

**The Future of Central Banking:  
A Lesson from United States History**

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# **1. Introduction**

I'm going to begin by reviewing a crucial episode in U.S. monetary history together with resulting decisions by the U.S. Supreme Court. This is an unlikely topic for a conference on the future of central banking, but is in fact highly relevant. In developing that argument I will refer to a paper given at the BOJ conference last year by Goodfriend in which he promotes an analytical classification for thinking about monetary policy (JME, 2010). Following this discussion, I will conclude by outlining a way of conducting monetary policy that is inspired by metallic standards of the past—thus illustrating the connection between today's policy issues and

the monetary arrangements of previous centuries.

Let's review what the Constitution says about monetary arrangements:

(i) *“The Congress shall have power ... to borrow money on the credit of the United States, ..., to coin money, regulate the value thereof, and of foreign coin, and fix the standard of weights and measures”* [Art I, Sec 8].

(ii) *“No state shall ... coin money; emit bills of credit; make any thing but gold and silver coin a tender in payment of debts ...”* [Art I, Sec 10].

From these it seems clear that the vision embodied in the Constitution was that the nation's arrangements would feature a strict metallic standard— with gold or silver as the standard commodity, or, gold-silver bimetallism.

There is no mention of money in the amendments, so a basic question is: how were these provisions overturned so as to result in today's fiat-money system with FR notes as legal tender and no trace of a metallic standard?

## **2. Greenbacks**

Fiat money made its first appearance after adoption of the Constitution, in the Civil War of 1861-65, with issues of the infamous "Greenbacks" in 1862, 1863, and 1864. Total Greenback emission was \$450 million, which alone represented a near-doubling of money supply relative to 1860. The context for the first issue was that in late 1861 matters were going badly for the U.S. government as militarily the Southern forces were holding

their own, and financially the U.S. was having major problems. Both orthodox and unorthodox schemes had been attempted, and still the North was finding it extremely difficult to raise funds needed for the war (Mitchell, 1903). Additional taxation would be unpopular and borrowing was viewed as likely to require “prohibitively high” rates of interest. So the Treasury Secty, Salmon P. Chase—of whom we shall hear more—and an energetic committee chairman, Rep. Elbridge G. Spaulding, devised a plan of issuing fiat paper money, the “Greenbacks.” These were legal tender notes, non-redeemable, non-expiring, and non-interest-bearing.



表紙/Face



裏紙/Back

アメリカ【グリーンバックス】  
 U.S.A.  
 "Greenback". Legal Tender Note, 1862  
 10mm × 180mm

政府は南北戦争の戦費調達のため紙幣を乱発し、1864年には金で表わした1ドル紙幣の価値は35セントにまで低落した。

Spaulding wrote the legislative bill and led its passage, which met with much opposition in the House. He argued that haste was necessary; that the government would “be out of means to pay the daily expenses in about thirty days, and the committee do not see any other way to get along till we can get the tax bills ready....”. [Not true]

In the debate, constitutionality of Greenback issues was questioned by many as their characteristics were similar to those of the “bills of credit” specifically prohibited by the Const. Unfortunately, at least for the sake of clarity, this prohibition applies to the states but not—at least not explicitly—to the Congress. Resulting ambiguity enabled the Greenback

proponents to argue that their issue was justified by the Constitution's grant to the Congress of the power "... to make all laws which shall be *necessary* and proper for carrying into execution the foregoing powers, and all other powers vested by this Constitution in the Government of the United States ..." [Art I, Sec 8]. Strong counter-arguments were made in 1862 that the Greenback issues would be only "helpful" to the govt's conduct of the war, not *necessary*, and the bill barely squeezed through Congress. But it was signed by President Lincoln on Feb. 25, 1862, and the first issue took place in April. At the time, Sec Chase expressed misgivings about making notes legal tender—see Mitchell (1903, pp. 68-74).



### **3. Legal Tender Cases in the Supreme Court**

If the Greenback issue had been only temporary, the nation might have returned after the war to a metallic standard, as in many other cases. That was not to happen, however, because of “... congressional inaction (failing to repeal the laws quickly and return to a specie standard) and Supreme Court approval once the laws were tested.”

It was natural that no challenges to the constitutionality of the Greenbacks would arise until after the War. The first case to make it to the Supreme Court was *Hepburn v. Griswold*, in 1869. The lender, who had made a loan (in dollars) before issuance of the Greenbacks, went to court

when the borrower attempted to make repayment in Greenbacks. By this time, remarkably, Chase had become Chief Justice (of Supreme Court). In fact, he was part of 4-3 majority who ruled that the Legal Tender Act of 1862—for which he was largely responsible—was unconstitutional!

That was not the end of the story. On the very day on which this ruling was made public, President Grant announced the appointment of two new justices to the Court, both of whom had made rulings that showed that they supported the validity of the legal tender laws. So, when another legal-tender case made it to the Court in 1871, the 1869 ruling was overturned and the legal-tender laws ruled to be consistent with the

Constitution. (Chase voted in the minority, again judging the laws to be unconstitutional.) This ruling, in *Knox v. Lee* (1871), was upheld in later cases (1872 and 1884).

It is interesting to consider whether Grant's appointment of two Greenback-favorable members to the Court should be considered as a successful "packing," and thereby as a predecessor of Roosevelt's infamous attempt in 1937. It turns out that Grant's actions were less objectionable. {The main reason is that the Court had been temporarily below its previous number of justices, as the result of a congressional act of July 1866 (brought about to avoid Court appointments by President

Johnson, who had been impeached in 1868 but acquitted). The act enlarging the Court to nine justices had been passed in 1869, possibly with an eye to overturning the expected ruling in Hepburn case. See Hepburn (1935), Dunne (1960), Ratner (1935).}

#### **4. Supreme Court Decisions and Future Monetary Policy**

But what does all of this have to do with current and future monetary policy? The point is that the Supreme Court arguments in favor of Greenback constitutionality were based largely on a crucial confusion between monetary and fiscal policy. In particular, “the power to borrow money” is a fiscal, not a monetary provision. It gives Congress the right

to *borrow*—to sell government debt to the public—an activity that does not entail any necessary change in the stock of money, especially when the funds are immediately spent on military expenses (as in 1862). When the Treasury sells or purchases bonds rather than raising or lowering taxes (in order to finance increased or decreased government expenditures) there is no implied change in the stock of HP money, which is basically Goodfriend’s 2010 criterion for monetary policy.

But the reasoning of Supreme Court justices in two crucial cases did not recognize this distinction. Instead, they argued as if the quoted power (“to borrow money”) would justify the issue of legal-tender fiat money.

These cases were *Knox v. Lee* (1871) and *Julliard v. Greenman* (1884)—see *Hepburn*, *Dunne*, *Timberlake*. Also, arguments by congressmen in 1861 in favor of the Greenback issue (*Mitchell*), and by minority members in the Court's 1869 case, had also involved this confusion. In sum, the failure to distinguish between monetary and fiscal policy actions was a major contributing factor to the Supreme Court decisions that made possible the shift of the U.S. monetary standard from a metallic-money to a fiat-money system, a change of fundamental and momentous proportion. Of course this change was not completed until much later, as convertibility into gold was maintained from 1879 until 1933 and some remaining

elements of a metallic system until 1971. But the “legal tender” cases were necessary preludes to the later steps in the process of demetallization; without them, later actions and rulings would have been different. Now, essentially the same failure has been present in the discussion of the recent financial crisis, as argued in Goodfriend’s paper, which emphasizes the implications for central-bank independence.

## **5. Contemporary Relevance**

I have suggested that monetary arrangements in the U.S. have departed sharply from those specified by the Constitution, and that the change has been based in crucial ways on invalid reasoning. Does that mean that I

would favor a return to a metallic standard? In fact, I would not favor an attempt to return to a gold or silver or bimetallic standard, and only partly because doing so would be nearly impossible to achieve. More important is that we could now do better by recreating the essence of the Constitution's instructions within the context of today's paper money and with an improved policy target. The purpose of the constitutional provisions was to prevent major changes in the purchasing power of money (the MOE). Given the absence of broad price indices in those days, the specification of a fixed metallic standard was the only way known to the authors of providing a degree of price level stability. That the "value"



specified by Art I, Sec 8, was to be adjusted rarely (if ever) was, it seems clear, implied by the phrases “to coin money” and “regulate the value thereof” appearing in the same sentence as those pertaining to standards for weights and measures. Given today’s technology, however, near-constancy of the value of money could be provided better by specification of a broad price index, rather than the price of gold, for the system to keep constant. For the U.S., Congress could designate a broad price index and assign the Fed the technical task of keeping its inflation rate equal to (or close to) zero. This would provide the U.S. with a monetary standard, which we do not have at present, and would specify the Fed’s duties in

such a way that it would have monetary policy independence. This could then be used in meeting the standard specified—as in the Constitution—by the Congress.

Obviously, this reasoning could be applied to Japan or other nations with market economies. In addition, this setup would be entirely in the spirit of the New Keynesian type of monetary policy analysis that had represented something of a “consensus” among researchers before the crisis of 2007-2009 erupted, in a manner that has demoralized and confused economists and policymakers in recent years.