the United Kingdom, an event by which many people have been much alarmed, instead of diminishing, increases the security of the publick. It obliges all of them to be more circumspect in their conduct, and, by not extending their currency beyond its due proportion to their cash, to guard themselves against those malicious runs, which the rivalship

> of so many competitors is always ready to bring upon them. It restrains the circulation of each particular company within a narrower circle, and reduces their circulating notes to a smaller number. By dividing the whole circulation into a greater number of parts, the failure of any one company, an accident which, in the course of things, must sometimes happen, becomes of less consequence to the publick.
>
> (WN II.ii.106, 329)

Ignorance is therefore a curable disease for Smith. Once banks understand what they have 'not always understood' banks will not over-issue. And because every man is driven by his desire to better his condition, there is no reason to believe that banks will forever 'not attend to [their] own particular interest'. To a potential destructive force there is therefore a market antidote. The instability seen in the past does not have to persist in the future.[15]

Similarly, the problems associated with public credit are not really problems. First, longer wars due to their decreased immediate cost may not always be a cost to all, as some people may enjoy the longer length (WN V.iii.37, 919). To Smith the real problem seems to be over-expenditure by the government, rather than the credit issued to pay for it. The problem seems to be war,[16] not paper money. WN concludes by recommending to Great Britain a 'diminution of her expenditure . . . [as] it is surely time that Great Britain should free herself from the expence of defending those provinces in times of war, and of supporting any part of their civil or military establishments in time of peace' (WN V.iii.92, 946).

The fact that public credit is not a problem for Smith is confirmed by the explicit reference that in a commercial society debts are usually mitigated by the prosperity commerce generates. So Smith reassures:

> The same commercial state of society which, by the operation of moral causes, brings government in this manner into the necessity of borrowing, produces in the subjects both an ability and an inclination to lend. If it commonly brings along the necessity of borrowing, it likewise brings along with it the facility of doing so.
>
> (WN V.iii.5, 910)[17]

An additional constraint on possible abuses of paper money, which is actually an additional benefit of the introduction of paper money, is the development of an ethical system and of a system of justice, or at least of a system that uses credit as a signal of virtue. Smith echoes Wallace, among others, when he realized that 'None will give credit but to men of integrity, prudence, and activity, or to men of substance. Here then are natural checks and limits, beyond which credit will not be extended' (Wallace [1734] 1969, 28). Chiara Baroni (2002) superbly presents how

Smith sees credit as an instrument to develop a 'man of credit', a virtuous man to whom it is worth lending. And, similarly, at the government level, as Wallace claims, 'WHEN a free government is able to contract great debts by borrowing from its subjects, this is a certain sign, that it has gained the confidence of the people' (Wallace [1734] 1969, 53), so Smith states that a government that is able to have credit is a just government – a government that is trusted with the use of private property:

> Commerce and manufactures, in short, can seldom flourish in any state in which there is not a certain degree of confidence in the justice of government. The same confidence which disposes great merchants and manufactures, upon ordinary occasions, to trust their property to the protection of a particular government; disposes them, upon extraordinary occasions, to trust that government with the use of their property . . . The security which it grants to the original creditor, is made transferable to any other creditor, and, from the universal confidence in the justice of the state, generally sells in the market for more than was originally paid for it.
>
> (WN V.iii.7, 910; see also Rosenberg 1990)

The commercial society that Smith analyzes (or proposes?) is therefore a sound society. It requires vanity to generate it and markets to sustain it. Paper money is an example of one of the sub-systems that contribute to its subsistence and development (cf. Skaggs 1999). Vanity is at the base of a commercial society that generates, among other things, paper money. The limitations that paper money generate may be corrected by commerce itself. Not much more is needed.

Conclusion

During the eighteenth century the introduction of paper money in the form of paper credit begins to flourish. Its functioning is described by many, including Smith. Its potential as a policy instrument is a topic of debate for many, but not for Smith.

The expansionary monetary policies associated with the positive effects of paper money are usually rooted in benevolent motivations. The fears of monetary expansion associated with paper money are usually rooted in the fear of the love of power. Smith is aware of the claims that paper money may be the instrument that solves a country's economic problems, as benevolent leaders will use it wisely. Indeed, he is aware of the attempts to use paper money to solve a country's problems such as the scheme developed by John Law. He is also aware of the claims that paper money may be the instrument of a country's destruction, as knavish leaders will use it to increase their power. Indeed, he is aware that the then high prices may be the first symptom of the pending destruction, as argued by

David Hume. But Smith simply and quickly dismisses Law's scheme as 'extravagant' and Hume's high prices as due to 'bad weather' rather than a sign of the pending catastrophe caused by paper money. Using money as a policy instrument does not seem to be part of Smith's view of the world.

This chapter claims that what looks like Smith's lack of vision for using paper money as a policy instrument to stimulate the economy is due to his focus on understanding a purely commercial society. In a commercial society like the one Smith describes, not only is there little need for government, but there is also little need for love of power and for benevolence. Smith seems to imply that a world in which power is the predominant motivation of human action is a world of force; on the other hand, considering benevolence as the predominant motivation would describe a world of angels. A commercial world, however, has a different motivational force at its base. For Smith, this motivational force is vanity. The absence of the accounts of positive and negative potential of manipulating paper money in Smith's works may imply that only human vanity is (or should be?) necessary to have a functioning, prosperous, and moral society based on commerce.

Notes

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1 See for example Hume (*Essays*, 355) 'Public stocks, being a kind of paper-credit, have all the disadvantages attending that species of money. They banish gold and silver from the most considerable commerce of the state, reduce them to common circulation, and by that means render all provisions and labour dearer than otherwise they would be.'

2 The possible reasons for this development in the role of the State are outside the scope of this chapter; its presence is simply accepted.

3 'Such members of the society as remain unemployed, either from natural infirmities or misfortunes, and who thereby become a load upon others, are really a load upon the state. This is a disease which must be endured. There is no body, no thing, without diseases. A state should provide retreats of all sorts, for the different conditions of her decayed inhabitants: humanity, good, policy, and christianity, require it' (Steuart [1767] 1966: 73). Or: '59 Whether to provide plentifully for the poor be not feeding the root, the substance whereof will shoot upwards into the branches, and cause the top to flourish?' Berkeley, Query 59; '158 When the root yieldeth insufficient nourishment, whether men do not top the tree to make the lower branches thrive?' (Berkeley [1735] 1979: Query 158)

4 'Bankruptcy is, without any question, superior to new excises. It is easier and more expedient. . . . But bankruptcy is too sudden and strikes too impetuously. Worse still, it strikes the people around the prince, the most powerful people, from whom tumult and rebellion are to be feared; it slashes his faith with hideous scars, thus weakening it. Augmentation of the currency had the same effect as bankruptcy, but the harm from it is slower to come and is distributed over everyone as it fails' (Galiani [1751] 1977, 188).

5 '. . . augmentation of the currency arises from the fact that it has rarely been undertaken in order to satisfy the true needs of a virtuous prince. It has almost always been due to greed or to false counsel of only apparent utility' (Galiani [1751] 1977, 168).

6 See for example Bishop Berkeley [1735] 1979, who, while disliking gold and silver money (Query 42–3, 283–7), promotes paper money as an instrument to achieve public happiness (Query 224, 288–9).

7 See, among the examples, the requests to print more money during the French Revolution (Albertone 1992).

8 The tradition to see commercial and monetary activities somehow magical is long. See, for example Jonson 1987.

9 There is a reference, again quickly dismissive, to Sir Robert Walpole's policy proposal in the student notes to Smith's Lectures on Jurisprudence where Smith claims that 'Sir Robert Walpole endeavoured to shew that the public debt was no inconvenience, tho' it is to be supposed that a man of his abilities saw the contrary himself' (LJ, 515).

10 A 'dictator' is a single decision maker, a person (legal or real) with sovereign decision power. An assembly as well as a monarch may be 'dictator'. Usually, a 'dictator' contrasts a decisional structure based on a plurality of centers. 'Benevolent' means that the 'dictator' is public-spirited, not self-interested. A 'benevolent dictator' will always do only what is best for society, and not what is best for himself.

11 The desire of praiseworthiness is the desire to gain the approbation of the impartial spectator by emulation, once our man within has become impartial. 'Emulation, the anxious desire that we ourselves should excel, is originally founded in our admiration of the excellence of others. Neither can we be satisfied by being merely admired for what other people are admired. We must at least believe ourselves to be admirable for what they are admirable. But in order to attain this satisfaction, we must become the impartial spectators of our own character and conduct. We must endeavour to view them with the eyes of other people, or as other people are likely to view them. When seen in this light, if they appear to us as we wish, we are happy and contented. But it greatly confirms this happiness and contentment when we find that other people, viewing them with those very eyes with which we, in imagination only, were endeavoring to view them, see them precisely in the same light in which we ourselves had seen them. Their approbation necessarily confirms our own self-approbation' (TMS III.2.3, 114).

12 Smith's use of vanity in TMS is not always clear-cut. He usually uses the idea of vanity simply as the desire to attract someone else's attention toward oneself, and to receive approbation. The other, whose attention and approbation one wants, is both the man without as well as the man within. Later in TMS, in particular when he describes different systems of moral philosophy, Smith uses the idea of vanity differently. Smith criticizes Mandeville because he is unable to distinguish between one's desire to be the object of approbation of a real spectator and of the impartial spectator. Here Smith defines vanity as the desire to be approved of even if undeservedly. The vanity to which I am referring in this chapter is the former and not the latter.

13 Smith's reliance on markets is not complete. He is well aware of possible market failure, and he is willing to have government intervene in such situations. See Viner (1991) and Stigler (1971). See also Arnon (1999), Carlson (1999), and West (1997).

14 For an account of the history of free banking in England see White (1995). For a modern version of it see Cowen and Croszner (1994).

15 Cf. Hume (*Essays*, 363): 'So great dupes are the generality of mankind, that,

notwithstanding such a violent shock to public credit, as a voluntary bankruptcy in ENGLAND would occasion, it would not be long ere credit would again revive in as flourishing a condition as before. . . . And though men are commonly more governed by what they have seen, than by what they foresee, with whatever certainty; yet promises, protestations, fair appearances, with the allurement of present interest, have such powerful influence as few are able to resist. Mankind are, in all ages, caught by the same baits: the same tricks, played over and over again, still trepan them.'

16 For an excellent account of Smith's aversion for war see Fleischacker (2004). On the role of a standing army in Smith see Montes (2004).

17 'It is much better to keep far on the safe side, and never to stretch the public credit. But, certainly, the limits for such a rich commercial nation as Britain, extended farther than many have imagined' Wallace ([1734] 1969), 50–1.

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