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Banking and the State

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Abstract
This is an introductory essay to a symposium on the monetary and banking systems and their relation to the state. The essay briefly summarizes the three papers. It links the arguments of the papers, one of which is itself a historical piece, to ones extending back to the eighteenth century. Classical political economists were suspicious of fiat currency because of the historical record of debasement and resulting inflation. In the nineteenth century, writers searched for sound money, which was typically commodity money. In the twentieth and twenty-first centuries, economists search for a monetary constitution.

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I. Introduction

The three papers in this symposium were originally presented at a session at the 2013 APEE meetings, titled "Banking and the State: Is Divorce Possible?" It was inspired by discussions at a September 2013 Liberty Fund colloquium, "Central Banking, Free Banking, and the Gold Standard." Along with slavery and the tariff, the monetary system was one of the major, contentious political issues of nineteenth-century America. The authors together cover both the monetary and banking parts along with the financial system more broadly.

The Hamiltonian and Federalist impulse was to craft a national economic policy in which a national bank would support national economic endeavors (especially the promotion of manufacturing).

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The Jeffersonians and later the Jacksonians preferred a more laissez-faire approach to economic development. They also opposed a national bank. Twice the Hamiltonians maneuvered to create a national bank (The First and Second Banks of the United States), and twice their opponents euthanized it by denying renewal of its charter. "Divorce" between banking and the state was their goal.

At the 2013 APEE meetings, I asked whether divorce would be possible again.

Hans Eicholz introduces us to some of the history. He captures the *Weltanschauung* of Hamilton and his followers. Hamilton's "efforts moved exactly contrary to the core contribution of Adam Smith" (Eicholz 2014, p. 43). That contribution was the recognition of the invisible hand and the spontaneous order it produced. Hamilton favored "the time-honored rules of mercantile policies" like protective tariffs for manufactures (Eicholz 2014, p. 45).

Eicholz presents an interesting twist on intellectual history. As he observes, we are accustomed to being told of German intellectual influences on America. What Eicholz details, however, is how Hamilton's ideas migrated to Germany and became embedded in the German Historical School. Then the ideas migrated back to America. Today, intellectual inheritors of the German Historical School have discovered a kindred spirit in Alexander Hamilton. "Hamilton's ideas had come home to interpret Hamilton" (Eicholz 2014, p. 55). The article contributes to our understanding of Hamilton and the migration of ideas. It also neatly sets up the topic of the symposium.

Mark Calabria examines "whether a free-market, or even a less-regulated, banking system is feasible within the United States" (Calabria 2014, p. 11). To do this, he looks at economic and financial freedom globally. He employs the indices of economic and political freedom for his empirical measures. Not surprisingly, he finds a high correlation between a broad measure of business freedom and one of financial freedom (Calabria 2014, p. 12), so countries with an ideology of freedom are more likely to have less-regulated financial institutions. Still, he observes that "banking does appear special, at least in terms of its relationship to government" (Calabria 2014, p. 13). The ghost of Hamilton stalks the world. He observes that the trend globally is for more regulation of financial services: think of the Dodd-Frank Act in the United States. Calabria ends on a cautiously optimistic note, however.

Thomas Cargill summarizes the state's role in money. "The State from the beginning has assumed some role in the financial and monetary regime, but from the beginning of the twentieth century to the present, the State's influence has rapidly increased," he writes (Cargill 2014, pp. 29–30). The State's increasing role in the financial system results in "an inefficient allocation of capital over time" and "financial and economic crises" (Cargill 2014, p. 30). Market failures exist, which in principle, might justify state intervention. But, empirically, "any role of market failure pales in comparison to the role of State policy failure in the monetary and financial regime" (Cargill 2014, p. 33). Federal Reserve policy resulting in inflationary episodes has resulted in multiple financial crises. Monetary and regulatory policies interact in housing markets so as to cause crises. (Cargill 2014, p. 35) "Divorce is not in the future" (Cargill 2014, p. 38). He places some hope in education to constrain state intervention in financial services.

II. Sound Money

The three papers are a continuation of debates begun in the eighteenth century, intensifying in the nineteenth century, and continuing into the twentieth century. That is most evident in Eicholz, but is also true of Calabria and Cargill. Calabria analyzes financial freedom. In the eighteenth and nineteenth century, a debate raged over free banking versus central banking, and the extent of banking regulation (Smith 1936; White 1984).

The idea of sound money arose in the nineteenth century (Hepburn 1903). It was a term of art, associated with a number of institutions and policies. Commodity money was typically seen as sound money.

The term is often used today without being defined precisely. In *Human Action,* Mises (1966, p. 782) equates sound money with a classical commodity standard.

> The principle of soundness meant that the standard coins—i.e., those to which unlimited legal tender power was assigned by the laws—should be properly assayed and stamped bars of bullion coined in such a way as to make the detection of clipping, abrasion, and counterfeiting easy. To the government's stamp no function was attributed other than to certify the weight and fineness of the metal contained.

Mises's characterization of sound money is legalistic, but later in the paragraph he repeats his long-held view that the gold standard came about spontaneously and "without intergovernmental treaties and institutions." Mises's position on sound money is in the tradition of nineteenth century liberalism.

III. The Political Economy of Money

In his 1952 epilogue to *The Theory of Money and Credit,* Mises devoted a chapter to "The Classical Idea of Sound Money." There he portrays sound money as an integral part of a wider liberal program. For that program, Mises (1952, pp. 413–14) characterized the main political problem as "how to prevent the rulers from becoming despots and enslaving the citizenry." Mises (1952, p. 414) argued that "the idea of sound money . . . was devised as an instrument for the preservation of civil liberties against despotic inroads on the part of governments."

For Mises (1952, p. 414), sound money is as much a political institution as an economic one. "Ideologically it belongs in the same class with political constitutions and bills of rights. The demand for constitutional guarantees and for bills of rights was a reaction against arbitrary rule and non-observance of old customs by kings."

Mises continues to de-emphasize the purely economic aspect of sound money. "The sound-money principle was not so much derived from the Classical economists' analysis of market phenomena as from their interpretation of historical experience," he wrote. In the *Wealth of Nations,* Adam Smith had already noted the propensity of sovereigns to debase the coinage in order to pay their debts when he wrote, "The raising of the denomination of the coin has been the most usual expedient by which a real publick bankruptcy has been disguised under the appearance of a pretended payment" (Smith 1776, vol. 2, p. 929). Aftalion (1990) provides an economic interpretation of the French Revolution centered on the insurmountable debts of the ancien régime and the inflation that ensued. All these experiences were in the minds of the classical economists. Thomas Sowell observes that "the classical economists, with their general distrust of government, tended to regard a paper currency as the road to inflation" (Sowell 1974, p. 64).

A gold standard "renders the determination of the monetary unit's purchasing power independent of the policies of governments and political parties" (Mises 1952, p. 416). It is not that the purchasing power of money is invariant—the goal of modern monetary theorists—but that it is not manipulated by the state. That distinction is fundamental to the sound money argument. To reiterate, the goal is to keep the state from manipulating money for its own interests, to the detriment of the interest of the people at large.

Sound money is not an instrument of fiscal policy. Again, this argument is as much a political or constitutional one as an economic one. "The gold standard appears as an indispensable implement of the body of constitutional guarantees that make the system of representative government function," wrote Mises (1952, p. 416).

IV. Stable Money

What of the alternative of maintaining the purchasing power of money through deliberate policy? Even in the nineteenth century, economists focused on the costs of commodity standards. There was expense associated with coining gold and holding reserves. Smith (1776, vol. 1, p. 292) observed that "the substitution of paper in the room of gold and silver money, replaces a very expensive instrument of commerce with one much less costly, and sometimes equally convenient." He was neither the first nor last to make the point (Sowell 1974, pp. 64–65).

In the nineteenth century, there were long swings in gold's purchasing power. New gold discoveries mid-century in California and Australia threatened inflation (Mises 1952, p. 416). Later productivity increases in industry and agriculture, along with widespread adoption of gold, put downward pressures on prices. Still later, the discovery of yet new sources of gold in South Africa and the invention of new mining technology once again threatened inflation. Major inflations were associated with wartime finance, however. In the end, the sum of all these forces left prices about the same at the end of the century as they were at its beginning.

By the twentieth century, many economists came to believe that central banks could do better than the classical gold standard by stabilizing the purchasing power of national monies. That idea came to be most associated with Irving Fisher. Many agreed with him. Schumpeter (1954, pp. 1091–110) chronicles the development of the intellectual arguments. Rothbard (1963, pp. 169–81) focuses on the spread of the public policy debates.

Stable money was offered as an alternative to sound money. In purely economic terms, a monetary rule of maintaining price stability—zero inflation—is an attractive alternative to the gold standard. It meets both critiques of gold: (1) its resource cost and (2) its medium-term swings in value. The textbook case for stable money is well known, and I will not belabor it here.

The answer to the stabilizers is contained in two words: Public Choice. In money, the classical economists were Public Choice theorists before the formal development of that theory. Mises followed in their footsteps. He proffered both technical economic and Public Choice arguments against stable money.

Mises considered stable money as impossible. He argued that acting man ceaselessly upsets whatever configuration of prices and output may exist temporarily. "Human action originates change. As far as there is human action there is no stability, but ceaseless alteration," he wrote (Mises 1966, p. 223). Mises had his own vision of creative destruction.

Stable money does not aim at perfection, however, but at tolerable stability. A monetary policy of price stability need only be an improvement over the performance of the gold standard. What are the prospects for price stability under a managed fiat currency?

On a blackboard devoid of real-world incentives and self-interested individuals, a price rule and a quantity rule can be made equivalent or alternative policies. But the two policies are not equivalent when viewed through the prism of Public Choice theory. Governments will want to manipulate monetary policy to suit their interests, notably to finance fiscal deficits. Central banks, which are seldom truly independent, will bend to pressure (Cargill and O'Driscoll 2013).

Sound money is a rule in a constitutional sense. By contrast, stable money is an artifact, equivalent to a piece of legislation that can be altered with the change of the legislative winds. Constitutions are not immutable, nor should they be, but they are far more stable than the legislative agenda of a sitting Congress or Parliament.

One can talk of monetary "rules," but the rule for sound money and that for stable money belong to two different political and constitutional domains. Hayek (1973) distinguished between law and legislation. Law encompasses the rules of just conduct in a society and is the product of evolution over centuries. It is discovered, not made. Law produces order: "a state of affairs in which a multiplicity of elements of various kinds are so related to each other that we may learn from our acquaintance with some spatial or temporal part of the whole to form correct expectations concerning the rest, or at least expectations which have a good chance of proving correct" (Hayek 1973, p. 36).

A gold standard is lawful in Hayek's sense and produces a monetary order. Individuals can form long-term expectations and make long-term contracts without fear that the expectations will be disappointed or the contracts abrogated by government fiat. Law produces an abstract order in which many individual purposes can be served. Legislation is aimed at achieving a specific good, often for specific individuals. Law promotes the general welfare, while legislation promotes a specific good.

A monetary rule aimed at producing stable money has been the product of legislation. The first modern example was the Reserve Bank of New Zealand Act of 1989, which mandated low inflation rates and established governance and incentives for the achievement of that goal. Inherent in any piece of legislation is the possibility of its being changed (as the New Zealand Act was eventually). Moreover, if as is almost inevitable, some degree of discretion is left to the monetary authority, then there is room to alter the rule for "special circumstances." Gold standards have been temporarily abandoned, mostly in wartime, but their constitutional status was a powerful restraint.

The euro presently occupies a kind of middle ground. It is the product not of national legislation, but of the European Union. The European Central Bank (ECB) has only one stated goal: low inflation. The ECB is not subject to national control and is not supposed to monetize the debt of the member states (though it now appears to being doing just that). Fiscal policy remains under national control, however, and the current EU debt crisis that began in Greece has manifested the tensions within such a system. I am inclined to call inflation targeting by the ECB a quasi-constitutional rule, and only time will tell how that works out.

V. The Prospects for Sound Money

The gold standard has often been described as inflexible. To its critics, that is a weakness, while to its advocates, that is a benefit. The United States has been formally on a fiat standard since August 15, 1971, when President Richard Nixon closed the gold window and effectively ended the Bretton Woods system of a gold-exchange standard. Bretton Woods was nominally a gold standard, but the world was really on a dollar standard. When the constraint of the requirement to exchange dollars for gold was tested, Nixon abandoned gold.

If the classical economic case against fiat money is correct ("the road to inflation" in Sowell's characterization), the price and output volatility that culminated in the stagflation of the 1970s was no accident. The Great Moderation beginning in the 1980s buttressed the stable money case (Taylor 2009). Central banks seemed to have finally gotten it right and produced economic growth with declining inflation rates. Yet, there were recurring asset bubbles ending unpleasantly: the Asian Financial Crisis of 1997–98, the Russian financial crisis of 1998, the dot-com bust of 2000–01; and the great housing boom and bust of 2002–09. In the aftermath of that global financial crisis, central banks are being pressured to serve their finance ministers and treasury secretaries.

Central banking under a fiat standard is undisciplined, and money becomes the handmaiden to fiscal policy. No long-term expectations can be formed, and long-term contracts denominated in nominal terms become a speculative vehicle. The only certainty is volatility.

History cannot be rewound, and we cannot return to sound money by the path that took us there in the first place. Sound money, whether a gold standard or something else, will not be restored spontaneously. But it has never been more important that we plan for the restoration of sound money. A little over fifty years ago, Leland Yeager produced a classic volume, *In Search of a Monetary Constitution* (1962). Sound money is a monetary constitution. In honor of the fiftieth anniversary of the publication of Yeager's book, Liberty Fund held a seminar in 2012 to reexamine it. The papers from that seminar are forthcoming in White, Vanberg, and Kohler (2015). Perhaps, along with the papers in this symposium, they will help in the discovery of a new monetary constitution.

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