

MONEY AND BANKING: A CONSTITUTIONAL PERSPECTIVE

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Banks either are or should be fiduciaries holding the public's funds as a public trust. Those who want to participate in the risk-taking aspects of banking are shareholders (or should be shareholders). If the government is called upon to share the risks of banking, especially the risks of investment banking, then it should be a shareholder. As Edward J. Kane puts it, "For investment banker's risk, there should be investment banker's reward for the taxpayers." And once the government is a shareholder, it owes a public duty to restrain the egregious risk taking and excess executive compensation in which banks seem to have wanted to engage for the last 30 years or so. The resolution of this dilemma is to avoid governmental share ownership of banks by avoiding governmental risk sharing in partnership with the banks (which is a form of classic corporatism that has nothing to do with free-market economics).¹ Holding banks to the

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¹Evidence emerged in the late fall 2014 civil trial arising from the 2008 Federal Reserve and Treasury bailout of the creditors of AIG, the largest property and casualty insurer, illustrating the corporatist tendencies of emergency lending. One of the bigger issues was whether an official lender (the Federal Reserve Bank of New York, in this instance) should accept a pledge initially amounting to 79.9 percent of the shareholders' equity of AIG to secure an initial loan of \$85 billion. The Reserve Bank's legal authority to make such a loan or to accept such security was questionable at best (I think that such actions were unauthorized by statute or precedent). The relevant statute is Section 13(3) of the Federal Reserve Act, as amended in 1991 (12 U.S.C. Section 346). On the AIG trial, see Morgenson (2014). Edward J. Kane has worthwhile comments in that article.

standards of fiduciaries, at least with respect to deposit taking and access to the payments system, is the essence of sound constitutional advice about money and banking.

The Monetary Constitution

Article I, Section 10, Clause 1 of the U.S. Constitution provides that “No State shall . . . emit Bills of Credit [or] make any Thing but gold and silver Coin a Tender in Payment of Debts.” The first part of this quotation means that no State can issue its own currency or have a state-owned bank issue currency notes backed by the full faith and credit of a State, a matter decided, among other places, in *Briscoe v. Bank of Commonwealth of Kentucky*, 36 U.S. 257 (1837).

On the second part of this quotation, I have written elsewhere as follows:

[T]he states are banned from passing legal tender laws for anything except gold and silver coin; however, bullion is excepted and cannot be made legal tender. This means that state legislatures could proclaim bullion or anything else a form of money lawful for commerce, exchange, and the payment of taxes. But the states cannot *require* private persons to accept anything other than gold or silver coins. A legal tender law requiring the acceptance of alternative forms of money usually affects property rights negatively by requiring an exchange of things of value (goods and services in commerce) for things of lesser value (e.g., fiat currency) [Todd 2009: 65].

Edwin Vieira Jr. has written extensively on topics related to the powers of States or private citizens to use gold and silver as money. I believe that he and I agree that nothing except political blowback from the Established Orders prevents the States from making gold and silver coins at least lawful money and even a legal tender within their boundaries. Treasury objections regarding individual coinage, apparently emanating from coinage and counterfeiting statutes enacted near the end of the Civil War, apparently prohibit individuals from issuing their own gold and silver coins other than as collectible medallions. The States are prohibited from “coin[ing] Money” by that same Article I, Section 10, Clause 1, of the Constitution.

One of the important federal anti-counterfeiting statutes from Title 18 of the United States Code is Section 486, “Uttering Coins of Gold, Silver or Other Metal”:

Whoever, except as authorized by law, makes or utters or passes, or attempts to utter or pass, any coins of gold or silver or other metal, or alloys of metals, intended for use as current money, whether in the resemblance of coins of the United States or of foreign countries, or of original design, shall be fined under this title or imprisoned not more than five years, or both.

An important point to note, however, is that the Treasury’s objections to individual coinage are based on statutes, not the Constitution. Congress probably could not authorize state-issued gold and silver coins. Individually minted coins, however, even coins subject to state regulation, could be authorized if 18 U.S.C. Section 486 were repealed or amended. Under current tax rules, gold and silver coins still would be subject to taxes on capital gains (and state sales tax laws) in the absence of corrective legislation.

Official U.S. coins, however, clearly could be made a legal tender under existing state law, leaving open the question of foreign official gold or silver coins. A good argument could be made that, at a minimum, the official gold and silver coins of our neighbors within the North American Framework Agreement of 1994 (Canada and Mexico) should be made a legal tender within the United States, at least for the duration of that Agreement.

What about the power of Congress to authorize the issuance of legal tender paper money? In 2009, I wrote about this issue as follows, but today I would preface my passage with “Alas”:

The Constitution does not prohibit Congress from authorizing legal tender paper money. When this issue was debated in Philadelphia [in 1787], even George Mason agreed that the hands of Congress should not be tied *in an emergency* on this point [Todd 2009: 65].

About all this, the Constitution merely says in Article I, Section 8, Clause 5, that Congress shall have the power “To coin Money, regulate the Value thereof, and of foreign Coin.”

Many writers have argued that the Constitution should be interpreted as prohibiting a legal tender law for other than gold or

silver at the federal level in light of the explicit provision applying to the States. Indeed, under the Coinage Act of 1792, a bimetallic standard was made the law of the land, and, over the next century or so, only bank notes redeemable in gold or silver on demand passed as lawful money (receivable for customs duties and taxes). The history of bank notes under the Banks of the United States, the National Banking Act, and the Federal Reserve Act is reserved for discussion another day.

Meanwhile, in Philadelphia in 1787, the question of a prohibition of irredeemable federal paper money was raised several times. One delegate, George Read of Delaware, said that he regarded the absence of a prohibition of such paper money as “alarming as the mark of the Beast in Revelations” [Madison *Notes*, August 16, 1787]. On the statement that I attributed to Mason, he prefaced it by saying that he doubted that Congress had the power to issue paper money “unless it [the power] were expressed” [Madison *Notes*, August 16, 1787]. Mason’s statement also made it clear that he wanted Congress to limit the issuance of paper money to emergencies. Further, Madison, writing as Publius in *The Federalist*, No. 10, said that schemes like “a rage for paper money” should be considered together with “other improper or wicked project[s],” a phraseology that tends to reinforce the general principle that the Framers did not want irredeemable paper money to have legal tender status in nonemergency events.

At the founding of the Republic, the presumptive and ordinary state of affairs was *no* paper money—it was to be issued only in an emergency, if then. The bimetallic or gold standard (the country alternated between the two over the years) was suspended in a few emergencies, most notably during the Civil War and again in March 1933. In the Civil War, paper money was issued with wild abandon (on both sides), and domestic banks generally suspended gold payments. In foreign exchange, Union securities fell to about 40 percent of their pre-war values; Confederate currency and securities became worthless with the end of the War. Full resumption did not occur until 1879. In March 1933, domestic gold payments were prohibited for what proved to be 40 years, and U.S. banks still are prohibited from accepting deposits redeemable in gold or making domestic loans repayable in gold. In other words, the emergency that George Mason contemplated now has lasted 81 years. It is nearly certain that, had the Framers foreseen our era, they would have written an

explicit prohibition of irredeemable paper money into the Constitution.

Still, the Federal Reserve and the Treasury seem to have gotten away with it, at least so far. But we all owe a debt to Richard Timberlake (2013) for his contributions to keeping the paper money vs. gold standard debate alive in the post-1971 era.

Central Banking in the United States

The important constitutional point about central banking in the United States is that the Constitution is silent about it. Secretary of State Thomas Jefferson urged upon President George Washington the argument that strict construction of this silence in the Constitution required the president to veto the bill chartering the First Bank of the United States in 1791 for a 20-year term. The Bank, he noted, was not among the powers enumerated for Congress.

Treasury Secretary Hamilton prevailed in that debate, winning the charter for the Bank, but his arguments relied on the following provisions of the Constitution:

- The Preamble, to “promote the general Welfare”;
- Article I, Section 8, Clause 1: “The Congress shall have Power to lay and collect Taxes . . . , to pay the Debts and provide for the common Defense and general Welfare of the United States”;
- Article I, Section 8, Clause 2: “To borrow Money on the credit of the United States”;
- Article I, Section 8, Clause 5: “To coin Money, regulate the Value thereof, and of foreign Coin”;
- And Article I, Section 8, Clause 18: “To make all Laws which shall be necessary and proper for carrying into Execution the foregoing Powers.”

Hamilton argued that these clauses constituted sufficient authority for the chartering of a national bank, which would be convenient for the conduct of the Treasury’s debt issuance and redemption activities, as well as for the Treasury’s receipt of taxes and disbursements. Jefferson argued that the Treasury could do all these things without a national bank or through the existing state banks (then in Philadelphia, New York, and Boston). Hamilton argued that “necessary” merely meant “convenient.” Jefferson argued that Congress

should not violate the Constitution for a degree more or less of mere convenience. Hamilton argued that the whole structure of the list of related powers constituted “implied powers” of Congress, essentially to do anything of a general welfare–promoting nature. Jefferson argued that there are no implicit powers, only explicit powers, and that chartering a bank was not among them. In the end, however, Jefferson essentially advised President Washington that he could sign the Bank charter bill unless he thought Hamilton had misled Congress or that Congress was corrupted by “interest,” what we would call either bribery or a conflict of interest today. Washington signed the bill on February 25, 1791. Later, in *McCulloch v. Maryland* (17 U.S. 316 [1819]), Chief Justice John Marshall, who had the still-unpublished exchanges of correspondence among Hamilton, Washington, and Jefferson, upheld the constitutionality of the Second Bank of the United States (1816–1836), which was organized largely along the lines of the First Bank. Marshall’s reasoning followed Hamilton’s quite closely, including extensive verbatim copying (without citation of sources—Marshall only rarely ever cited sources anyway).²

So if you do not like the Federal Reserve System, you have to figure a way either to persuade Congress to repeal or revise it, or to re-argue *McCulloch v. Maryland* and persuade the Supreme Court that Chief Justice Marshall was wrong. And there are large law firms in New York (usually those representing state-chartered banks) willing to re-argue *McCulloch*.

Meanwhile, back in Philadelphia in 1787, what exactly did the Framers decide about central banking? The issue came to a head in the convention on September 14, 1787, only three days before the convention adjourned. Madison’s *Notes* show that a short but spirited debate was opened on the language that became Article I, Section 8, Clause 7, specifying that Congress shall have power “To establish Post Offices and post Roads.” Benjamin Franklin, who became the first postmaster general, was interested in this clause and suggested amending it to add “cutting canals where deemed necessary.” James Madison suggested

²See generally, Malone (1951), especially, the chapter on “The Bank and the Constitution.”

[A]n enlargement of the motion into a power “to grant charters of incorporation where the interest of the U.S. might require & the legislative provisions of individual States may be incompetent.”

James Wilson of Pennsylvania and Edmund Randolph of Virginia both spoke briefly in favor of the amended and enlarged plan. However, Roger Sherman of Connecticut and Rufus King of Massachusetts spoke against it. King remarked that

The States will be prejudiced and divided into parties by it [a power including incorporation]. In Phila. & New York, it will be referred to the establishment of a Bank, which has been a subject of contention in those Cities. In other places, it will be referred to mercantile monopolies.

Wilson’s replied that

As to Banks he did not think with Mr. King that the power in that point of view would excite the prejudices & parties apprehended. As to mercantile monopolies they are already included in the power to regulate trade.

Madison’s *Notes* describe the end of the debate as follows:

Col. [George] Mason [of Virginia] was for limiting the power to the single case of Canals. He was afraid of monopolies of every sort, which he did not think were by any means already implied by the Constitution as supposed by Mr. Wilson.

The motion being so modified as to admit a distinct question specifying & limited to the case of canals,

[Vote of the States as units, with two states not voting: 8-3 against, with “ay” votes cast by Pennsylvania, Virginia, and Georgia.]

The other part [related to a power to grant charters of incorporation] fell of course, as including the power rejected [Madison *Notes*, September 14, 1787].

So there you have it: The power to charter corporations (understood to include the power to charter a national bank) was considered

explicitly and was voted down. In their 1791 debate, Jefferson alluded to this point in his summary objections delivered to President Washington, but Jefferson was not supposed to know what was said in Philadelphia because he was not there (he was in Paris in 1787). The proceedings of the Constitutional Convention were supposed to be secret. (We assume that Madison, who came around to opposing the national bank, told Jefferson.)

Hamilton's reply to Jefferson argued, essentially, "Who knows exactly what went on in that room four years ago?" (Madison was not supposed to be keeping notes, and they were not published until 1840). Hamilton urged reliance on the ratified text and the doctrine of implied powers. Ironically, Washington was in Philadelphia that summer and should have been able to remember the debate in 1787 because he was the presiding officer of the federal convention [Malone 1951].

Ten Fundamental Truths about Money and Banking

One of the root causes (perhaps *the* root cause) of the current financial crisis (it should be "recent crisis," but has it really ended yet?) was a failure of the public policy debate (and of individual preferences) to consider carefully the obvious implications of one policy choice for the next and obviously interlinked policy choice. A related concern is rhetorical consistency, as in whether any one or more policy choices really belong within the political economy model that public policy allegedly is following at any given moment. Rhetorical consistency could be called avoidance of the "Chinese menu, column A/column B" approach to policy choices.

An unregulated banking system, for example, with no or ineffective reserve requirements, probably requires a larger role for deposit insurance than any other type of banking system *if* (and it is a big *if*) public policy decrees that safety of deposits comes ahead of any other consideration. However, guaranteeing deposits opens other cans of policy worms, appearing to be derived more from corporatist than from classically liberal or free-market political economy models.

Ten fundamental truths (some scholars call them "warranted assertions") about money and banking are listed below in the form of ordinal or ranked sets of policy choices, with each subsequent policy choice depending on the preceding policy choice. These truths

should be kept in mind as we examine varying constitutional and statutory models for the structure of money and banking.

1. Gold is money; everything else is credit. This saying, attributed to the original J. P. Morgan in response to the question, “What is money?” is still as true today as it was 100 years ago (Morgan 1912). Once acquired, gold (or silver in a bimetallic system) becomes the only asset that has monetary value at all times and in all circumstances. Also, unlike anything else on most financial statements, gold (or silver) as an asset does not have to be the liability of anyone else.

In the recent financial turmoil, the price of gold fluctuated, but its value remained more relatively constant than other assets.³ Considered as a commodity instead of as money, gold futures prices have declined less than most agricultural, energy, and non-precious metals future contracts.

2. In unregulated or free banking policy, either extreme position works, at least within its own terms. Either banks should follow a gold standard and maintain an adequate gold reserve against their liabilities, or they should maintain no reserve and issue liabilities valued entirely at whatever the bid price is in the market, regulating the quantity of issue to affect the bid price. Central banks may be convenient but, strictly speaking, are unnecessary under this set of choices.⁴
3. In a regulated or lawful money banking system, either extreme position also works, at least within its own terms. Either banks

³The monthly average price of London market gold in the heart of the crisis, from March 2008 (failure of Bear Stearns) to April 2009, was about \$850–\$900 per ounce, with a volatility range of \$988.50 per ounce (the nominal price peak until then in March 2008) to \$729.50 per ounce (the post-crisis low) in November 2008. Since the end of the Federal Reserve’s emergency lending period (roughly April-May 2009), converted into the first Quantitative Easing period (open market purchases instead of emergency loans), the monthly average price of gold has been about \$1,300 per ounce, with a volatility range of \$1,821 per ounce (August 2011, the onset of the first Greek payments crisis in the eurozone) to \$1,162 per ounce (weekly average, November 10, 2014). The December 7, 2014 spot price was \$1,192.14 per ounce, and the market has observed a general trading range of about \$1,200 to \$1,400 per ounce for the greater part of the last two years (World Gold Council 2014).

⁴Cato Institute-affiliated scholars like Lawrence H. White and George Selgin have written extensively about free banking over the years. See also, Rothbard (1976).

should be held to a statutorily mandated reserve requirement in gold or lawful money (which includes U.S. government bonds, notes, bills, currency, and lesser coin redeemable in gold or silver), or they should hold no gold but should hold statutorily prescribed reserves of full-faith-and-credit (FFC) U.S. government obligations.

The question of fractional reserve banking versus 100 percent reserve banking arises within this category. Both credit and the means of its repayment are obtained more easily under fractional reserve banking. But the unsubsidized safety of the banking system is assured more easily under 100 percent reserve banking. Central banks or a governmental regulatory system, or both, tend to play much more significant roles under a set of choices including fractional reserve banking.

4. Federal deposit insurance may be helpful in preventing irrational bank runs, but so may credible public assurance of the prudent conduct of the banking business. Plans like “safe banking” (the separation of the deposit-taking and payments system functions of banking from the lending functions of banking), 100 percent reserve banking, and a postal savings system (a form of government-sponsored enterprise) have inconveniences, but they provide for safety of deposits without federal deposit insurance. A banking system that allows the commingling of the deposit-taking and lending functions falls more closely to requiring some sort of deposit insurance than a system that does not allow commingling (Phillips 1995; Cochrane 2014).
5. Allowing depository institutions to engage in risk-taking activities that are not closely related to the traditional business of banking normally should require that those activities be segregated from the institutions’ deposit-taking and payments functions in order to prevent the adverse consequences of those risks from endangering the value of savings and payments. For example, allowing near-gaming activities, like the underwriting of credit default swaps inside insured banks or inside registered broker-dealers holding customers’ funds is begging for trouble. That is like lining up dominoes so that the fall of one ensures the fall of all (see Ivry, Son, and Harper 2011).

For a time, ending at the Federal Reserve in 1984, banking supervisors set at least some store in the “real bills” doctrine, which held that commercial banks should make only loans related to self-liquidating current transactions in commerce. Purchases of real estate, capital goods, and the like were “speculative investments” whose financing was deemed more appropriate for investment banking. As a monetary policy tool, the real bills doctrine died in the 1930s (it is a pro-cyclical policy tool, which is inconvenient in recessions), but as a prudential supervision tool, there is much to be said for enforcing conformity of assets with this doctrine in contrast to, for example, displaying an impressive array of credit default swaps. (Ask any bank examiner.)

6. Counting on supervisory or regulatory zeal and diligence to offset some, most, or all of the new types of risks introduced into a banking system (like over-the-counter or OTC derivative contracts, such as interest rate, foreign exchange, and credit default swap agreements) is a vain hope over time. James Madison expressed this thought best in his *The Federalist*, No. 10 (1787), as follows:

It is in vain to say that enlightened statesmen will be able to adjust these clashing interests, and render all subservient to the public good. Enlightened statesmen will not always be at the helm. Nor, in many cases, can such an adjustment be made at all without taking into view indirect and remote considerations, which will rarely prevail over the immediate interest which one party may find in disregarding the rights of another or the good of the whole.

The Framers of the Constitution believed that only properly constructed institutional structures, designed to create and maintain categorical distinctions amounting to a system of checks and balances, with separation of powers, could ensure the public good and the property rights of individuals. Very little evidence (perhaps no evidence) has developed over the years to prove that they were wrong in their belief.

7. It is a mistake, because it is an ever-present temptation to those who run it, to establish a central bank, to charge it with regulation of the currency issue and the supply of bank credit in the economy, and to authorize that central bank to make loans to

particular institutions while simultaneously being the chief supervisor and regulator of those institutions. The ever-present temptation is to use the discount window (or carefully targeted open-market operations) as a means of covering up supervisory mistakes. One's initial reaction to a sudden and sharp rise in central bank credit when these various functions are unified in one institution, as they are today in the Federal Reserve System, probably should be assumptions that a very large supervisory and regulatory policy mistake has been made and that the principal recipients of central bank largesse are those most engaged in gaming the system.

8. When central bank liquidity infusions begin to rise to flood-stage levels, as they currently do, then it is time to inquire whether an unforeseen outside shock to monetary policy is causing the flood or, rather, an eminently foreseeable failure of prior supervisory and regulatory policy. It generally is argued (sometimes more facetiously than at other times) that a supervisor cannot detect conscious and deliberate fraud, but if the supervisor creates or fosters an atmosphere in which fraud may flourish, then it is not irrational for the supervisor to be on sharper alert for fraud. The post-1980 situation probably falls somewhere between conscious fraud and profound neglect of very foreseeable risks and of duty.⁵
9. If the banking system is commingling traditional banking activities (deposit-taking together with commercial lending) with nontraditional banking activities (insurance or securities underwriting), then it is both prudent and rational to require that customers' funds devoted to those different sets of activities be segregated on the banks' accounting books. Governmental protections, to the extent admitted at all, should extend only to those functions related to maintenance of the principal components of the commercial economy (the pooling of deposits and the lending of funds) and not to the supplemental but nonessential components of commerce (insurance and securities underwriting). And it would be a fundamental mistake not to supervise and regulate banks if they both accept retail

⁵For evidence of at least some supervisory awareness of this problem (i.e., inept supervision, created in no small part by regulatory capture), see Dudley (2014) and Tarullo (2014).

deposits and make commercial loans in amounts below the sizes appropriate for syndicates of bond underwriters. Traditionally, by the way, mortgage loans were considered speculative and usually were made by specialized mortgage lending entities.⁶

10. Governmental protection of the banking system took many forms even before the current crisis. It is unclear whether the public receives a fair and reasonable return on its governmental investment in banking. Current government protections that did not exist at common law or in classical economics include: perpetual bank charters (instead of 20-year charters), limited personal liability of directors and principals through corporate forms of organization (instead of partnerships and sole proprietorships), federal deposit insurance, Federal Reserve discount window assistance, and free finality of payment for transactions posted on Fedwire. A few, free-market banks still exist (in partnership form, not receiving retail deposits, not Federal Reserve members, and the like), but they are fairly discreet and tend to be unknown to the general public. On the other hand, they tend to have been around for a long time (nearly 200 years) because of the prudent lending and investment practices that they have followed. (Please contact me if you do not know who they are.)

Conclusion

A central bank may be convenient for some purposes but, strictly speaking, is unnecessary in a free banking, gold standard, or 100 percent reserve banking system. If we decide that fractional reserve banking is desirable, then a central bank or some kind of privately owned bankers' bank (or effective clearing house association) makes more sense. If we decide to have fractional reserve banking with no gold in the system, then a central bank might be a more rational

⁶After this paragraph was written, in a surprise, last-minute maneuver just before the Christmas holiday congressional recess in December 2014, the omnibus federal budget reconciliation bill passed both houses of Congress containing a provision repealing Section 716 of the Dodd-Frank Act of 2010, the "Lincoln amendment," which required federally insured banks to "push out" most non-cleared credit default swaps and certain other over-the-counter derivative transactions. Going forward, it appears that insured banks may engage in such activities without push-out (Weisman 2014).

solution to the liquidity problems that are likely to emerge, but even then, banks should be charged with greater attention to maintaining their own reserves of liquidity. But even if we have a liquidity-providing central bank, Congress should not be excused from legislating either a strict numerical limit on the upper bound of the bank's balance sheet or a limitation on the allowed rate of growth of that balance sheet.

To do less is for Congress to abdicate its power "to coin Money [and] regulate the Value thereof."

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