

## THE DEBATE OVER MONEY MANIPULATIONS: A SHORT HISTORY

In 1989, economist Paul Samuelson reiterated the generally sunny view of the future of the Soviet economy that had become a staple of his influential economics textbook, concluding that “the Soviet economy is proof . . . a socialist command economy can function and even thrive.”<sup>1</sup> Within two years, the Soviet Union would be no more. Eighteen years later, another textbook author named Ben Bernanke would extol the strength of the U.S. economy in a speech to the Federal Reserve Bank of Chicago: “Given the fundamental factors in place that should support the demand for housing,” said Bernanke in May 2007, “we believe the effect of the troubles in the subprime sector on the broader housing market will likely be limited.”<sup>2</sup> Over the next two years, the Great Recession would take hold and Bernanke himself would defend Fed policies that purchased, at par, trillions of dollars of mortgage-related debt held by Wall Street firms deemed “too big to fail”—purchases made possible solely through the Fed’s monopoly on the creation of money.

One recalls these events not to mock economists who possessed poor forecasting skills, a class which is not in short supply. Rather, I mention each case to highlight the extent to which the model-obsessed mainstream establishment of the

economics profession often misses what it later accepts as obvious. Neither Samuelson nor Bernanke was an outlier. In fact, they represented the dominant view of many, if not most, economists of their particular generations working in the neoclassical tradition.

Neoclassical economics is a tradition that has made high-powered mathematics an end in itself, if only because such a methodological approach allows economists to mimic (spuriously) the rigor of the natural sciences. The problem is that such an approach requires minimizing the role of capital (which is difficult to model) and ignoring the history of economic thought (which is never modeled). What results are models that are often either wrong or of poor predictive quality. In the process, the diminution of capital theory and the history of economic thought has led the mainstream to forget a debate that has lasted for most of human history about the nature of monetary inflation, the incentives of those who promote it, and the resulting full costs when it has been created. This debate was often a heated

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one in U.S. history, and the economic crisis that began in 2008 has led to its reappearance. While some economic theorists believe that the debate over monetary inflation was definitively resolved during the Progressive Era—with its mainstreaming of inflationary monetary institutions characterized by the ascendancy of central banking and national currencies—the economic crisis that began in early 2008 has revealed that in reality this debate has only been hibernating.

### LYDIANS AND ROMANS

Our story begins in ancient Lydia during the sixth century B.C., in the region of modern-day Turkey. While Lydia's king, Croesus, is known to historians primarily for the loss of his kingdom to Persia, economists remember him because he was also the first recorded king to mint coins. Lydian "staters" had Croesus's own image on them, and they were used, in part, to finance wars of empire. Croesus soon learned that his wars were more easily funded when he debased his coins, allowing him to create more currency than his supply of precious metal would otherwise allow. In the process, Croesus illustrated two rules of money creation that would appear repeatedly in world history. First, entities charged with the coining of money—including Lydian rulers, medieval goldsmiths, and modern central bankers—have an inherent tendency to inflate its production, and they will almost always do so unless limited by institutional factors, such as the existence of competing currencies or the establishment of a strong metallic standard. Second, when money creation is a state function, its abuse will benefit the expansion of the central state, facilitating the redistribution of wealth to the special interests of the political class and the financing of wars that citizens are unwilling to finance voluntarily.

Croesus displayed a tendency within human nature that would prove particularly dangerous to society whenever money creation is monopolized. During the last centuries of the Roman Empire, for example, Roman denarii would be greatly debased as desperate Caesars spent lavishly on themselves and the politically well-connected factions in society, as well as on their far-flung military empire. The results for Nero were the same as in contemporary times. Prices rose, because increases in the money supply do not magically increase the store of real wealth, so that when the new money is spent, prices are bid upward. Those groups in society that are not favored by the political class pay for such lavish spending in the form of higher prices, thus promoting divisions in society that otherwise would be less acute. Also, in the Roman case, those who held silver now had strong incentives to hoard it, since the debased currency with Caesar's image on it was considered legal tender. When coins of the same face value but with different quantities of precious metal are flowing freely in society, market actors will remove whatever coinage is not debased. Thus, we observe in Rome what would later be identified as an example of Gresham's Law: Bad money drives out good.



*Croesus's Currency*

### INFLATION IN THE MEDIEVAL WORLD

With the fall of Rome, problems resulting from monopolies on money creation

were largely absent in the West until the high Middle Ages and the reemergence of secular power that characterized that era. According to the French bishop Nicole Oresme, monetary manipulation “was never done in cities or kingdoms formerly or now well governed.” Oresme, writing in the fourteenth century, is considered by many to be the first modern monetary theorist, and he was spurred to address the moral implications of monetary matters by the reemergence of monetary inflation in the West. The result was a brilliant work entitled *Treatise on the Origin, Nature, Law, and Alterations of Monies* (often referred to as the *De Moneta*).<sup>3</sup> Oresme’s thought would later be developed by Scholastic thinkers in succeeding centuries, thus heavily influencing the economic thought in Europe up to the birth of the Austrian School in late nineteenth-century Vienna. Oresme especially addressed practices engaged in by the prince (in his case, King Charles V of France), noting that the monarch’s manipulations of the money supply were having the same deleterious and divisive effects in France as they had in ancient Rome. It is no surprise that he considered such manipulation a form of *theft* and condemned it strongly. Oresme asked: “Can any words be too strong to express how unjust, how detestable it is, especially in a prince, to reduce the weight [of his coins] without altering the mark?”<sup>4</sup>

Oresme noted that one of the trade-offs that results when the prince debases the currency to enrich himself and his court is a general decivilizing of society. Since prices rise when debased money circulates, individuals face higher levels of scarcity than would otherwise be the case, thus hindering the development of the division of labor and the societal interdependencies that it engenders. Since trades necessarily decrease, we witness a decline

in social cooperation. Oresme also articulated an early version of Gresham’s Law, when he discussed the process of good money leaving the realm to where it is more highly valued, which happens when the prince lowers the intrinsic value of money by reducing its metal content. This practice creates what we call arbitrage today, because “men try to take their money to the places where they believe it to be worth the most. And this reduces the material for money in the realm.”<sup>5</sup>

So the debate now reemerging in our day can actually be traced to these arguments made by Oresme, who witnessed the monopoly on money creation leading to the aggrandizement of secular power, and who, thinking like an economist, noted the full costs of this monopoly on society as a whole. It makes sense, then, that in much of the West economics would develop as a subset of what was known as the Moral Sciences: normative issues of morality fueled the development of the positive elements in economic thought. It also cast the Church as an authority that would either counter or influence the development of the emerging nation-states over the ensuing centuries, during which time the debate over the effects of money creation would comprise just one element.

Throughout the late Middle Ages, Scholastic thinkers built an intellectual edifice upon foundations established by Thomas Aquinas in numerous academic disciplines, and economics was no exception. Among the Scholastics, the School of Salamanca in Spain was especially notable for developing and refining many economic principles that would later be revealed to the Anglophone world, seemingly *ex nihilo*, in the writings of Adam Smith. One Spaniard of note was Juan de Mariana, a Jesuit who invoked the papal bull *In Coena Domini*—which excommunicated any ruler who imposed new

taxes—to justify also excommunicating rulers who debased the currency. Mariana considered taxes and inflation as equal forms of theft and as evils that could endanger one's soul. (His king didn't like his writings and so threw the seventy-three-year-old priest in prison for making his argument public.)<sup>6</sup>

#### NEW WORLD, SAME RESULTS

As nation-states developed in late-medieval Europe, monetary inflations became increasingly common. Inflation's role in the rise and fall of nations, especially in Louis XVI's France, was well known to inhabitants of North America, many of whom escaped highly politicized, militarized, and mercantile societies for a new start on a different continent. The decision in colonial America to name the new monetary unit the "dollar"—as opposed to calling it a franc or a pound—reflected this sentiment. Both the franc and the pound had been devalued in order to finance French and British imperialism, whereas the more decentralized regions of Germany were characterized by competing currencies and kingdoms, which ensured a market penalty to any individual creator of money who debased his currency. One German money-creator was a Bohemian count whose currency had a strong reputation for soundness. This currency was called "Joachim's thalers," which led to the term "dollar."

During the period following the American Revolution, but before the adoption of the U.S. Constitution, money creation was carried out by the individual states as well as by private competing banks. The Articles of Confederation, which envisioned no government existing beyond or above the thirteen states that comprised the Confederation, contained no provision for paying Revolutionary War debt issued by the Continental Congress (and financed with "continentals"). Nonetheless, a group

of financiers led by Robert Morris created the Bank of North America, which agitated successfully for debt-holders to be repaid at par. Many of these debt-holders had only recently purchased the debt from other, smaller debt-holders, at a significant discount from par—precisely in anticipation of such an outcome. The politically connected insiders made fortunes as their distressed assets were suddenly revalued by political fiat. Such policies did not simply begin during the financial crisis of 2008, which was characterized by holders of various forms of mortgage debt being similarly paid off at par due to political interventions in defiance of market forces. In both instances, we witness an example of a class of people who benefit from money creation and who will therefore agitate for the establishment of institutions that maintain such practices, together with a counter-class that does not benefit from the inflation and, in fact, is compelled to pay for it in the form of higher prices.



*First Bank of North America*

After the Constitution was ratified, Morris's protégé Alexander Hamilton succeeded in creating the first Bank of the United States, which would pick up where the Bank of North America left off. This bank was controversial from the start, because nowhere in the Constitution is the federal government given the power to engage in banking. The bank immediately began inflating, to the extent that producer prices rose at an annual rate of

12 percent a year for its first six years of existence. This inflation, which financed spending on military programs and interest on existing debt, had the effect of enlarging the number of classes that came to depend on government inflation and benefit from it. The bond between monetary and foreign policies has roots running to the the founding of the nation.

Although the federal government was quite constrained at the time compared to today, this early episode would establish a precedent by which the government would expand its scope over society through the ensuing decades. The justification that government-sponsored monetary inflation is necessary—if only to finance projects to go abroad in search of dragons to slay—was set, and this was going to occur whether or not citizens were willing to be taxed to make it happen. The result would be, as always, fortunes being made by those who prosper solely on government spending.

The appeal of monetary inflation is obvious to political classes that must be able to redistribute wealth in order to remain in power. Modern governments have only three methods of finance: taxation, debt, and inflation. All three encompass the problems associated with wealth redistribution, in that resources are expropriated from private hands for the use of public bureaus that carry with them significantly different incentive effects, as well as the problems associated with the introduction of extra-market force to ensure that redistribution occurs.

Taxation amounts to a wealth transfer forced on present generations, while debt amounts to a wealth transfer forced on future generations; given the political resistance to such transfers, inflation becomes the preferred form of redistribution for at least two reasons. First, when the new money reaches the politically preferred groups in society that get to spend it, prices

have not yet risen. They will eventually rise in response to increased demand for goods and services that result simply because the new money is in circulation. This allows the government to grow without risking an immediate political cost. Second, the rise in prices is equivalent to an increase in taxes, with the difference being that while taxes affect disposable income at the time they are imposed, monetary inflation affects disposable income at whatever point in the future it causes prices to rise. This form of finance—economists call it “inflation as a tax”—is preferred because people often do not make the connection between the increase in prices and the previous monetary inflation. In fact, they often blame “greedy” businesses for raising prices, when those businesses are simply adjusting to increases in demand. The lag between the initial money creation and the increase in prices makes their relationship less obvious.

That one class benefits from inflation while another is forced to finance that benefit creates divisions in society which, in the extreme, can lead to revolutions, such as in France in 1789. The effects of monetary inflation also explain the rise of the Jacksonians in the United States of the 1830s. The Jacksonian movement reflected a popular revolt by those classes that paid for the inflations brought on by the Second Bank of the United States primarily to finance the War of 1812. The boom-and-bust cycle set in motion by the bank’s inflationary monetary policy resulted in the first major economic correction in U.S. history—the Panic of 1819—and raised the ire of a politician-farmer from Virginia named John Taylor of Caroline. Taylor represented those people who thought of the United States in the plural, had opposed the Constitution and demanded provisions within it that they hoped would both restrict the federal

government and nurture a republic.

Needless to say, Taylor opposed the federal government's monetary policies and laid the blame for the 1819 panic directly on the steps of the Bank of the United States. Taylor's arguments are pertinent to the monetary debates of today:

In also ascribing our distresses to a diminution of bank currency [he is referring to the post-panic credit crunch], and urging it as an evidence of bad policy, [we] ought to have foreseen that the history of this fact was understood by the nation. We know that the [increase in the money supply] was caused by the expenses of the last war, and by the influence of the banking bubble to awaken fraudulent speculations; and not by manufactures. Public expenditures and knavish designs united to produce [the banking bubble, which was] urged by the [government] as a proof of national prosperity, [it] was in fact one cause of national and individual distress. It tempted governments to launch into an ocean of extravagance, and individuals into an ocean of speculation. . . . It produced a great number of bubbles, under the denomination of internal improvements, having the effect of enriching projectors and undertakers, and impoverishing the people. The bursting of the banking tumor left behind the sores of public extravagance, foolish public contracts, excessive taxation, and great private debts; all of which it had generated; and these are proposed to be cured, by letting them run on, and promoting a gangrene, by the new bubble of granting an enormous bounty to another set of undertakers.<sup>7</sup>

Here Taylor described what the Nobel laureate economist F. A. Hayek derided as the “hair of the dog” strategy—which is to initiate a new round of money creation to combat a recession that had itself been brought on by the previous creation of too much money. In other words, he is describing, and denouncing, the very policy that the Federal Reserve is pursuing today.

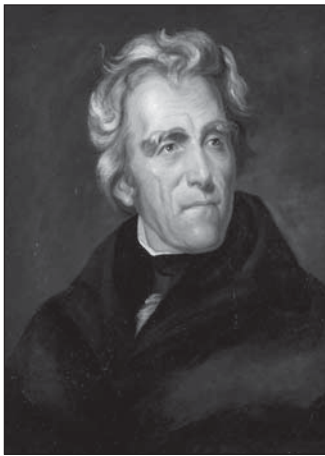
Taylor later argued that these disastrous economic results of monetary inflation could have been predicted, given the experience of Revolutionary War finance. He wrote:

The local redundancy of money [meaning inflation], confined to a few persons, and factories [meaning the politically well connected classes that benefit from inflated currency by spending it first], was originally produced, and has been subsequently increased, by using currency more to transfer, than to exchange property. . . . The sudden appreciation of revolutionary certificates above twenty-fold beyond the value at which they were bought, was a transfer of property by law, of about one hundred millions from the public to a few fortunate speculators. . . . In this acquisition, the majority in no State participated; it was bestowed on the initiated few, skilled in the secrets of legislation, and able to manage its stratagems for their own emolument.

Taylor pointed out that, early on, those who benefit from government spending through inflation will plow a certain amount of their wealth back to Washington to perpetuate political support for the system. The public's disgust with such activity fueled a political movement—Jacksonianism—that gave birth



to a Democratic Party deeply opposed to central banking. In the process, this movement tapped into a sentiment that was so strong that we would not see another central bank in the United States again until the next century. According to Andrew Jackson biographer Robert Vincent Remini, Jackson considered the bank “dangerous to the liberty of the American people because it represented a fantastic centralization of economic and political power under private control.” Elsewhere, Jackson called the bank “an irresponsible power” that spent its money “as a means of operating on public opinion.” As a result, it had become “a vast electioneering engine” that could “control the Government and change its character.”<sup>8</sup>



*Jackson: Wary of the Central Bank*

#### THE PROGRESSIVE ERA AND THE FED

Those politically well-connected groups that benefited from inflation controlled the Whig Party and then the Republican Party, and eventually they would gain support in the Democratic Party as well. A national banking system appeared during the Civil War, and the government used regulation to encourage banks' inflation while protecting them from the market

penalties that inflation would otherwise carry, such as the loss of specie and the incidence of bank runs. Such penalties are likely in economies with competing currencies, in which states as well as private banks issue currency based on an existing supply of gold or silver. Sound banks maintain a one-to-one relationship between their specie and currency; unsound ones do not. Therefore, banks that inflate their currency tend to lose specie over the course of normal redemption, while increasing the likelihood of bank runs by a general public that is naturally concerned about protecting its wealth.

Given this situation, it is not surprising that boom-and-bust cycles would grow in length and intensity during the period between the Civil War and the creation of the Federal Reserve. Banks would issue currency based on an actual supply of real goods, which was most often gold or gold bullion. If they issued currency in direct proportion to their supply of such metals, then they were engaged in what is called 100-percent-reserve banking, and their accounts would always clear. But if they gave in to the temptation to print more currency in greater proportion than their supply of metal, they were engaged in fractional-reserve banking.

When they did this, price inflation resulted. Income and wealth were also redistributed because people were purchasing goods not in exchange for an existing supply of real assets but in exchange for . . . nothing. Economic activity increased, but it was not sustainable because it was not financed by real savings. When people in the market became aware of such practices, they demanded gold or silver in exchange for their existing store of inflating banks' currencies. Fraudulent banks can run out of real assets in such scenarios, and this provides a strong market incentive not to engage in fractional-

reserve banking. The fear of bank runs was a healthy fear.

In the Progressive Era, however, with rising spending on war and welfare, and with pressure on banks to inflate to finance these activities, the boom-and-bust cycles grew worse and worse. One redeeming characteristic of this era was that banks were forced to internalize their losses. When banks faced runs on their currencies, private financiers would bail them out. But when the financiers reached the limit of their willingness to do so, efforts began in secret to engineer a new “lender of last resort.” By December 1913, the Federal Reserve Act would become law, resulting in the implicit socialization of the banking industry in the United States. The act was popularly called the Currency Bill because it was to create a bureaucracy that would assume the currency-creating function of member banks.

With the Jacksonian generation long gone, the Federal Reserve Act represented a victory in the long debate over the effects of monetary inflation—a victory for the inflators. Indeed, the Currency Bill made inflation the law of the land, requiring that only 40 percent of the existing gold reserve back up the new currency, in contrast to the 100 percent reserve required under traditional gold standards and maintained by the sounder banks. This debasement was justified as providing businesses a more secure operating environment characterized by gently rising prices, which (it was assumed) the central bank could orchestrate once the tendency to financial panics had been removed. If successful, debasement would especially help farmers who thought the resulting higher prices implied higher revenues and therefore some protection from foreclosure. Since creation of the Fed required member banks to relinquish all money-creating activity, and since the new Fed-

eral Reserve notes would be a legal-tender currency, the banking industry as a whole became cartelized; the costs imposed on banks that wanted to operate outside the new Federal Reserve System were simply too high.

Those who opposed the Currency Bill considered it unnecessary. If banks were simply held to standards similar to other, more efficient industries—the rule of law at the very least—then fewer fraudulent banks would ever emerge, while market institutions would penalize those banks that overissued currencies and brought about bank runs and financial crises. As Ludwig von Mises would later write: “What is needed to prevent any further credit expansion is to place the banking business under the general rules of commercial and civil laws compelling every individual and firm to fulfill all obligations in full compliance with the terms of the contract.”<sup>9</sup>

The creation of the Fed may have been a defining moment in the centuries-long debate over money creation, as central banking has been a feature of nearly all twentieth-century monetary systems. However, recent events suggest that the creation of the Fed was not the last word, as a movement spurred by the financial crisis of 2008 has taken on almost Jacksonian proportions, calling for an end to the Fed or at least the emergence of some institutional constraints on the Fed’s ability to inflate the currency at will. The crisis had the salutary effect of making the relationship between money creation and the politically preferred groups in society who profit from it obvious. The resulting debate is very much the same as the one engaged in by Nicole Oresme, pitting those who benefit from inflation against those who end up financing it. One major difference in the debate today is the sheer size of the government. Each



decade since the creation of the Fed has witnessed an ever larger percentage of the population become dependent on government spending made possible through inflation. Although the government could finance its present activities through current taxes and fees and still reach a size comparable to what we see today, further growth made possible through inflation allows it to avoid the trade-offs necessary when financing one bill (for more guns) requires cutting back on another (for more butter). Such politically uncomfortable trade-offs can be avoided as long as the populace cannot connect the growth in government to the depletion of real wealth across society.

Now that it has reemerged, it is not certain how this debate will be resolved. That it caught the model-prone mainstream of the economics profession by surprise illustrates the current state of a capital theory that does not distinguish well between capital that results from savings and “capital” that is created out of thin air. That it pits those factions who pay for monetary inflation against those who benefit from it is fitting—and consistent—with economic theory and history.

recent works analyzing Oresme’s monetary contributions, see C. J. Nederman, “Community and the Rise of Commercial Society: Political Economy and Political Theory in Nicholas Oresme’s *De Moneta*,” *History of Political Thought*, vol. 21, no. 1 (2000), and Jörg Guido Hülsmann, *The Ethics of Money Production* (Auburn, AL: Ludwig von Mises Institute, 2008).

- 4 Johnson, *De Moneta*, chapter 12, 19.
- 5 Ibid., chapter 20, 32.
- 6 Mariana presented this argument in *De Monetae Mutatione*, which is quoted on page 11 in Gerald P. O’Driscoll Jr., “Monetary Order for a Free Society,” at <http://bit.ly/cUK31I>.
- 7 The two John Taylor quotes are found in his 1822 book *Tyranny Unmasked* (New York: Cosimo Books, 2005), 21 and 36, respectively.
- 8 For more on Jackson and his fight with the bank, see Robert Vincent Remini, *Andrew Jackson* (New York: Twayne Publishers, 1966), chapter 8. The quotes in this section are found on page 164.
- 9 Ludwig von Mises, *Human Action: A Treatise on Economics*. (Auburn, AL: Ludwig von Mises Institute, 1998), 440.

## NOTES

- 1 Paul Samuelson and William Nordhaus, *Economics*, 13th ed. (New York: McGraw Hill, 1989), 837.
- 2 Ben S. Bernanke speech at the Federal Reserve Bank of Chicago’s Forty-third Annual Conference on Bank Structure and Competition, Chicago, Illinois, May 17, 2007.
- 3 The *Treatise* was translated from the Latin by Charles Johnson and published in Part One of Charles Johnson, *The De Moneta of Nicholas Oresme and English Mint Documents* (London: Thomas Nelson and Sons Ltd., 1956). The first quote in this section is found in the *De Moneta* on page 29. For more