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

Keynote Speech by Bennett T. McCallum

The United States Constitution evidently calls for monetary arrangements with a strict metallic standard—gold, silver, or bimetallic. How were these provisions overturned so as to result in today's fiat-money arrangement with no trace of a metallic standard? A crucial step involved Supreme Court decisions after the Civil War with regard to the constitutionality of the fiat "greenbacks" issued during the war. The reasoning expounded by the Supreme Court in these decisions relied importantly on a failure to distinguish between monetary and fiscal policy provisions. Essentially the same failure has been present in much of the recent discussion concerning the financial crisis of 2007–09.

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Carnegie Mellon University and National Bureau of Economic Research (E-mail: bmccallum@cmu.edu)

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I. Introduction

In this presentation, I will begin by reviewing an important and interesting episode in U.S. monetary history, together with some resulting decisions by the U.S. Supreme Court. This may seem like a strange topic for a conference on the future of central banking, but I believe that it is in fact highly relevant. In developing the position, I will be referring to a paper given at the Institute for Monetary and Economic Studies, Bank of Japan, International Conference in 2009 by my colleague, Marvin Goodfriend—a paper that promotes an analytical framework for thinking about monetary policy.[1] Following this development, I will conclude by briefly outlining some ways of conducting monetary policy that are inspired by metallic standards of the past—thereby illustrating a second type of connection between today's policy issues and the monetary arrangements of long-past historical experiences.

Let us begin by reviewing what the Constitution of the United States has to say about monetary arrangements. It is an easy matter to do so, because monetary affairs are mentioned only twice in the Constitution, with the two brief provisions being as follows:

(1) "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 . . ." (Article I, Section 8).

(2) "No State shall . . . coin Money; emit Bills of Credit; make any Thing but gold and silver Coin a Tender in Payment of Debts . . ." (Article I, Section 10).

From these provisions, it seems abundantly clear that the vision and presumption embodied in the Constitution was that the nation's monetary arrangements would feature a strict metallic standard—one with either gold or silver as the standard commodity or, alternatively, one involving a gold-silver bimetallic system.[2] As there is no mention of the monetary standard among the amendments to the Constitution, a fundamental question arises naturally, namely: how were these provisions of the Constitution overturned so as to result in today's fiat-money arrangement in which Federal Reserve notes serve as legal tender and there is no trace whatsoever of a metallic standard?

II. The Greenbacks

The occasion upon which fiat money made its appearance in the United States, for the first time since the adoption of the Constitution, was the Civil War of 1861–65, with three issues of the infamous "greenbacks" occurring in 1862, 1863, and 1864. The total greenback emission was US$450 million, which alone would have represented a near-doubling of the money supply relative to its magnitude in 1860.[3] The context for the

1. A revised version of this paper will be published shortly in the *Journal of Monetary Economics*. See Goodfriend (2010).
2. This opinion has been expressed by Hepburn (1924, pp. 73–74 and p. 179), Timberlake (1989; 1993, p. 4), and McCallum (1989, p. 24).
3. Timberlake (1993, p. 86) states, "The stock of money in circulation in 1860 was on the order of $500 million, composed of roughly equal amounts of currency and bank deposits." Hepburn (1924, p. 204) gives an estimate of $448 million.

first of these issues was that in late 1861 matters were not going well for the U.S. government. Militarily, the rebellious Southern forces were holding their own (at the First Battle of Bull Run), and financially the United States was finding it difficult to provide its armies with troops and supplies. Both orthodox and unorthodox schemes had been attempted, and still the North was finding it extremely difficult to raise funds needed for prosecution of the war.[4] Additional taxation of U.S. citizens would be unpopular, and borrowing was viewed as likely to require "prohibitively high" rates of interest.

Consequently, the Secretary of the Treasury, Salmon P. Chase—of whom we shall hear much more—and an enthusiastic committee chairman, Rep. Elbridge G. Spaulding, devised a plan for finance by issuing fiat paper money, which came to be called "greenbacks." These would be legal tender notes, non-redeemable, and non-interest-bearing. Spaulding wrote the legislative bill, and then he and Chase led its passage, which met with much opposition in the House of Representatives.[5] Spaulding argued that haste was necessary; 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. . . ."[6]

At the time, the constitutionality of the greenback issues was questioned by numerous observers (including many members of the U.S. Senate), as their characteristics were highly similar to those of the "bills of credit" specifically prohibited by the Constitution.[7] Unfortunately, at least for the sake of clarity, this prohibition applies to the states but not—at least not explicitly—to the Congress.[8] The resulting degree of ambiguity enabled the greenback proponents to argue that their issuance was justified by the Constitution's granting 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. . . ." (Article I, Section 8). Strong counter-arguments were made in 1862 that the greenback issues would be only "helpful" to the government's conduct of the war, not "necessary," and the bill barely squeezed through Congress.[9] But it was signed by President Abraham

4. For a detailed description, see Mitchell (1903, pp. 1–43).

5. It should be said that Chase was following this course of action with considerable reluctance. Indeed, Mitchell (1903, p. 4), describes him as "a secretary of the treasury who cherished a strong predilection for metallic money."

6. This claim turned out to be "a gross exaggeration. The Legal Tender Act did not pass until 48 days after Spaulding's ominous forecast, and no notes were issued for 34 days after the bill was signed into law" (Timberlake [1989, p. 310]).

7. The greenbacks were nonredeemable, non-interest-bearing, indefinitely lived, full legal tender (for private and public debts) liabilities of the Treasury, known as U.S. Notes. The term "bills of credit" was used to refer to fiat paper money issues of various types issued by the 13 colonies prior to the Declaration of Independence. For one analysis of the controversial results of some of these episodes, see McCallum (1992).

8. The Constitution also declares, in the 10th Amendment, that "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." This provision evidently gives the states precedence in some sense, making it strange that some power expressly denied to the states could be permissible by the Congress, but it does not pertain to the matter in question because the latter is prohibited to the states.

9. In fact, at the subcommittee level, the bill fell one vote short of the number required for it to be sent on for consideration by the House of Representatives. One member of the subcommittee then changed his vote so that the full membership of the House could consider it. There it passed (in January 1862) by a vote of 93 to 59. Several of the congressmen voting in favor expressed the view that it was to be only a temporary expedient; the chairman, Spaulding, himself stated that "when peace is secured, I will be among the first to advocate a speedy return to specie payments" (Mitchell [1903, p. 67]).

Lincoln on February 25, 1862, and the first issue took place in April 1862. At the time, Secretary Chase expressed considerable misgivings about making the notes legal tender (Mitchell [1903, pp. 68–74]).

III. 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 happened in many cases in European history. This was not to happen in this instance, however. Calomiris (1992, p. 283) notes that "the permanence of the federal encroachment into the supply of currency and the regulation of the numeraire depended on 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 greenback issues would arise until after the conclusion of the Civil War. The first case to make it to the Supreme Court was Hepburn v. Griswold, in 1869. Griswold, who had made a loan (in dollars) to Hepburn before the issuance of the greenbacks, went to court when Hepburn attempted to make repayment in greenbacks. By this time, strangely enough, Chase—who had been Secretary of the Treasury in 1862—was Chief Justice of the Supreme Court. Furthermore, he was part of the 4–3 majority that ruled in favor of Griswold by declaring that in part the Legal Tender Act of 1862—for which he was largely responsible—was unconstitutional!

This was not the end of the story, however. On the very day on which the Hepburn v. Griswold ruling was made public, President Ulysses S. Grant announced the appointment of two new justices to the Supreme Court, both of whom had as judges made rulings indicating that they held positions clearly supporting the validity of the legal tender laws. Consequently, when another case involving legal tender made it to the Supreme Court, in 1871, the Hepburn v. Griswold ruling was overturned and the legal tender laws were ruled to be consistent with the Constitution. (Interestingly, Chase found himself voting in the minority this time, as he again judged the laws, which he had requested as Secretary of the Treasury in 1862, to be unconstitutional.) This later ruling, in a case known as Knox v. Lee (1871), was upheld in subsequent cases, including Juilliard v. Greenman in 1884.

I am drifting a bit away from our main subject, but find it irresistible briefly to consider whether President Grant's appointment to the Supreme Court of two members who favored greenbacks should be considered a successful "packing" of the court, and thereby a predecessor of President Franklin D. Roosevelt's infamous attempt to pack the court in 1937. Very briefly, it turns out that President Grant's actions were considerably less objectionable, even though the nominees' views on the matter were known, for two reasons. First, Grant had made the appointments before the outcome of Hepburn v. Griswold was announced. Second, and much more fundamentally, Grant's action in increasing the size of the court evidently was not as blatantly improper. The court had been temporarily below its previous number of justices, as the consequence of a Congressional act of July 1866 brought about (supposedly) by the desire of Congress to avoid court appointments by President Andrew Johnson, who had been impeached in

1868 but acquitted. The act enlarging the Supreme Court to nine justices was passed in 1869, possibly with an eye to overturning the ruling in Hepburn v. Griswold (although that ruling had not yet been made). For more details, see Hepburn (1924, pp. 255–256), Friedman and Schwartz (1963, p. 47), Dunne (1960, pp. 76–77), and Ratner (1935).

IV. Supreme Court Decisions and Future Monetary Policy

But what, one might well ask, does all of this have to do with current and future monetary policy arrangements? My answer is that the Supreme Court arguments in favor of greenback constitutionality relied to a substantial extent on a crucial confusion between monetary and fiscal policy. In particular, note that "the power to borrow money" is a fiscal, not a monetary, provision. Specifically, it gives the Congress the right to *borrow*—to sell government debt to the public—an activity that does not necessarily entail any change in the outstanding stock of money. "Borrowing" and "lending" are terms that pertain to fiscal actions, not monetary actions; for when the U.S. Treasury sells or purchases bonds rather than raising or lowering taxes (to finance increased or decreased government expenditures) there is no necessary or implied change in the nation's quantity (stock) of high-powered money—and no change in the private sector's holdings when the borrowed funds are immediately spent on (e.g., military) supplies and wages, as was the case in 1862.

But the reasoning expounded by 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 (in 1871) and Julliard v. Greenman (in 1884).[10] In addition, the arguments made by congressmen in 1861 in favor of the greenback issue,[11] and by minority members of the Supreme Court in the case of Hepburn v. Griswold (Hepburn [1924], p. 257), also involved this confusion. In sum, it is my argument that the failure to distinguish clearly between monetary and fiscal policy actions was a major contributing factor to the Supreme Court decisions that made possible the alteration of the U.S. monetary standard from a metallic money to a fiat money system, a change of truly fundamental and momentous proportion.

Of course, this change was not completed until much later, as convertibility of paper money into gold was maintained from 1879 until 1933 and some elements of a metallic system remained until 1971, as is well known. But the legal tender cases were necessary preludes to the later steps in the process of de-metallization; without them, subsequent actions and judicial rulings could have differed greatly from those that actually transpired. Thus, the failure of legislators and justices to recognize the basic distinction between monetary and fiscal policy played a central role in the basic and momentous historical change, from metallic to fiat regimes, in U.S. monetary arrangements. But essentially the *same* failure has been present in much of the recent discussion concerning the financial crisis of 2007–09, as is revealed in the analysis

10. Confusion, in Supreme Court reasoning, of borrowing with monetary powers is pointed out in discussions by Hepburn (1924, p. 264), Dunne (1960, pp. 78–79 and p. 82), and Timberlake (1989, p. 312; 1993, pp. 137–138).

11. These arguments are extensively documented by Mitchell (1903, pp. 44–81).

of Goodfriend (2010), whose argument focuses on this distinction and emphasizes its fundamental importance for central bank independence.[12]

V. Contemporary Relevance

The foregoing discussion has suggested that monetary arrangements in the United States have departed sharply from those specified by the Constitution, and that the change has been based in crucial ways on invalid reasoning. Does this mean that I would favor a return to the metallic standard implied by the Constitution?

In fact, I would not propose or favor an attempt to return to a gold or silver or bimetallic standard, and only partly because doing so would now require a constitutional amendment that I—and probably most readers—would judge to be nearly impossible politically to achieve. More important, in my opinion, is that we could now do better by recreating the essence of the Constitution's instructions within the context of today's paper money arrangements and with an improved monetary policy target. In particular, the provisions of the Constitution were clearly designed to prevent major ongoing changes in the purchasing power of the medium of exchange. Given the absence of publicly available data on comprehensive price indices in those days—or even any form of rapid communication among hypothetical statistical offices in different cities—the specification of a fixed metallic standard was the only means known to the authors of providing a semblance of price-level stability.[13] That the "value" specified by Article I, Section 8 of the Constitution was to be adjusted very infrequently (if ever) was, it seems clear, implied by fact that the expressions "to coin money" and "regulate the value thereof" appear in the same sentence as that pertaining to establishment of standards for weights and measures.

Given today's technology, however, near-constancy of the value of the medium of exchange could be provided by governmental specification of a comprehensive price index, rather than the price of gold, that the monetary authority could keep at a virtually constant level over time by standing ready to buy or sell (via a redemption medium such as Treasury bills) bundles of goods and services specified by the comprehensive index.[14] For the United States, for example, the Congress could designate a widely defined price index and assign the Federal Reserve the technical task of keeping the associated inflation rate equal to (or at lease close to) zero.[15] Indeed, it would be possible

12. The framework proposed by Goodfriend (2010) emphasizes the distinction by means of the following definitions: (1) pure monetary policy consists of central bank open market purchases (or sales) of Treasury securities; (2) pure credit policy consists of changes in assets held by the central bank with the monetary base held constant; and (3) interest-on-reserves policy consists of changes in the interest rate paid on commercial bank reserves held with the central bank. A purchase by the central bank of non-Treasury securities is then a mixture of monetary and credit policy, a mixture that has direct fiscal ramifications.

13. In simpler words, the Constitution's authors believed that a gold (or silver or bimetallic) standard was the most effective device for maintaining the purchasing power of money, thereby preventing inflations or deflations that would be unfair to either creditors or debtors and disruptive for the society at large.

14. See Yeager (1992).

15. Here I am not taking a position on whether the system should permit base drift. In choosing the index and setting the target inflation rate, the Congress should of course take advantage of professional expertise in such matters, which would (I believe) correctly involve considerable discussion with officials and economists of the Federal Reserve System. It might be argued that the Fed's role would be to adopt a policy rule, for adjustment of

for the assigned task to be to keep some measure of aggregate nominal spending (such as nominal GDP or final demand) growing steadily at a non-inflationary rate. This would provide the United States with a clear monetary standard, which we do not have at present, and would specify the Fed's duties in such a way that the Fed would have monetary policy independence, which would then be used in meeting the standard specified, in accordance with the Constitution, by the Congress.

Obviously, this type of reasoning could be applied to Japan or other nations with market economies. In addition, an arrangement of the type described would be entirely in the spirit of the "New Keynesian" or "New Neoclassical Synthesis" type of monetary policy analysis that had represented something of a "consensus" among researchers, as described by Goodfriend (2007) and exemplified by Woodford (2003), before the crisis of 2007–09 erupted in a manner that has demoralized and confused economists and policymakers in recent years. This spirit, it might be added, involves viewing the central bank's role as that of the *monetary authority,* rather than a *financial intermediary* (i.e., a "bank"). It reflects the sharply different duties of the central bank under metallic and paper arrangements, either of which can be designed to support a monetary standard that provides price-level stability.

a policy instrument (an interest rate or monetary base growth rate), that would be intended to achieve price-level stability over a period longer than the intermeeting span.

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