

**Letter****Letter: How Hume's model defined gold standard era**

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A statue of David Hume. The philosopher presented his famous model of the 'price-specie flow mechanism' in 1752 © Jeff J Mitchell/Getty

**YESTERDAY**

In his insightful Alphaville piece ([FT.com](https://www.ft.com), June 7) Michael Pettis argues for the “unprecedented” role of the US dollar relative to sterling in the gold standard era. Yet, two things are also important to highlight with regard to the period before the first world war.

First, the theoretical background of the gold standard. In 1752, David Hume presented his famous model of the “price-specie flow mechanism”, depicting an automatic mechanism, under which a monetary regime could eliminate imbalances in the balance of payments between two countries.

According to Hume's model, a deficit country must pay for the excess import of goods using the currency of the surplus country. This means that according to the monetary arrangements of the gold standard system, gold will be transferred via their central banks from the deficit country to the surplus country, thus reducing the money supply and the general price level in the former, improving its relative competitiveness, and increasing its exports as opposed to imports; this will finally rebalance the payments of the deficit country versus the surplus country.

Hume's model remains the dominant conceptual approach in economic thought regarding the gold standard.

Second is the dominance of the Bank of England during the prewar period — eloquently expressed by Keynes, who describes it as the “conductor of the international orchestra”.

In the absence of an American central bank — the Federal Reserve was only created in 1913 — the role of the dollar in the international monetary system was limited, as for central banks and governments alike the British pound provided the same collateral as gold. In fact, the dollar's ranking among world currencies, on the eve of the first world war, testifies to the fact that the absence of a central bank harmed the American currency, despite the US being the largest economy in the world. As Barry Eichengreen puts it in *Exorbitant Privilege*, not only the French franc, the Deutschemark, the Swiss franc and the Dutch guilder, but also the Italian lire, the Belgian franc and the Austrian schilling all ranked higher than the US dollar.

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