
Free-Market Money: A Key to Peace

BY STEVEN HORWITZ

When I teach money and banking, I begin the section on the history of the American monetary system by asking my students what the following dates in U.S. history have in common: 1812–1816, 1863, 1913, and 1971. The obvious answer is, “times of war or close to it.” (If you count the Great Depression as a metaphorical war in the eyes of politicians, you could add 1934–35 to the list.)

The answer I am looking for, however, is, “times of increased federal government involvement in the monetary system.” That both answers are correct is no coincidence. For hundreds of years governments have intervened in monetary institutions in order to use them to raise revenue through the manipulation of money and credit, and most often that revenue has been used to make war.

War finance has long been the overt and covert rationale for an expansion of government’s role in the banking system. For classical liberals, exploring this historical relationship sheds light on the sources of both government control over money and the duplicity with which the state often heads to war. The connection illustrates that government intervention in money has no justification in the failures of free-market monetary systems, but rather grew out of the need for revenue. However, it also illustrates the ways in which government can mislead with respect to war by subverting the democratic process and using less-than-transparent means to finance wars, especially unpopular ones.



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That classical liberals believe both that government should get out of the money-regulation business and stick to defending the territory of the United States from attack, rather than intervening in the domestic affairs of other nations, often strikes proponents of the “conventional wisdom” as odd. This sort of reaction

has greeted Ron Paul’s presidential candidacy, which has argued for an immediate withdrawal from Iraq and for the gold standard. Most conservatives, of course, deride the former position, while the left (and some on the right) do the same to the latter. What few if any seem to realize is that these two positions have a deep and important historical connection: If you want to make it harder for the U.S. government to act like an imperial power, you need to find ways to reduce the resources available for it to do so. Preventing the state from creating money would eliminate its ability to manipulate

the monetary system to raise funds surreptitiously for foreign adventurism.

Fighting wars requires resources. Governments have only four ways to raise revenue: sell off assets, borrow, tax, or inflate/manipulate the currency. If we assume that states interested in making war are also ones interested in accruing power, selling off assets is unlikely, at least as anything but a last resort.

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Both borrowing and taxing have their limits. The most common strategy for financing wars is to sell war bonds. If governments go in this direction, they better have buyers, which assumes that the populace is in general agreement with the conduct of that war. War bonds are a hard sell for unpopular wars. For example, World War II bonds sold well as the public was convinced it was proper to respond to the direct attack by the Japanese and to attempt to stop the Nazis. However, you will look in vain for any Vietnam War bonds, nor have any Iraq War bonds been available since the 2003 invasion. When governments wish to conduct unpopular and often unjustifiable wars, engaging in borrowing tied directly to that purpose is unlikely to succeed.

Raising taxes to fight a war also requires at least some public agreement with the policy because tax-raising politicians may well be voted out if the war is unpopular. For politicians the downside of raising taxes (like the downside of using conscription to obtain soldiers rather than paying them market wages) is that it is an obvious and painful grab for resources by the state. Taxes make the costs of war very visible and spread them across the whole population. (Conscription is very visible, but more concentrated on the draftees.) From the standpoint of political actors, it would be preferable to raise the necessary resources in a way that is much less obvious and therefore has less potential for political conflict. Whenever politicians can disguise and/or delay the true costs of their programs, they will do so. This is where the monetary system enters the picture.

Governments that can either create money directly or use regulation to force banks to provide the resources will be able to conduct war more often and with less political resistance than those that cannot.

From 1791 to 1811, the federal government had partial ownership of the First Bank of the United States, which did not charter or regulate banks, but instead produced a limited amount of currency and served as the government's bank. With the completion of the War of 1812, it became convenient for the federal

government to have such a bank in operation again, and so the Second Bank of the United States was created in 1816 (lasting until 1836).

In 1863 the federal (Union) government for the first time offered charters for individual banks. With charters came regulations, one of which was the requirement that bank-issued currency be backed with U.S. government bonds. Whenever a federally chartered bank wanted to give its customers paper currency, it had to purchase such bonds, whose face value slightly exceeded the value of the currency and then present them to the Comptroller of the Currency in Washington, who then printed the bank's notes. Aside from the effect on war finance discussed below, this cumbersome process was the root of the periodic currency panics that struck the post-Civil War banking system and ultimately led to the Federal Reserve System as the "solution" in 1913.

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Guaranteed Bond Market

The stated rationale for the bond-collateral requirement was that it provided safety in case the bank failed and could not redeem its notes in gold. However, Congress also knew that the requirement would, in theory, create a guaranteed market for U.S. government bonds, which in turn would enable the Union government to have revenue to pay for the Civil War. Interestingly, when the federal government first offered the charters, almost no banks signed up; they kept their state charters because the federal charters offered no advantages and some minor disadvantages. Not content to lose that way of financing the war, Congress quickly passed a 10 percent tax on the banknotes of state-chartered banks. This now made federal charters notably more advantageous, leading a significant number of banks to apply. By the end of the 1860s federally chartered banks were proliferating and the large market for the bonds had come to pass. Between the original bond-collateral requirements and punitive tax on the state-chartered banks, the federal government used its power over the monetary system to ensure a market for bonds to pay for the Civil War.

Although the Great Depression was itself not a war, it certainly took on many of the characteristics of one, as the Roosevelt administration attempted to pass legislation and programs that were of questionable constitutionality and popularity. Like many wartime activities, it is plausible to argue that the New Deal programs benefited business constituencies more than the public at large. (Halliburton's role in the Iraq War provides a contemporary example of this sort of damaging corporate capitalism.) The administration's outlawing of private gold holdings in 1934 and the Banking Act of 1935, which created a variety of new federal interventions—the most notable giving the Federal Reserve new powers to create money through bond purchases—were both examples of using the monetary system to provide resources for a growing state. These powers were certainly useful when the government took the country into World War II a few years later.

Vietnam Inflation

The Vietnam era provides an example of a direct connection between inflation of the money supply and war finance. The Johnson administration made a conscious decision to finance the Vietnam War through inflation rather than higher taxes. The increase in money was accomplished by buying up government bonds from financial institutions; as payment, the government simply credited the institutions' accounts. This saved interest payments on those bonds and therefore also allowed the government to issue additional Treasury securities at the same total interest cost they had before the new money was created. The bottom line was that the Fed created additional money and allowed Congress to run more debt at no greater cost in the process.

At the time Federal Reserve Notes held by foreign central banks were still redeemable in gold at the Fed. As a result of the inflation (depreciating dollar) of the late 1960s, the Fed saw a massive flow back of Federal Reserve Notes from foreign governments, which began to reduce U.S. gold holdings. This drain of gold reserves


led President Nixon to close the “gold window” in 1971, breaking the last remaining link between the dollar and gold. With excess supplies of money no longer generating any direct negative economic consequences for the Fed, the even-greater inflation and macroeconomic disorder that characterized the rest of the 1970s and '80s were no surprise.

Thus the need to finance the Vietnam War led to increased government control over money, which led to macroeconomic disorder (much as we saw in the late nineteenth-century banking panics), which in turn led to calls for more government intervention. Aside from the direct problems of financing the warfare state, increased control of money by the state often sets off what Ludwig von Mises called the “interventionist dynamic,” in which one state intervention has negative unintended consequences that create the perceived need for more intervention. The business cycle is one example of this process.

One can tell similar histories about the creation of central banks and other forms of government monetary intervention in other countries across the globe. The need to fund war and empire has been behind the creation of many a central bank. It's easier to pay for bombs and bullets if you have the equivalent of a

printing press at your fingertips.

Because inflation's costs are normally dispersed, subtle, and longer term, politicians find it a politically more palatable way to raise revenues, especially for unpopular causes. This point is even more important because politicians play up the very short-term benefits of inflation as if they were a panacea for a stalled economy. Persuading the public to accept those ephemeral and small short-term gains without an understanding of the long-term costs is part of the general deception often used to promote empire-building wars.

For those who object to an American empire, protesting the occupation of Iraq may seem the best course. But institutional changes that would deprive the state of resources—specifically, privatization of the monetary system—would be much more effective. 

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