Governments and Money

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> We do not pretend, that a National Bank can establish and maintain a sound and uniform state of currency in the country, in spite of the National Government; but we do say that it has established and maintained such a currency, and can do so again, by the aid of that Government; and we further say, that no duty is more imperative on that Government, than the duty it owes the people, of furnishing them a sound and uniform currency.
>
> —Abraham Lincoln

Abraham Lincoln connected sound banking with political liberty, affirming that government has both the ability and the obligation to provide a stable currency. His belief in the importance of a sound currency has been shared by most thinkers for the past 250 years.

Lincoln's view that government would actually provide a stable currency, however, has enjoyed less acceptance. Skepticism about the government's role with regard to money has been the dominant view since the founding of the republic. These doubts are well summarized by prominent 20th-century economist Ludwig von Mises (1949: 422):

> Whatever a government does in the pursuit of aims to influence the height of purchasing power depends necessarily upon the ruler's personal value judgments. It always furthers the interests of some people at the expense of other groups. It never serves what is called the commonweal or the public welfare.

Constitutional forms of government usually specified a stable currency, but as James Buchanan (1994: 4) recently observed, such provisions have been inadequate:

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> This framework role for government also was considered to include the establishment of a monetary standard, and in such fashion as to insure predictability in the value of the designated monetary unit. (It is in the monetary responsibility that almost all constitutions have failed, even those that were allegedly motivated originally by classical liberal precepts. Governments, throughout history, have almost always moved beyond constitutionally authorized limits of their monetary authority.)

Debates about Money

History is unfortunately replete with examples of governments trying to print money in order to finance their expenditures. Nobel Prize winning economist Friedrich von Hayek (1976: 29) put it this way: "History is largely a history of inflation, and usually of inflations engineered by governments and for the gain of governments." In recent times, the hyperinflations of Germany in the 1920s and of Bolivia, Argentina, and Brazil in the 1980s are all examples of governments debasing their currencies and engaging in what Mises (1949: 782) called "a fraudulent attempt to cheat the public."

Until the second half of the current century, there was little intellectual disagreement that a stable currency was best. The debate centered on how to provide it. The notion that some inflation might be desirable (or at least should be tolerated) entered public policy debates for a relatively short time in the post–World War II period. After enduring painful inflation experiences in the 1960s and 1970s, though, the question of whether to eliminate inflation is no longer widely debated.

In the closing years of this millennium, the problem of how to provide a stable value of money has regained prominence. Alternative approaches to stabilizing currencies are being pursued around the world. Public policy debates have returned to this issue because people are rethinking the role of government in their societies. The likely monetary institutions of the 21st century will reflect the dynamic economic and political processes currently at work. It remains to be seen whether nations achieve and maintain stable currencies because of government, as Abraham Lincoln believed, or in spite of government, as thinkers as diverse as James Madison, Mises, and Hayek contended.

Sentiment that government powers should be constrained by constitutional design is certainly not unique to the monetary arena. For example, Madison set forth principles of government that underscore his views on money. In his elaboration of the "rule of law," he comments, "To trace the mischievous effects of a mutable government would fill a volume" (*The Federalist*, No. 45). His doubts about elected

representatives' ability to provide a stable currency are reflected clearly in his adherence to a specie standard. Madison's defense of an exclusive role of Congress boils down to a distrust of populist sentiments: "A rage for paper money, for an abolition of debts, for an equal division of property, or for any other improper or wicked project, will be less apt to pervade the whole body of the Union than a particular member of it" (*The Federalist*, No. 10).

The history of money over the past two centuries shows the world groping for different institutional structures that limit governments' temptations to debase money in order to satisfy some shortsighted political objectives. The approaches used in the past have been functions of the nature of money prevailing at the time and of societies' views about the proper role of government. The approaches used in the coming century will surely be different from those of the past 200 years if either of these two factors changes materially. In particular, while government will surely have some responsibility in providing a stable currency, government's exact role should not be taken for granted.

What Is Money?

Adam Smith ([1776] 1976: 309) defined the role of money as a medium of exchange, describing it as "the great wheel of circulation." However, money functions in at least two other ways: as a store of value and as a standard of value (unit of account). When we hold money, we trust that it will largely maintain its worth. If the value of currency is allowed to erode under conditions of inflation, the ability of money to serve as a store of value is seriously hampered. As a unit of account, money serves as a measuring stick, telling us how many units of something exchange for a unit of money.[1]

An often-overlooked consideration is that while money is an integral part of society because of its service of these three roles, it is not desired for its own sake. Smith ([1776] 1976: 458–60) pointed out, "No complaint, however, is more common than that of a scarcity of money. Money, like wine, must always be scarce with those who have neither wherewithal to buy it, nor credit to borrow it. . . . It is not for

[1]An appreciation of this role was evident in the thinking of Thomas Jefferson (1819), who confided to a friend: "There is, indeed, one evil which awakens me at times, because it jostles me at every turn. It is that we have now no measure of value. I am asked eighteen dollars for a yard of broadcloth, which, when we had dollars, I used to get for eighteen shillings; from this I can only understand that a dollar is now worth but two inches of broadcloth, but broadcloth is no standard of value. I do not know, therefore, whereabouts I stand in the scale of property, nor what to ask, or what to give for it."

its own sake that men desire money, but for the sake of what they can purchase with it."

This confusion between more money and more purchasing power has contributed in large part to the pervading lack of trust in government provision of money. As Mises suggests, governments are often tempted to answer the cry for more purchasing power by simply creating more money. But in so doing, the opposite effect is achieved—the purchasing power of money is actually reduced. The result, as Alchian and Allen (1977: 484) explain, is inflation: "a rise in the number of dollars required to purchase a given standard of living."

If inflation makes individuals uncertain about what to ask or what to give for goods or services, then the quality of money deteriorates, reducing its effectiveness as a medium of exchange. Money is no longer either an efficient store of value or an efficient unit of account, because this "ruler" with which we make our measurements is continually changing.

Three points are clear. First, inflation is highly undesirable. Second, governments have incentives to abuse their power of mintage which, coupled with historical experience, has slowly created a consensus among citizens that they cannot trust their governments with unfettered control over money. Third, the mechanisms people have contrived to protect themselves from the seemingly arbitrary debasement of currency have varied over time.

The Gold Standard

For most of recorded history, governments have taken some role in providing money to the economy. In early times, that role was limited to "authentication"— verifying that coins contained the indicated metals. Even in historical monarchies, however, the authorities would occasionally lie to their people about money. People's dual reliance on and distrust of government with regard to the value of money is an age-old phenomenon.

The view that, despite all contrary assurances, governments will eventually abuse their powers as counterfeiters led countries to develop institutions aimed at limiting a government's ability to print additional money. One such method was the gold and silver standards followed (on and off) by most countries from 1821 to 1973.

Specie-backed currency took money out of immediate government control. For example, if the dollar were defined as equal to 1/20 of an ounce of gold, then the number of dollars that the United States could issue would be constrained by its holdings of gold reserves. Moreover, if Britain then defined its currency as equal to 5/20 of

an ounce of gold—as it did before World War I—the dollar/pound exchange rate would be fixed at $5 per pound. If either government issued more currency than proscribed by its gold standard—say, to finance a budget deficit—it would lose gold reserves to the country with the more stable currency. In this way, gold strengthened a government's covenant with its public not to erode the purchasing power of its money.

The unfortunate problem with a specie standard was that the value of money was only as stable as the value of the specie backing it. This led Benjamin Franklin (1729) to note that because "silver itself is of no certain permanent Value, being worth more or less according to its Scarcity or Plenty, therefore it seems requisite to fix upon something else, more proper to be made a *Measure of Values*."

Although a specie standard could clearly result in undesirable swings in the purchasing power of money, the costs of having a fiat currency were thought to be even higher. In a letter to a friend, Madison (1820) stated, "It cannot be doubted that a paper currency, rigidly limited in its quantity to purposes absolutely necessary, may be equal and even superior in value to specie. But experience does not favor reliance on such experiments. Whenever the paper has not been convertible into specie, and its quantity has depended on the policy of the Government, a depreciation has been produced by an undue increase, or an apprehension of it."

Later, commenting on a "Report on a State's Bank," Madison (1831) wrote, "But I am not yet weaned from the opinion long entertained, that the only adequate guarantee for the uniform and stable value of a paper currency is its convertibility into specie." Repeating his view that a stable paper currency is theoretically possible, doubts remained: "What is to ensure the inflexible adherence of the Legislative Ensurer to their own principles and purposes?" Madison left no doubt about what is essential—a money that has stable value. His doubts about the people's elected representatives providing a stable currency are reflected clearly in his adherence to a specie standard—especially given his recognition that paper money supplied by an honest government is superior to a specie standard.

The quantity theorists of the late 19th century, John Stuart Mill and Alfred Marshall, also believed that although a gold standard provided undesirable swings in currency value, it was the only way for governments to provide a stable paper currency. Mill (1907) observed,

> After experience had shown that pieces of paper, of no intrinsic value, by merely bearing upon them the written profession of being equivalent to a certain number of francs, dollars, or pounds . . . governments began to think that it would be a happy device if they

> could appropriate to themselves this benefit. . . . The only question is, what determines the value of such a currency. . . . We have seen, however, that even in the case of metallic currency, the immediate agency in determining its value is its quantity. . . . The value, therefore, of such a currency is entirely arbitrary.

Citing 19th-century economist William Jevons, Mill asserts, "The relation of quantity to uses is the only thing which can give value to *fiat* money." That being the case, Mill thought that convertibility (to metal) was the only thing to prevent temptation to "depreciate the currency without limit."

For the first 195 years following the Declaration of Independence, most government paper currencies were linked to specie. The U.S. dollar was defined in terms of a weight of gold (or occasionally silver). However, this did not completely restrain governments from manipulating the value of their currencies. First, in order to generate revenue, countries would frequently abandon the gold standard during times of war. Second, even without officially abandoning gold, countries can and did periodically redefine the value of their currencies in terms of gold. Instead of allowing gold or foreign reserves to consistently drain from their coffers, they would "be forced" to devalue their currency.

At first glance, it would appear that a gold standard provided no real discipline if countries could devalue their currencies at will. The discipline came from the fact that countries actually could not do so without suffering a cost. If it was threatened that a country would devalue its currency, massive speculative attacks would ensue as investors attempted to shed themselves of that currency. The devaluing country would eventually lose massive amounts of foreign reserves (gold and foreign currencies). For instance, Britain lost nearly 28 million ounces of its gold reserves defending its currency in 1966–67. On a single day (November 17, 1967), Britain lost reserves valued at more than $1 billion.

The common wisdom is that the frequency and destabilizing effects of such attacks caused the Bretton Woods system, and thus the last vestige of a gold standard, to be abandoned in 1973. While this is correct on a superficial level, the underlying cause was that despite the threat of speculative attacks, governments around the world were unwilling to do what was necessary to maintain a stable currency—namely, to limit the supply of fiat money.

On the subject of deliberate, governmentally engineered devaluations of currency, Mises was blunt in his condemnation. His criticism of the stated as well as the unstated objectives of a devaluation policy are as relevant today as when he wrote *Human Action* almost 50 years

ago (1949: 790): "It is impossible to take seriously the arguments advanced in favor of devaluation."

Alternative Monetary Arrangements

Another way to keep governments "honest" is to remove the power to inflate from those with the most incentive to inflate. This is achieved by building in a high level of independence between the central bank—which has the power to inflate—and the Treasury—which has the incentive to inflate. This institutional structure is not a panacea, but has proven especially useful: Studies have shown that countries with more independent central banks have lower inflation rates on average (Alesina and Summers 1993).

The high-inflation era of the 1970s showed us what countries unfettered by fixed exchange rates and dollar convertibility into gold will do left on their own. Addressing this deficiency, the U.S. Congress passed House Concurrent Resolution 133 in 1975, requiring the Federal Reserve to announce annual targets for monetary growth rates. In 1978, the Full Employment and Balanced Growth (Humphrey-Hawkins) Act was passed, requiring the Fed to explain these objectives and any deviations from them. Most major central banks experimented with this form of "instruments monitoring" in the 1970s and 1980s, establishing growth rates for various money measures in an effort to put boundaries on the rate of inflation.

Despite the relatively low inflation rates realized by most industrial countries around the world since 1983, the call for further institutional constraints on central banks is growing. One example is legislation enacted by New Zealand and other countries that the sole objective of central banks is to provide price stability. Similar legislation has recently has been introduced in the U.S. Senate by Connie Mack and Alfonse D'Amato.

Another institutional constraint that can be adopted by smaller countries that lack an established reputation for low inflation is currency boards. The central idea behind currency boards is to look more seriously at the discipline provided by fixed exchange rates. For example, in order to maintain a fixed exchange rate between Argentina and the United States, Argentina's monetary policy must, in essence, be dictated by the United States. If the United States has the credibility to maintain low inflation, the hope is that Argentina's currency board will also achieve credibility over time.

Currency boards are much like a small-scale version of Bretton Woods except that there is no longer a link between the dollar and gold to guarantee that the United States will follow a low-inflation

policy. Currency boards are probably best described as small boats anchoring themselves to a large ship. As in the Bretton Woods experience, there is not much to keep the smaller boats from drifting if the large ships themselves are not firmly anchored.

Perhaps the most interesting mechanism by which a stable currency might be achieved was proposed by Hayek (1976) in *Denationalisation of Money*. Although central banks, currency boards, and the gold standard each attempt to restrain a government's tendency to inflate, Hayek suggested that governments be removed altogether from the provision of money. He contended that if private currencies are allowed to circulate freely, competition will ensure that the value of these currencies will remain constant. If any issuer attempts to collect too much seigniorage by printing excessive amounts of its currency, consumers will substitute out of that currency into a competing currency with a more stable purchasing power. The offending currency will cease to circulate as money. Thus, currency issuers will have an incentive to remain honest.

Writing 20 years ago, Hayek was clearly ahead of his time. His proposal that governments be completely removed from the money-making business is not likely to come to fruition in the near future. Nevertheless, his basic proposition that competition will provide the necessary incentive to keep people (or countries) honest is relevant today. International currencies are increasingly competing to become the currency of choice. The rapid "dollarization" in Eastern Europe, the former Soviet Union, and Latin America shows how a foreign currency can become a legitimate substitute for a domestic currency that has failed to maintain its value. Even in currency-board countries like Argentina, the ability of individuals to hold dollar accounts provides a strong incentive for the government to maintain its currency board.

Paradoxically, it may be the end of fixed exchange rates and the discipline provided by that system that have allowed internationally competing currencies to flourish. Economists have often cited Gresham's law to argue that money must be provided by governments and not by private banks. This famous dictum states that "bad money will always drive good money out of circulation." This led many to believe that a government monopoly on printing money is necessary.

Recent history teaches us the opposite. As Hayek (ibid.: 31) pointed out,

> Gresham's law will apply *only* to different kinds of money between which a fixed exchange rate is enforced by law. With variable exchange rates, the inferior-quality money would be valued at a lower rate and, particularly if it threatened to fall further in value,

> people would try to get rid of it as quickly as possible. The selection process would go on towards whatever they regarded as the best sort of money among those issued by the various agencies [or countries], and it would rapidly drive out money found inconvenient or worthless.

But why does a country with credibility not cash it in and inflate to collect extra seigniorage? The answer is clear if we rephrase the question to ask why Mercedes-Benz will not sacrifice quality in exchange for short-term profits.

Conclusion

The concepts of competitive money, currency boards, or central bank independence were no doubt far from the mind of Abraham Lincoln when he spoke of the government's obligation to provide a stable currency. However, these may be a few of the mechanisms by which a government can ultimately achieve this end. It must be remembered, however, that these different options are not independent. The threat that Argentineans will shift into dollars if Argentina drops its currency board is seen as a strong incentive for the nation to keep it.

The potential that the same competition that has served market economies so well may discipline a country's ability to print money freely is particularly promising. According to Hayek (ibid.: 74), "It might prove to be nearly as difficult for a democratic government not to interfere with money as to regulate it sensibly." He argues that countries around the world should abolish "any kind of exchange control or regulation of the movement of money between countries . . ." and provide "the full freedom to use any of the currencies for contracts and accounting." Further, there should be "the opportunity for any bank located in these countries to open branches in any other on the same terms as established banks" (ibid.: 17).

Laws could be changed in various ways in the United States to foster more effective competition. For example, federal law (Title 31, Section 5103) states that "United States coins and currency (including Federal Reserve notes. . .) are legal tender for all debts, public charges, taxes, and dues. Foreign gold and silver coins are not legal tender for debts." This law might be altered so that contracts written in terms of foreign or alternative domestic monetary units, including specie, could compete with dollars. Twenty years ago, the British House of Lords "ruled that in English courts, foreign creditors could now have their claims recognised in their own currencies" (*The Financial Times*, 6 November 1975).

Governments must have a role in the enforcement of contracts. As Mises (1949: 780) observed, the laws and courts of a country

> define what the parties to the contract had in mind when speaking of a sum of money. . . . They have to determine what is and what is not legal tender. In attending to this task the laws and the courts do not *create* money. . . . In the unhampered market economy the laws and the judges in attributing legal tender quality to a certain thing merely establish what, according to the usages of trade, was intended by the parties when they referred in their deal to a definite kind of money.

Legislation requiring enforcement of "specific performance" by the courts would increase the opportunity for currency competition. Currently, in most countries of the world, when there is a dispute involving a contract that is stated in terms of a currency or unit (such as gold) other than the national currency, courts will not require performance in the stated unit, but will require that an "equivalent payment" in the national currency be paid.

Money in the 21st century will surely prove to be as different from the money of the current century as our money is from that of the previous century. Just as fiat money replaced specie-backed paper currencies, electronically initiated debits and credits will become the dominant payment modes, creating the potential for private money to compete with government-issued currencies. Such competition between private and governmental monies may help countries around the world to finally live up to Lincoln's challenge of fulfilling "the duty [government] owes the people, of furnishing them a sound and uniform currency."

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