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ONE

The Current Condition of Monetary Affairs in the United States

It is easy to perceive that individuals by agreeing to erect forms of government... must give up part of their liberty for that purpose; and it is the particular business of a Constitution to mark out **how much** they shall give up.... which says to the legislative powers, "Thus far shalt thou go and no farther." A Constitution, when completed, resolves the two following questions: First, What shall the form of government be? And, secondly, What shall be its power? And the last of these two is far more material than the first.

Anonymous
The Founders' Constitution, "Four Letters On Interesting Subjects," 1776, Vol. 1, 638

The money clauses in the U.S. Constitution are brief, simple, and explicit; the humblest mind can understand them without elaborate interpretation. Article 1, Section 8 states that "The Congress shall have Power ... To coin Money, regulate the Value thereof, and of foreign coin, and fix the Standard of Weights and Measures." Section 10 denies the states any monetary powers. It declares that, "No State shall ... coin money; emit Bills of Credit; [or] make any Thing but gold and silver Coin a Tender in Payment of Debts." Yet today the U.S. monetary system seems in conflict with those clauses. In particular, it has no place for gold or silver. All of the hand-to-hand currency in everyday use consists entirely of paper notes – bills of credit – issued by the Federal Reserve System, and none of it is redeemable in anything except other "bills of credit." While the U.S. Treasury also issues coin currency for use in smaller exchanges, none of the currency, paper or coin, is worth anything as a commodity. It is all *fiat.* All checkable bank deposits, the only other money of any consequence, is based either on bank-held Federal Reserve note currency or on reserve balances of commercial banks in Federal Reserve Banks. These reserves are redeemable only for bills of credit – the aforementioned Federal Reserve notes. In sum, all bank

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reserves and hand-to-hand currency are issues that the Federal Reserve System – the U.S. central bank – has created by what is now regarded as standard monetary policy, primarily, purchases of U.S. government securities that the U.S. Treasury has previously marketed to finance the federal government's long-recurring fiscal deficits. None of it is based on gold or silver; none of it can be redeemed for gold or silver. The entire redeeming medium, fiat Federal Reserve notes, is legal tender for all debts, public and private. Federal Reserve notes and "credit" have completely replaced gold and silver. Yet, the words "Federal Reserve" are nowhere to be found in the Constitution of the United States.

Settled and accepted U.S. policy not only flouts the constitutional prohibition against fiat legal tender money – bills of credit – it also fails to provide any gold or silver money in any form.[1] Courts of law will not even hear cases that would challenge this status quo. They throw out attempts to restore constitutional money as "frivolous." Somehow, between the time that the Constitution and the first ten Amendments were ratified and the present, gold and silver money have disappeared, while the prohibited bills of credit – in this era, Federal Reserve notes – have become conventional standard money. Congress and the Executive branch have often initiated the policies that have reversed what once seemed to be eternal verities, while Supreme Court decisions have sanctioned the changes and given them permanence.

This breach of explicit constitutional provisions, which appears illegal on its face, should have an excuse, or at least an explanation, intelligible to anyone and everyone. The present status of the monetary system seems, however, to have been accepted at all levels – from the unschooled layman to the denizens of the Supreme Court – without serious argument, and without embarrassment at the obvious contradiction between what the Constitution specifies and what has come to exist today.

The Supreme Court is a body of legal experts who, understandably, have interpreted the Constitution from legal and political perspectives. When the Court has handed down decisions that call for an understanding of economics, particularly monetary economics, the justices have had to rely on

[1] "Fiat money" is any money – always a paper currency – that a government issues on its own authority and without any visible redeeming medium, such as gold or silver. "Fiat" is the vocative form of the Latin verb, "fio," and literally means "Let there be," in this case, "Let there be money." "Bills of credit," discussed both here and further on, are the *fiat* currency that governments have issued at various times in the past and present. They are explicitly prohibited to the states by the Constitution, and by implication as well to the federal government.

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"expert" testimony from what are often special pleaders, or from their own superficial knowledge of monetary affairs. At times they have also deferred on these matters to Congress or the Executive branch, who are no better equipped than the justices in either economic doctrine or the analysis of monetary complexities.

The Justices are not to be condemned on this account. They can hardly be both learned legal analysts and accomplished professional economists. Consequently, putting an economics perspective into the briefs for the Court's decisions should add credibility to future judgments that cover similar ground, and may correct for posterity mistaken judgments that are now a part of accepted policy. Such a project may seem politically unrealistic. But if no one suggests corrections to what has been handed down as the ultimate word from the Court, manifestly incorrect or improper arguments become part of accepted law and endure forever.

Any work on the history of monetary affairs must treat explicitly the operations of both metallic standards (gold and silver) and central banking institutions. The money clauses of the Constitution provide legal sanction for a bi-metallic monetary standard, that is, one in which both gold and silver coins are legal tender for all debts public and private. To make such a standard operational, Congress had to specify the terms – that is, the mint prices in dollars – on which the two metals would be legal tender. The two metallic moneys would then reflect an explicit legal ratio of monetary value, that is, an *exchange rate*. The history of how this bi-metallic standard worked, therefore, is also a necessary backdrop to a review of Court decisions, particularly those that abused or rescinded the explicit provisions specifying gold and silver as the only legal tender.

Central banks first appeared during the later nineteenth and early twentieth centuries. During the twentieth century, they acquired a monopoly on the provision of base money and have completely supplanted metallic standards, which are now nothing more than artifacts in the dust-bin of history.

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TWO

The Emergence of Money in Civilized Societies

Through the ages from ancient times, monetary devices have come into existence spontaneously, in much the same fashion that wheels, levers, writing materials, energy products, languages, and countless other human innovations have appeared. All of these devices make life easier; and by significantly reducing the real costs of man's existence, add to the total product that private institutions can generate and use.

Because money is an economizing agent for any society that exchanges goods and services, it has appeared in many diverse cultures and over many centuries of man's existence. Money, however, has had an evolutionary history somewhat different from that of other commonly used technical devices. Its appearance and use have often given rise to mystical suppositions and superstitions about its nature and those who control it. These traits have accompanied it into the twenty-first century. More importantly, because of its unique properties, money in all ages has been an object of state intervention and control.[1]

Money evolved from commodities that were not money. As primitive peoples began to exploit their productive abilities, they first bartered goods and services directly in order to realize the economic benefits of their specialties. Very soon, they learned to barter indirectly. By exchanging a surplus item for some intermediate good, people could ultimately realize a more desirable end-product or service. These indirect bartering devices were rudimentary media of exchange that had nascent monetary properties.

[1] The following brief history of the evolution of money is well known. For further details, see my account of this evolution in, *Gold, Greenbacks, and the Constitution*. The George Edward Durrell Foundation: Berryville, Va., 1991, pp. 1–12, and my article, "Gold Standard Policy and Limited Government," pp. 167–191, in *Money and the Nation State*.

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Carl Menger, a founder of Austrian economics, correctly captured the dynamics of the shift from barter to money in his *Principles of Economics*, published in 1871. "As economizing individuals … became increasingly aware of their economic interest," he wrote, "they everywhere attained the simple knowledge that surrendering less saleable commodities for others of greater saleability brings them substantially closer to the attainment of their specific economic purposes."[2] While "only a small number of economizing individuals … recognize[d] the advantage accruing to them from the acceptance of other, more saleable, commodities" in exchange for their own goods or services, others observing the "economic success" of those employing an intermediate good to achieve their ends, adopted the medium themselves. "In this way, custom and practice contributed in no small degree to converting the commodities that were most saleable" into media of exchange.[3]

Besides describing the path by which some common goods became money because of greater "saleability," Menger made three other important observations:

First, money's appearance was "… not the product of an agreement on the part of economizing men nor the product of legislative acts. No one invented it." Rather, money-commodities appeared *spontaneously* as special devices to meet human needs, much like language, the wheel and common law.[4]

Second, "the specific forms in which [money] has appeared were everywhere and at all times the result of specific and changing situations." The emergence of money was scattered over time and place, and primitive moneys took many forms – cattle, weapons, furs, salt, and, only later, metals. Menger correctly noted that what might have become an optimal metallic money, say, gold in an urban-commercial setting, would not have been so viable a money as, say, cattle in a rural-nomadic society.[5]

Third, Menger noted, governments, whether benign or oppressive, had little to do with the development of money from barter. "The origin of money … is, as we have seen, entirely natural and thus displays legislative influences only in the rarest instances. Money is not the invention of the

[2] Menger, Carl. *Principles of Economics*. New York and London: New York University Press, 1981. Translated by James Dingwall and Bert Hoselitz (German edition first published in Vienna in 1871), p. 262.

[3] *Ibid*., p. 261.

[4] *Ibid*., p. 271.

[5] *Ibid*., pp. 263–266.

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state. It is not the product of a legislative act. Even the sanction of political authority is not necessary for its existence."[6]

Although he denied any historic role for the state in the origin of money, Menger suggested that the state might contribute significantly to the acceptability of money. "The sanction of the state," he argued, "gives a particular good the attribute of being a universal substitute in exchange, and although the state is not responsible for the existence of the money-character of the good, it is responsible for a significant improvement of its money-character."[7]

The "sanction of the state" and the "significant improvement" Menger thought possible was for the state to impress upon the money already circulating the additional property of *legal tender* so that everyone would be forced to accept it. A debtor then would be able to clear an obligation to a creditor immediately and without controversy.

Governments have always claimed that monetary systems under their direction require the legal tender provision – that legal tender somehow gilds the gold. The argument is, however, specious on two counts. First, any contract may contain in its text, along with other details, the agreeable medium for its payment. Given this condition, no case exists for a state-enforced legal tender provision. Second, since freely circulating money is already acceptable as far as private volition will take it, impressing it with the legal tender feature can only force it into exchanges where people do not need or want it.

In his section on coinage, Menger embellished his argument for state enforcement of legal tender – an argument that has been common through the ages:

> The best guarantee of full weight and assured fineness of [gold and silver] coins … can be given by the government itself, since [the government] is known to and recognized by everyone and has the power to punish crimes against the coinage. Governments have usually accepted the obligation of stamping the coins necessary for trade. But they have so often and so greatly misused their power that economizing individuals … almost forgot the fact that a coin is nothing but a piece of precious metal of fixed fineness and weight, for which … the honesty and rectitude of the mint constitute a guarantee. Doubts even arose as to whether money was a commodity at all. Indeed, it was finally declared to be something imaginary resting solely on human convenience.[8]

[6] *Ibid.*, 261–262.
[7] *Ibid.*, 262.
[8] *Ibid.*, p. 283.

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At this point, Menger signed off on the subject.[9] He apparently could not fathom why or how governments that could do so much good in promoting viable moneys ended up doing so much harm. Public choice economics that would explain this seeming contradiction would not appear until 70 years later.

I quote Menger's musings at some length because his analysis of the early progress of money as a medium of exchange from barter is so reliable, and because his presumption of the role of the state in making a good thing better reflects so well common prejudice on this subject, both in Menger's day and in the present. Money, in this naïve Mengerian world of benign governments, is an unusual artifact: When forced upon society by a legal tender law, its quality and utility improve.

Both laymen and trained professional economists unthinkingly presume that governments as functionaries of the state must configure and control any monetary system. Though money in every case came into existence through the private sector, and while experience shows that governments have routinely abused monetary systems, acceptance of state control over money seems assured by default. The momentum of the status quo is overwhelming; the possibility of spontaneous order to regulate monetary affairs appears to have been lost or forgotten.

Primitive moneys initially had no connection to the state. However, once the more rudimentary moneys had evolved into metallic coins, states became interested and, very quickly, a controlling influence. In ancient Greece, for example, the ruling state assumed for itself the prerogative of coinage. The seal stamped on coins became a trademark. Wealthy and powerful merchants whose coins were current, and who themselves could assume political office, used their power to establish coining monopolies. Minting became exclusively a state function.

State authorities realized many benefits from their coinage powers. First, coinage provided a means of exploiting the booty from military conquests and mining enterprises by facilitating expenditures. It also enhanced the state's collection of tribute and taxes, which, noted Arthur R. Burns in his work on ancient money, "the Romans for the first time made efficient." Religious authorities also coined ornaments and temple treasures in order to obtain usable currency.[10]

[9] Menger concluded his discussion of coinage by remarking at length on the difficulty of producing smaller denominations of coinage for common use – the problem that the Framers tried to remedy with "coin money and regulate the value thereof." *Ibid.*, pp. 283–284.

[10] Burns, Arthur Robert, *Money and Monetary Policy in Early Times.* New York: Augustus M. Kelley, 1965 (New York: Alfred A. Knopf, 1927), p. 458.

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The state did not at first exploit its coinage powers by debasement. The city-state of Athens had a respectable and widely accepted coinage. However, "The Romans," noted Burns, both the republicans and emperors, "attended more to the exploitation than the perfection of coining … They gave the world the inestimable curse of practical knowledge of all the possible methods of inflation apart from the use of paper money."[11]

In order to make coinage profitable for itself, the state extended the routine practice of stamping coins with a seal of weight and fineness to a stamp of coercive authority that forced acceptance of the coin. Burns noted that Greek coins did not reflect any direct evidence of legal tender, but Roman coins were another matter. As Burns put it:

> It is beyond doubt that legal tender regulations existed in some form or other from earliest times. No unit of account could come into general use until it was legally defined, and [legal specification] would involve a statement of the means by which a debt expressed in the unit could be settled. … The Roman state fixed the rate at which coins were to pass, and presumably at this rate they were legal tender and had to be accepted. They were at no period punch-marked ingots to be placed in the balance at the option of the payee.[12]

Burns's careful study of ancient coinage suggests an answer to Menger's innocent observation on how the state might improve the properties of coined money. No matter how it *might* do so, experience through the ages has confirmed that it will *not* do so. Once state authorities had monopoly control over the coinage – "the prerogative of coinage" – they learned very quickly how to cheapen the gold and silver coins, which they pretended to certify as to weight and fineness, by alloying them with low-cost base metals. Roman rulers, with few exceptions, debased coin currency by this means for four centuries.

Through debasement, state authorities generated *seigniorage*, which is the revenue derived from the excess monetary value of the struck coin over the resource costs of producing it. It is the "profit" earned by any government that issues money. More importantly, it is a tax on everyone who uses the government money.

Only a ruling state, through its power of legal tender, can realize seigniorage. No private person or corporation, even if permitted to produce money, could endow the money with any legal tender provision to force it on the money-using public. Competition in the private production of money would make significant seigniorage impossible.

[11] *Ibid.*, p. 465.
[12] *Ibid.*, pp. 378–380.

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The state assumed legal tender power, as Menger's account suggests, so that it could specify weights and fineness of particular denominations of coins already exchanged voluntarily. While this simple function may have seemed harmless, it was never necessary. The state does not need a legal tender power over coinage to promote acceptance of its money; the quality of the money itself does that.

Arguing that the legal tender power is necessary to "improve" the coinage system has provided all states, past and present, with vast amounts of seigniorage. This power has also been a confiscatory policy on many occasions when states have generated inflations and hyperinflations with their issues of fiat money. Nonetheless, *legal tender* has become, and is still, an accepted prerogative of the state. It forces acceptance of the paper money that all governments issue, and provides them with significant revenues.[13]

[13] For example, the U.S. government has long been realizing approximately $30 billion per year in seigniorage from the money-creating activities of the Federal Reserve System. In the year 2010, however, seigniorage increased to almost $80 billion due to Federal Reserve bail-outs that included the monetization of "junk" bonds.

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THREE

The Bimetallic Monetary System and Appearance of a National Bank

BIMETALLISM

Precious metal moneys – gold and silver – first became prominent and widely used in medieval Europe. Silver was the base for most medieval moneys until after the Crusades when trade flourished with Byzantium and other eastern countries that used gold. Since silver was still the common money metal in Europe, the introduction of monetary gold stimulated a movement toward bimetallism.

A bimetallic standard is one in which a political authority makes two metals, usually gold and silver, legal tender. Specified quantities of both metals, coined according to prescribed standards of fineness, are then lawful moneys, and cannot be refused when proffered to liquidate debts. (A transaction can also be defined as a “debt” that is assumed and cleared immediately when the purchaser pays for the goods.) Once both metals are specified as legal tender, they necessarily have a fixed, legal mint value relative to each other – a monetary datum. Actual market ratios between the metals may differ slightly from mint values, but market arbitration keeps this disparity minimal.

To make a metallic standard operational, a legislature must follow certain principles and procedures. First, it must specify the value of the unit of account, say, the dollar, in terms of a weight of gold, and for a bimetallic system also a weight of silver. It does so by prescribing a gold coin of a convenient denomination, and likewise a silver coin. Congress defined the dollar as 24.74 grains of pure gold, and also as 371.25 grains of pure silver. The basic gold coin that Congress specified was the $10 gold Eagle, which contained 247.4 grains of gold, with an additional 10 percent base metal to make the coin durable enough for common use. The silver coin was the silver dollar, which had 371.25 grains of pure silver, plus 41.25 grains of base

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