MONEY AND WAR IN MURRAY ROTHBARD'S *A HISTORY OF MONEY AND BANKING IN THE UNITED STATES*

LEONIDAS ZELMANOVITZ*

I. Introduction

THE THESIS PROPOSED IN THIS PAPER is that strong as the protection of private property rights may seem to be in the United States, the lesson from Prof. Rothbard's account of the history of money and banking in the U.S. has been one of the relativization of those rights, especially through interventions in the monetary and financial arrangements whenever the necessities of war financing so required.

Institutions and Progress

The evolution of a civilization is a matter of historical record.[1] It can be measured by its successes in many different fields. For instance, material progress, increase in population, territorial expansion, artistic and scientific accomplishments are all dimensions of the advancements of a civilization.

It is possible to identify a parallel between the evolution of a civilization as recorded by history and its institutions in general and political institutions in particular. That is so because political societies are no more than groups of individuals and their institutions are no more than forms of interaction among those individuals, everyone pursuing their own interest in different fields.

In other words, it is the sum of the accomplishments of its members in different fields of human interaction and the unintended social results of their

*Leonidas Zelmanovitz (lzelmanovitz@libertyfund.org) is a Liberty Fund Fellow.

CITE THIS ARTICLE AS: Leonidas Zelmanovitz, "Money and War in Murray Rothbard's *A History of Money and Banking in the United States*," *Libertarian Papers* 2, 17 (2010). ONLINE AT: libertarianpapers.org.

[1]Historical here means what really happened in a given time and place, regardless of what we know about them.

individual effort that, once recorded by history, is understood as the progress of a civilization.

Let's clarify, perhaps the word "progress" may convey an idea that the evolution of civilizations here mentioned is unidirectional, but that is a wrong idea. "Progression" is here utilized meaning "whatever lies ahead"; not necessarily "good" or "better" circumstances.

For instance, the Greeks, who defeated the Persians twice, were able of noble and amazing feats that can only be compared in their exceptionality, as time goes by, with the ignoble and mean actions taken by their descendants during the self-destructive Peloponnesian war. The capacity of Greek leaders for two generations to coordinate the actions of a myriad of independent cities against the Persians without compromising their political independence was an amazing achievement; the incapacity of the leaders of the next generation to avoid self-destruction in a fratricidal war is beyond comprehension.

This perceived parallel between the recorded events and the quality of human interactions as reflected in the many different institutional dimensions of a society is true for an entire civilization and may also be valid for one of its independent political entities.

The generation of Athenians that defeated the Persians, built the Parthenon and established supremacy over the Aegean had surely more effective forms of interaction among them and with their neighbors than the generation who faced disaster in Sicily, indulged alternately in democratic excess and tyranny and was finally defeated in the Peloponnesian war.

The argument here is that what history shows, aside from the vagaries of fortune, [2] is the quality, the nature of human interaction in a given social group. It may be understood that the nature of their relationships is embodied in their institutions, in all their dimensions; being these institutions the fruit of the "common will" (those which are product of legislation) mentioned by Carl Menger, or those "which development come into being without a common will directed towards establishing them" (Menger, 1963: p. 146). And so understood, the institutions frame all aspects of social life such as the cultural, social, political, educational, and economical.

[2]Professor Lachmann in his book "The Legacy of Max Weber" (Lachmann, 1970: p. 49) points out that for the actor, formally, there is no difference if the constraints to his actions are produced by nature or by other individuals, although materially, the actions of other individuals are more difficult to predict; and he offers this statement about why institutions tend to be developed in human society (in order to make human behavior more predictable).

The eruption of the Vesuvius in 70 AD and the attack in Pearl Harbor in December 1941 were not produced by the Ancient Romans or mid-twentieth-century Americans; but they were responsible for their responses to those cataclysmic events; despair and fatalism was shown in the former with the abandonment of the site and fortitude, courage, determination was show in the latter with the mobilization for war.

Obviously, the claims just presented above only hold water at a high level of generalization; even during the most unsuccessful responses given by a social group to the challenges facing them at that moment, brave and trustful characters are to be found, efficient social arrangements may be in place. The claims presented here may be better interpreted as suggesting the existence of relative differences in time and place between the effectiveness of social institutions.

In order to measure the effectiveness of some institutions, a purpose for them must be agreed on first. If bees or ants were the subjects of the present discussion, probably no other criterion other than the growth of their societies would be used to gauge their success. Measuring the success of human societies only by their ability to perpetuate themselves, transmitting to the future generations their genetic code, seems a rather bleak perspective of what a human society is; it does not take into consideration the very essence of what a human life is.

Humans by nature have conscience and intelligence and the very purpose of their social arrangements is to enhance their individual opportunities to reach the limits of their potential, to flourish as individuals. Of course, there are many other ethical traditions with different conceptions about the purpose of human life and about political institutions, and this brief introduction for a short essay about the monetary history of the U.S. is certainly not the place for such inquiries; suffice it to say that the above mentioned view is the one here espoused.

The Purpose of Good Money and Some of Hindrances to Have it

In relation to the institutional arrangements for the economic activities of a society, the development of the economic capacities of a group of individuals is directly related to the extension of the division of labor among them. Since in human societies the individuals possess specific, local knowledge and subjective as well as technical knowledge about the opportunities for economic activity, the capacity to exercise this "intellectual division of labor", as Prof. Jesús Huerta de Soto points out by quoting Mises's *Liberalism* (Huerta de Soto, 2001: p. 173), is key for the overcoming of scarcity. And history has demonstrated that the best institutions for this purpose are the ones that grant the individuals better opportunities for them to exercise their creativity and their other productive capacities; namely: private property rights and freedom of contract, i.e., classical liberal institutions.

The availability of adequate money as an instrument for indirect exchanges in society may be understood as encompassed in the institutions mentioned above (classical liberal institutions); but just as independent courts of justice, legal enforcement and national defense, the supply of a generally accepted medium of exchange, for its importance, deserves a special treatment in any analysis and not being simply considered as part of the institutions guaranteeing property rights and freedom of contract. Obviously, any monetary institutions that come to be in contradiction with private property rights and freedom of contract (and the other institutions that are instrumental to their effectiveness) will be less then ideal. That is, it is not any monetary arrangement along with private property and freedom of contract that will result in the most effective social interactions aimed to overcome scarcity. And it is gruesome to note that the historical record is full of examples in which governments have intervened in the supply of money, resulting in the production of monies less than adequate for the purpose stated above of enhancing the division of labor by facilitating indirect exchanges.

Some of these instances are described by Prof. Murray Rothbard in his book *A History of Money and Banking in the United States—The Colonial Era to World War II* (from now on HMBUS). Specifically, in that book Prof. Rothbard describes, among many other historical events, some episodes in which, for fiscal reasons resulting from a state of war, the government intervened in the monetary institutions in the United States sometimes with disastrous effects for the economic performance of the American society.

The Nature of Money and the Broad Frame for the Debate on War Finance

For more than a century now, the main divide about the nature of money has been among the ones that see money as a spontaneously evolved institution in society whose purpose is the already stated one of allowing and enhancing the division of labor and the ones that see money as an institution created by the State as an instrument for its policies. The debate about war finance, in all its dimensions, from the description of its instruments to the evaluation of their efficacy and the justifications for their use in each given circumstance may be better understood in the context provided by the discussion on the nature of money. If money is just one more instrument for the implementation of State policies, then, there are no limits in that regard to what the government can do to money. On the other hand, if money is understood as the instrument for indirect exchanges then there are ethical limits to what can be done to money; and a precise understanding about what money is may inform the best ways to provide for war finance when necessary.

However, this paper is not to discuss philosophically whether the institutions of private property and freedom of contract in general or good money in particular are always of a higher value than national defense, neither to analyze contra-factually if better ways to provide the funds for national defense without interventionism in the money supply would have been better for American society.[3] The sole purpose here is to offer a presentation and an interpretation of Rothbard's historical[4] views on the relation between the fiscal necessities brought by war and interventionism in money and banking in the United States as read from HMBUS; therefore, it is a reflection on the ideas behind the historical events more than anything else.

II. Instruments for War Finance and the Sinews of Power

If a theoretical study of the economic consequences of the different methods of war financing is the object here, it seems advisable to start describing those methods. Following Mises in *Nation, State, and Economy*, Prof. Gabriel Calzada Alvares separates them in four categories: conscription-confiscation, taxation, inflation and war bonds (Calzada, 2005: p. 149).[5]

In the context of Mises's distinction between "Soldier's War," a somewhat limited form of war that may be compatible with a market economy and civilization itself, and "Total War," conscription, or the "Blood Tax" as Mises used to call it, is the very beginning of unlimited warfare. The rationale that may be inferred here is that once it is consented for the government to enslave part of the citizenry and potentially send to death, any other limitation on the power of government, such as private property, free

---

[3]In his introduction of the 2005 edition of HMBUS Prof. Joseph T. Salerno quotes Mises statement that since history is the record of human effort to better their condition and this evaluation is an intellectual endeavour "Thus, ideas are the main theme of the study of History," particularly the ones basing the values directing human action. For the historian, action and judgments of value, quoting Mises:

> Are the starting points of a specific mode of reflection, of the specific understanding of the historical sciences of human action (Rothbard, 2005: p. 12).

[4]It is historical in the sense of an enquiry into certain events as discussed by Prof. Oakeshott in his essay "On History" (Oakeshott, 1999: p. 1).

[5]See Mises, "Covering the State's War Costs," in *Nation, State, and Economy* (2006).

speech, whatever, loses its legitimacy. After all, how can someone have the right to refuse his property if others are forced to give their lives? [6]

About confiscation, according to Prof. Calzada, the taking of already produced goods and means of production would eliminate the incentives for entrepreneurs to make the necessary adjustments to transform the structure of production in order to deliver war supplies; being therefore a self-defeating method.

Considering taxation, inflation and public debt as instruments to raise the resources to wage war, it is important to take into consideration Mises' lesson that "War can be waged only with present goods" (Mises, 2006: p.139). Accepting Mises assumption, from an economic standpoint, that is, deciding about the use of the scarce resources available, a generation that wages war must bear its material cost. However, it must be understood that sometimes the share of the existing wealth that is required to the war effort is bigger than what can possibly be taken from the tax-payers without forcing them to fire-sell non-liquid assets, producing strong redistributive impacts; or simply the State does not have the tax-collection mechanisms to raise the amount required in a timely and orderly manner. These are the considerations that may lead to the use of one form of taxation over others or may induce the government to have recourse to to debt or inflation in order to respectively spread the burden of the material cost of the war among owners of liquid and illiquid assets and to collect more recourses than what would be possible to collect via taxation. The argument of Prof. Calzada in regard to the efficiency of the different methods of war finance as read from Mises and Rothbard is that taxation is to be preferred to inflation and to a lesser degree, war bonds, due to the distortions that they introduce in all sectors of the economy.

Prof. Calzada concludes that among different forms of taxation a general sales tax combines "the best possible mobilizing effects" with "the least violent attack on private property" (2005: p. 168).

The Financial Revolution in England

The classical account of the relation between money and war is P.G. M. Dickson's The Financial Revolution in England—a Study in the Development of Public Credit 1688–1756. The central thesis of the book is that it was thank to the capacity of the British Crown to raise money beyond

[6]The same point is made by Prof. Robert Higgs in *Crisis and Leviathan* quoting the economist Wesley C. Mitchell who wrote in 1943 that "When lives themselves are treated as means (to the end of military victory) so is property" (Higgs, 1987: p. 202).

its taxing capacity, through borrowing, that England was able to field the military forces necessary to succeed in war against France and its allies. So much so that, quoting a contemporary source (Issac de Pinto), the author states that the astonishing capture of Havana in 1762 "would not have been possible if one-third fewer ships and troops had been assigned to the task" (Dickson, 1967: p. 9).

Prof. Dickson then describes the features of the new system of public finance developed in that period, the development of the market for short-term and long-term public debt and the relations between the treasury and the financial markets in general.

However, his argument about the relation between the fiscal necessities of the Crown and the development of British financial markets can be understood as operating in two directions; that is, the creation of a stable and efficient government was a precondition for the development of successful public borrowing in the same way that such borrowing ended shaping, out of necessity, a more efficient and stable government in the United Kingdom.

Dickson's argument just exposed was further developed in both directions by other authors. One streak is to say, like Niall Ferguson does,[7] that the existence of a central bank (formally introduced in the UK with the privilege of monopoly of issuance to the Bank of England by the Peel Act of 1844) is crucial for governments to deal with emergencies like wars by the flexibility in the money supply that they allow (2008: p. 100); for instance, talking about the reaction to the crisis of 1914 he writes: "Then, as now, the authorities reacted to a liquidity crisis by printing money" (2008: p. 301).

The other direction is to stress the importance of the fiscal needs of the state to the very shape that financial markets took form. This direction is the one presented by Richard Sylla with his essay "Shaping the US Financial System, 1690–1913" in *The State, the Financial System, and Economic Modernization*. According to him, the financial requirements and policies of the State "determine the ways in which private financial institutions and markets emerge and develop" (Sylla *et al.*, 2007: p. 250). For the author, the financial programme of Alexander Hamilton, which was aimed to provide one more weapon to the Republic's arsenal, resulted in launching a banking system and a securities market in the United States; and for him, the lesson of history is that "virtually" every major financial innovation is just a reaction to the fiscal needs and policies.

---

[7]See Niall Ferguson's "Of Human Bondage" in *The Ascent of Money* (2008).

Money and Banking in Rothbard's HMBUS

The importance to understand how much the "quality" of social interactions (as crystallized in the institutions) is necessary in order to explain the general performance of a society has been presented so far. It was argued that that reasoning also applies to the monetary arrangements of any society and these arrangements, in their turn, are decisively influenced by the fiscal needs of the State, especially in cases of armed conflict. In those circumstances, the history shows the fundamental importance of having efficient arrangements to procure the resources necessary to wage war. The multiples perspectives from which the issue of war finance may be approached, it was also noted, include not only considerations of efficiency, but also moral considerations, and they are key to understand the legitimacy of war procurement in all its forms. It is now suggested that these topics are essential references to have in mind once discussing Prof. Rothbard's views on war financing as expressed in HMBUS.

III. Paper Money in Massachusetts during Colonial Era

The Monetary System in Place in Colonial Times

Prof. Rothbard starts his book describing the monetary system in place in Colonial America. He notes that the colonies adopted the monetary system of the colonial power, and despite being legally in a silver standard, England was in fact in a bimetallic standard with a fixed parity. Being precious metals internationally traded in the absence of a legal prohibition (what happened in the U.S. only by act of Congress in 1857), foreign coins used to circulate freely. In fact, gold and silver foreign coins comprised the bulk of the circulating medium in the colonies at the end of seventeenth century. The leading specie currency in the colonies was "by far" the Spanish silver dollar, what happened to be the world's most important coin since early sixteenth century and also the most stable coin in the Western world for three centuries (2005: p. 49). Prof. Rothbard also describes the first attempts of manipulation of the currency, either by England in forbidding minting and the export of English coins to the colonies or from the colonial governments in their attempts to make their exports more competitive debasing the shilling in face of the Spanish dollar; being those attempts outlawed by England as early as 1707.

So, Prof. Rothbard describes that aside from some "futile and inflationary" attempts to manipulate the currency, the monetary system in place in the colonies at the end of the seventeenth century was basically a classic bimetallic system with free exchange of the ratio between gold and silver, with a free flow of coins in and out of the colonies and no forced tender of a national currency.

Massachusetts First Issue of Government Fiat Paper Money

According to Prof. Rothbard, it was medieval China that pioneered government paper money; starting as early as the ninth century with government paper money redeemable in specie that three centuries later "evolved" into irredeemable fiat paper money. The next experience with government fiat paper money happened in colonial America. The colonial government of Massachusetts apart from China was the first government ever to issue fiat paper money; what they did in 1690 (2005: p. 51).

It is important to understand the circumstance in which that policy was adopted.

Jokingly,[8] Prof. Rothbard describes that the Massachusetts colonial government was "accustomed to launch plundering expeditions against the prosperous French colony in Quebec," noting that they were usually "successful." But one day, they were beaten and the expedition came back to Boston without booty to sell and pay the "soldiers." With no money to pay the soldiers and afraid of a mutiny, the colonial government tried to borrow money from Boston merchants but "its credit rating was not the best" and they failed in this attempt to raise the necessary money. Finally, in December 1690, in order to pay the soldiers, the colonial government decided to print £7,000 in paper notes.

According to Prof. Rothbard, "suspecting that the public would not accept irredeemable paper" the government of Massachusetts framed that political decision pledging that it would redeem the notes in specie "in a few years" (it actually took 40 years to do so) and that no more paper money would be issued, however, as soon as February, 1691 the government issued more £40,000 to repay "all of its outstanding debt" (2005: p. 52). However, the skepticism of the colonists with that first experience soon was perceived by the notes depreciation of about 40% against specie. That led the government to make the notes compulsory legal tender for all payments contracted in specie.

His next relevant reference is on page 53 when he states that in 1711 Massachusetts issued £500,000 "to pay for another failed expedition against

[8]Without a personal statement and I am unaware of any, it seems impossible to know for certain what the mood of Prof. Rothbard was while writing that passage. One can only guess that he was in a humorous mood in describing the pathetic events which led to the first experience with government fiat paper money in modern times.

Quebec". That massive issuance forced a devaluation of the notes, legal tender notwithstanding. Attempts by the British Crown to force Massachusetts back into a specie currency failed because the colony was unable to retire the notes au pair. Then, again in 1744, Professor Rothbard tells us that "another losing expedition against the French led Massachusetts to issue an enormous amount of paper money over the next several years." By 1748, Massachusetts alone had issued £2,500,000 and the depreciated shilling was valued one-tenth its value in silver in 1690.

Government Paper Money in the Other Colonies

By 1740 all the colonies but Virginia had adopted fiat paper money. In the late 1750's even the colony of Virginia "in trying to finance part of the French and Indian War against the French" (1754–1763) followed suit, according to Prof. Rothbard (2005: p. 54).

After the end of the Seven Years War (1756–1763), in 1764 Parliament extended the 1751 prohibition of new issues of government paper money in New England to all colonies and required the gradual retirement of outstanding notes, forcing the colonies back into a specie monetary standard, and ending the government paper money experiment in colonial America.

At this section, it is possible to see the direct link established by Prof. Rothbard in his narrative between the necessities of war financing and drastic manipulation of the money supply by the government; in this case, the introduction of government fiat paper money.

At this very first case, it is important to note that Prof. Rothbard does not comment on the merits of the measures and leaves open the door for many different interpretations. Objectively, is war a sufficient justification for the government to defraud the money supply by the adoption of fiat paper money? Is it possible to infer from Prof. Rothbard's account of the events what the opinions of the colonists were? And how about Prof. Rothbard's own opinion? Is he explicit about his views? On page 55, his comments first, about the British Crown forcing the retirement of paper money in middle of the Seven Years War; and second, on the "remarkable" stability of the specie standard during the conflict may induce a reader to think that neither as a matter of policy, war finance necessarily implies inflation, nor, "remarkable" as it may be, it is impossible to keep a "stable" specie standard in middle of a major armed struggle. In any event, these are the questions open by the description of the causes for the issuance of government fiat paper money in colonial America made by Prof. Rothbard.

IV. Revolutionary War Finance

In the chapter about the financing of the Revolutionary War, Prof. Rothbard describes the process that resulted in an expansion of the money supply from $12 million in 1775 at the beginning of hostilities to $225 million in five years due to the issue of non-redeemable fiat paper money by the Continental Congress. Such monetary expansion made the "Continental" paper money depreciate from a parity of $1 to $1.25 in specie at the end of 1776 to $1 to $168 by the spring of 1781 when it became "virtually worthless" (2005: p. 60).

Next, Prof. Rothbard mentions the issuance of government fiat paper money by the states "to top this calamity" adding $210 million by the end of the war to the nation's currency, and he describes various attempts by the states to slow the depreciation of fiat money by price controls and forced tender laws. Other measures against private property rights are also mentioned, such as the seizure of supplies by the Continental Army, forcing the farmers and merchants to accept devaluated currency or "certificates" issued by the Army's quartermasters. From these certificates, the federal government issued $200 million.

By 1779, having turned the government issued fiat paper money in something worthless, Prof. Rothbard tells us on page 61, the Continental Congress started to issue "loan certificates," which technically were part of the public debt but in essence were one more form of circulating currency. Those loan certificates had devaluated "as early as the end of 1779" to a 24 to 1 ratio with the specie and by the end of the war $600 million of them were issued.

Almost in the end of his chapter about the Revolutionary War finance on page 62, Prof. Rothbard comments on the "maneuvers" by Congressman Robert Morris to pay au pair in specie the depreciated loan certificates. According to Prof. Rothbard, Morris' two reasons were, first, to subsidize the speculators, and second, to make the case for granting the Continental Congress with taxing powers, which they lacked under the Articles of Confederation.

The Bank of North America

Next, Professor Rothbard mentions the establishment of a fractional reserve commercial bank with a monopoly of banking and issuance, in effect, the first central bank in the United States. It was the "Bank of North America," which started its operations in 1782; the Treasury controlled (5/8 of its capital) the bank and Congressman Robert Morris was its first president. In exchange of its privileges, the bank "lent most of its newly created money to the federal government to purchase public debt" (generated during the war). The new bank notes, although nominally redeemable in specie, soon were discredited and in 1783, after the end of the war, the bank was sold to private investors and re-charted in Philadelphia as a private bank, concluding the history of the first central bank in the U.S.

To conclude this chapter, Prof. Rothbard describes the deflationary and recessionary "scarcity of money" provoked by the contraction of paper money when the federal and state governments started repaying the wartime public debt. Some states tried to re-inflated currency in order to honor these payments without needing to increase taxation. These attempts ultimately failed because the states were forbidden to issue unredeemable paper money and the effect of Gresham's law only made specie scarcer.

In this chapter, Prof. Rothbard makes a value judgment about the propriety of the inflationary expansion of the money supply in order to finance the Revolutionary War and about the granting of banking privileges; although he does not comment on possible other sources of financing, his judgment about how the revolutionary war was financed is clear.

Can it be inferred from this chapter that for the founding fathers the foundation of the United States was an end that justified the means? In labeling as "catastrophic" the inflation produced by the fiat paper money, certificates and loan certificates issuance, Prof. Rothbard is clearly not only describing the consequences of such policies but expressing his opinion about them as well.

V. The Monetary Constitution of the United States

The American constitution in 1787 established a bimetallic monetary system, with legal but not forced tender, allowing therefore the circulation of foreign currency and forbidding the states to issue money. The provisions of the constitution regarding money were regulated in 1792 by the Coinage Act that established a fixed parity of 15 to 1 between silver and gold. Thus, the American Dollar became defined as either a weight of 371.25 grains of pure silver or 24.75 grains of pure gold.

The constitutional provisions were respectively a reflection (a) of the circumstances at that time (Prof. Rothbard mentions an estimation that by 1800 about 80% of the coins in circulation were foreign); (b) of the recent experience (with inflationary creation of paper money both by the states and by the confederation); and (c) of the prevailing ideas at the time (bimetallism with fixed parity was then the monetary regime in England).

The First Bank of the United States

Even before regulating the currency, a central bank, "The First Bank of the United States," was established as a cornerstone for the monetary arrangements of the new republic in a fashion similar to the UK in which the Bank of England was de facto a central bank. Hamilton's "Report on a National Bank" delivered to the House of Representatives in 1790 states the reasons for the establishment of a National Bank, and the second one is relevant for the present essay, i.e., the "greater facility to the Government in obtaining pecuniary aids, especially in sudden emergencies" (Hamilton, 1790). After some questioning (the constitutionality of a National Bank was questioned even by the Treasury secretary and the Attorney General), the Bank was established in 1791 as a fractional reserve bank.

At a time that taxes were paid in specie, the privilege of paying taxes with bank notes, giving them a quasi legal-tender status, plus the monopoly of a national charter, the deposits of all taxes and the Federal stake in the institution contributed for the success of the Bank in its inflationary credit expansion; most of it funneled to financing the floating of the "newly assumed federal debt", in the words of Prof. Rothbard.

However, on the eve of the 1812–1815 War, a proposal to renew the charter of the bank was defeated in congress and the bank was liquidated in 1811.

VI. The War of 1812 and its Aftermath

According to Prof. Rothbard, the financial system put in place at the beginning of the republic was aimed to fund the federal and state public debt acquired during the independence war with federal taxation; and he understands the restrictions on state paper money and any fiat money in general as reactions against the abuses of the revolutionary war. In this sense, the liquidation of the First Bank of the United States, with its inflationary credit expansion, may be accepted as "solving" an internal conflict in the first monetary policy of the United States that soon would be tested again by the needs of financing a military struggle.

Rothbard's Comments on War's Finance

The chapter of HMBUS on the 1812 War starts with the following sentences:

> War has generally had grave and fateful consequences for the American monetary and financial system. We have seen that the Revolutionary War occasioned a mass of depreciated fiat paper,

> worthless Continentals, a huge public debt, and the beginning of central banking in the Bank of North America (2005: p. 72).

The war was financed predominantly by the acquisition of public debt by an inflationary bank credit expansion; and according to Prof. Rothbard, they were encouraged to be formed by the government. There were 117 banks in 1811 and 212 incorporated plus 35 unincorporated banks in 1815. Prof. Rothbard estimates an increase of 87.2% of bank notes and deposits from 1811 to 1815 while the specie in reserves declined by 9.4% forcing the reserve ratio from 0.27 in 1811 to 0.17 in 1815 (2005: p. 73).

Due to the increased demand for redemption in specie in proportion to the increase of outstanding banknotes, most banks in the country soon were facing insolvency and with that risking the war-financing scheme in place. Therefore, in August 1814, the federal government permitted the banks to suspend redemption in specie. Specie payments were not resumed until February 1817, two years after the war was over.

Prof. Rothbard comments about this suspension:

> … in one of the most flagrant violations of property rights in American history, the banks were permitted to waive their contractual obligations to pay in specie while they themselves could expand their loans and operations and force their own debtors to repay their loans as usual (2005: p. 74).

Another form of war financing was the issuance of Treasury notes; and that also contributed to the wartime inflation of 35% on average, since those notes were used not only by the public in their transactions but also by the banks as "high-powered money" in the form of reserves upon which they pyramid their credit expansion.

According to Prof. Rothbard, the precedent of the suspension of payments in specie was more important than the inflation and "at least as important as the wreckage of the monetary system" (2005: p. 76). His reasoning to think so is that in case of any general crisis the banks would be allowed to suspend payments in specie again, creating a moral hazard that in fact made null the natural restraint imposed on the banks by the risk of facing a run in case of general crisis. In Professor Rothbard's description of the monetary system in the U.S. before the Civil War as one of "Decentralization without Freedom," it is implicit that individual banks may have been restrained by the risk of facing a run in case of lost of confidence, but the entire banking system was encouraged to discount the risk of a general run and therefore "economizing" in reserves.

The Second Bank of the United States, 1816–1833

For the present discussion, the establishment of the Second Bank of the United States is important only to illustrate the path of monetary policy after the War of 1812–15. The banks, checked only by the public perception of their competing strengths, continued the inflationary credit expansion of wartime. To put a stop on that, according to Prof. Rothbard, there were two possible paths: the first was the path of hard-money and the other was the path of a new central bank, which was chosen this time. "The Second Bank of the United States", like the first, was a private corporation with 20% of the shares owned by the Federal Government; and it enjoyed a monopoly to create a national paper currency, to purchase the public debt and to monopolize the deposit of funds of the U.S. treasure. The bank was able to support the local banks in resuming redemption in specie, essentially because with its support, the perception of the strength of local banks was enhanced and claims for redemption dwindled, allowing the banking system to continue with their inflationary expansion. Eventually, as early as 1818, the bank started to suffer a drain of specie, forcing it to adopt "heroic" contractions, that led to the panic of 1819, starting the first cycle of boom and bust in America and creating the background for the first articulate reaction to the status quo in money and banking, the movement led by Andrew Jackson.

The Jacksonian Movement

In trying to understand Prof. Rothbard's views on war finance in the US, it is important to describe the changes introduced in the monetary constitution of the United States by Andrew Jackson and his associates, since the new institutional arrangements were basically the ones in place at the beginning of the Civil War.[9] The Jacksonians are described by Prof. Rothbard as libertarians who pioneered the concepts of the Currency school in their policies. They succeeded in (a) their fight against fractional banking in general and the central bank status of the Second Bank of the United States in particular; (b) severing all links of the federal government with the banking system, operating exclusively with paper 100% backed by specie; (c) allowing the free circulation of foreign currency in the country; and (d) retiring the federal debt in its entirety. In 1857, an important part of Jackson's monetary reform was repealed when Congress striped legal tender power of foreign coins.

It is worthwhile to note an important feature of the banking system of the United States previous to the Civil War, that is, the "Free banking"

[9]Prof. Rothbard is famous for having changed the prevailing understanding about the Jacksonians among historians.

arrangements under which, although the banking business was open to competition with very small hurdles, they were regulated by the states. That feature have induced the state chartered banks to pyramid the issuing of their banknotes on state public debt (as a quid pro quo by their charters) and at same time offered a protection to them against systemic crisis by allowing them to periodic general suspensions of specie payments whenever necessary by the banking system as a whole (latest episode before the Civil War was in 1857).

With all its real life problems, Prof. Rothbard praises many features of the monetary arrangements of the U.S. before the Civil War, such as the clearance mechanism spontaneously developed into the system and administered by the Suffolk Bank. That clearance mechanism was interrupted in 1858 by political pressure and any hope of the reestablishment of an equivalent mechanism was lost with beginning of the confrontation.

VII. The Civil War

Prof. Rothbard's description about the impact of the Civil War on American finances is a sobering one. It was the cause for the U.S. to suspend redemption in December 1861, for the first time since the 1814–1817 episode caused by the 1812 War; and this time, it lasted two decades. Once in an inconvertible fiat standard, the federal government soon started to inflate the money supply, which was done through the Legal Tender Act of February 1862.

The federal expenditures increased exponentially during the war, rising from $66 million in 1861 to $1.3 billion in 1865. Those expenditures were mostly financed by public debt and not by issuance of fiat money. The deficit accumulated during the war reached the amount of $2.6 billion, of which $432 million were financed by printing fiat money and all the rest was borrowed. In order to fund this borrowing, all the savings in the country had to be drained, and the banking system was the instrument to achieve that goal.

Chief among the structural changes identified by Prof Rothbard was the new architecture of the banking system that resulted from the effort of war financing; with a "quasi-centralized fractional reserve national banking system" (2005: p. 122). The new structure ended the separation between federal government and the banks introduced by the Jacksonians and:

> (w)hereas the effects of the greenbacks were finally eliminated by the resumption of specie payments in 1879, the effect of the national banking system are still with us (2005: p. 137).

The new banking system was effectively built as an inverted pyramid, with the banks, in issuing their notes, multiplying their reserves, now, composed basically of federal debt (p. 142). On top of that, the country banks, which were not required to have specie reserves anymore, could have their reserves deposited with city banks, and these, in their turn, could have their reserves deposited with banks in New York City, which hold their reserves both in fiat money and specie; it worked to an extent that the money supply rose from $454 million to $1.773 billion during the war.

The process of replacing gold as bank reserve and the continuous attempts to curb the gold market by Treasury Secretary Salmon Chase while in office were necessary to force the country to adopt public debt and fiat money as medium of exchange and "high powered money" at the pace required by the funding of the war effort, with the creation of this new banking system "the federal government had an assured, built-in market for its debt" (2005: p. 142).

The well-documented chasing (no pun intended) of "gold speculators" and other forms of violence against private property and freedom of contract as part of the government policy did not passed unchallenged, though. Not only states such as California and Oregon effectively repudiated the fiat money by not accepting it in payment for state taxes and legislating "specific currencies contracts," but also the judicial institutions helped to protect individuals from the depreciation of the "greenbacks." Wholesale prices rose at a rate of 22.2% per year during the war.

The monetary and fiscal consequences of the war: In short, the monetary and fiscal consequences of the war were that the U.S. at the end of it had a "depreciated inconvertible greenback currency, and a heavy burden of public debt" (2005: p. 147). Then, according to Prof. Rothbard, yet another deleterious consequence of the war came in play: the perverse incentives for political forces to mobilize for the continuation of the inflationary credit expansion, summarized in the Carey's gospel (after the economist Henry C. Carey) of "high tariffs and soft money" (p. 148). Prof. Rothbard even describes *avant lettre* Keynesian schemes of public spending among the inflationists. Public spending was advocated by them, even if it was not necessary or conducive to better productivity in general, such as "pyramid building or digging holes in the ground" (p. 149). He also describes the importance of the railroad lobby among the inflationists. The actions of the inflationists prevented serious talk about resuming redemption until 1879, almost two decades after it was suspended.

The final last enduring change in the American monetary constitution as a consequence of the civil war came about when the greenback question reached the U.S. Supreme Court in the case of Hepburn v. Griswold which was decided in February 1870 and the acts of the Treasury Secretary were declared as "unnecessary and Unconstitutional" by a majority of 5 to 3. But a new Court, with two new judges, by a new majority of 5 to 4 in the case of Knox v. Lee declared paper money as constitutional in May 1871.

A last note by Prof. Rothbard about the struggle to resume normalcy in monetary matters after the war, with the resumption of redemption in specie, is about the compromise on bimetallism and silver purchases that in 1879 came into being along with the return to a redeemable currency.

For Prof. Rothbard, the Civil War was a turning moment in American monetary history, and the consequences of the war in terms of money and banking were all negative. So, with the chapters on the Civil War, Prof. Rothbard, as quoted above in different passages, makes clear his discomfort with the consequences resulting from the effort of war financing and its enduring marks on the monetary institutional arrangements of the United States.

VIII. The First World War

The Golden Years

The years between 1879 and 1913 were the years of the Gold Standard in the U.S. It was the time of the "free banking" system in which there were: a) non-note issuing banks regulated by the states, and b) national, issuing banknotes.[10] The bank notes were redeemable in specie, and they used to operate with fractional reserves; these reserves were cumulatively deposited in major cities around the country and ultimately in banks in New York City.

An analysis of those arrangements are not the object of the present essay; however, understanding the problems of having banks investing their reserves in state and federal bonds does not require much thought.

Other problem into brewing was the commitment to high tariffs and soft money of the Republican Party, expressed in the Sherman Silver Purchase Act (which doubled the purchases of silver by the Treasure and made the U.S. Dollar redeemable in either Gold or Silver at Treasury's discretion) and the McKinley Tariff Act, both from 1890.

[10]According to Prof. Vera Smith, in 1913, there were about 20,000 banks in the U.S., 7,000 of them, note issuing national banks, regulated by the National Bank Law and the others organized in accordance with the laws of the respective states in which they were established (Smith, 1990: p. 146).

In those years, many attempts to institutionalize bimetallism happened, shaking the confidence in the U.S. Dollar and the American commitment to a Gold Standard; not even the Sherman Silver Purchase Act repelled by the end of 1893 restored confidence, since other anti-gold political movements were active.

Nevertheless, it was a time of mild deflation, low interest rates, increased productivity and economic growth with the resulting growth in income per-capita; but a transformation in the political landscape in America was in place at the end of the nineteenth century. The elections in 1896 represented the end of the Democratic Party as "America's great laissez-faire, hard-money libertarian party," and its political space was occupied by the new "corporate, statist ideology of progressivism." The policies under which that long period of economic development happened yielded no more majority support and were replaced for a different set of values that would shape policymaking in the years to come; according to Prof. Rothbard:

> The progressive Era of 1900–1918 fastened a welfare-warfare state on America which has set the mold for the rest of the twentieth century (2005: p. 178).

The Federal Reserve System

The Federal Reserve System must be understood as part of the reshaping of American political institutions inspired by Progressivism.

Although the different initiatives of the Progressive Era were perceived by the public as motivated by "moral" concerns and guided by a "scientific" approach to the problems, specifically in the case of the central bank, as pointed out by Prof. Rothbard, the banks in general and the big banks in particular were concerned by lack of 'elasticity" of the money supply under the existing bank arrangements at the time. It was their inability to expand money and credit "as much as they wished" that led the banks to advocate for the establishment of a central bank with the responsibility of a lender of last resort; and it was done through third parties identified justly or unjustly as "grassroots", such as the ones gathered at the "Indianapolis Monetary Convention" in 1897 (p. 190).

The establishment of the Federal Reserve System as formally a central bank was not an entire novelty, however, since the Treasury to an extent had been functioning as a de facto central bank (2005: p. 207).

The political movement for the creation of a central bank finally succeeded in December 1913 when the Federal Reserve Act was passed creating the Federal Reserve System (Fed).

The Gold-exchange Standard

The monetary standard in place around the world in the decades that preceded the Great War, more than a fractional reserve gold standard, was a fractional reserve gold-exchange standard, under which reserves were not kept in gold but in a convertible currency mainly in Sterling Pounds or U.S. Dollars in a minor scale.

This system, which in effect pyramided the inflation on money supply in different countries around the world on top of already inflated pounds or dollars, actually loosened the constraints on note issuance by American and English banks, at same time that it lent the prestige of gold to the currency of peripheral countries as long as they integrated their financial systems globally. As stated by Prof. Rothbard:

> In that way, if U.S. banks inflated their credit, there would be no danger of losing gold abroad, as would happen under a genuine gold standard (2005: p. 219).

Bringing more and more countries to this system, justified as it was by some economic theories about the existence of "surplus" capital in the relatively more developed countries and clearly in the interest of their banking systems, became part of the foreign policy of both the U.K and the U.S. prior to the Great War and soon afterwards; a foreign policy that became indistinctly imperialist (p. 218).

Money and Banking in the U.S. during the Great War: It is symptomatic that there is no chapter about the monetary policy in the U.S. specifically during World War I in HMBUS, but instead, Prof. Rothbard chose to deal with those events under a chapter about the operations of the Fed from 1914 to 1928, the years that Mr. Benjamin Strong was the governor of the New York Fed. It served his purpose of showing the links between Fed's policy and the interests of the House of Morgan, which were invariably linked with British interests. According to Prof. Rothbard, one of the main reasons for the Fed to have adopted an inflationary policy during the war, which lasted with short interruptions until 1928, was to help Britain to finance their war effort and later to help the U.K. in their catastrophic decision of returning to the gold-exchange standard at the rate of 1914. In Prof. Rothbard's words:

> The United States inflated its money and credit in order to prevent Britain from losing gold to the United States, a loss which would endanger the new, jerry-built "gold standard" structure (2005: p. 271).

Actually, there are many evidences of the inflationary expansion of money and credit in the U.S. as part of the American war financing; and many of those evidences are quoted by Prof. Rothbard in the HMBUS. From the methods "of intimidation of business" employed by Hoover when he was "food czar in the World War I" to the activities of Mr. Eugene Meyer as managing director of the War Finance Corporation (WFC) in propping up the market for federal bonds and subsidizing American industries (p. 280). Prof. Rothbard even traces back to the collectivism engendered during WWI many of the initiatives to fight the Great Depression, such as the Reconstruction Finance Corporation (RFC).

However, it is necessary to go to other sources in order to find precise data about money and credit expansion in the war years, and Friedman's and Schwartz's A Monetary History of the United States shows that the wholesale price index in the U.S. from 1914 to 1918 rose from 65 to 130 in a scale that the wholesale price level of 1926 equals 100; the money stock rose roughly from $15 billion in 1914 to $30 billion in 1918 (Friedman and Schwartz, 1993: p. 197).

The federal debt increased immensely during the war; from $32 billion of total expenditures by the federal government from April 1917 to June 1919, no less than $23 billion were funded by borrowing and money creation (1993: p. 216).

The Fed could not possibly come into being in more adequate moment, since the raison d'être of a central bank was precisely as Alexander Hamilton wrote in his "Report on a National Bank" to be of "greater facility to the Government in obtaining pecuniary aids, especially in sudden emergencies", as mentioned before. And that was precisely what the Fed did in face of the necessities of war financing, in the words of Professors Friedman and Schwartz:

> The Federal Reserve became to all intents and purposes the bond-selling window of the Treasury, using its monetary powers almost exclusively to that end. Although no "greenbacks" were printed, the same result was achieved by more indirect methods using Federal Reserve notes and Federal Reserve deposits (1993: p. 216).

Summarizing the monetary impacts of the war finance, Professors Friedman and Schwartz state that from the $34 billion in expenses ($32 billion in Federal deficit plus $2 billion in additional Treasury cash balances), 25% was financed by taxes, 70% was borrowed and 5% was money creation. They also note that due to the fractional reserve system, the money supply increased $6.4 billion or $4.8 billion more than the fiduciary currency issued by the government.

During the WWI, the Fed proved its utility, now came the cost, in the form of the post war inflation, and it was big: it was roughly of the same magnitude of the variation in the money supply accumulated since the beginning of belligerence. From 1914 to 1920, the per-year change in wholesale prices in the U.S. was 15%, the annual change in the money supply was 13% and the per-year change in "high-powered money" was 12% (1993: p. 208).

There are many lessons to learn from the monetary history of the WWI; and if nothing else, the account given by Professors Friedman and Schwartz serves to reinforce the general theme of Prof. Rothbard's book in relation to the role of central banking in war finance.

IX. Concluding Notes

The subject of war finance is too broad to be dealt in the narrow confines of this short essay. An analysis of the treatment of Prof. Rothbard to war financing in his HMBUS, a much more humble proposition, is still too broad a topic to be completely covered with this paper. Some conclusions, however, are possible to be ventured. As a matter of fact, it seems clear that, for Prof. Rothbard, one cannot expect from American governments respect for private property rights and freedom of contract in general and sound money and free banking in particular in the presence of armed conflict. Prof. Rothbard shows this attitude of disregard for individual property rights as the "natural" response of different governments in different historical moments. He seems to accept this attitude as a "fact of life." In face of Prof. Rothbard corpus, it is from an acceptance of this attitude as the "natural" response from government in face military struggle than from any implicit agreement that the survival of the polity justifies the relativization of private property in general and sound money and free banking in particular that the absence of moral judgment in his book about those attacks may be understood.

As said before, the lack of discussion in his book about alternative ways to finance war other than debasing the currency and regimenting the banking system to drain the saving of the country in the shortest period of time possible may be simply because in a history book there is no place for contra-factual arguments. To think that Prof. Rothbard would have agreed with those arguments of *força maior* and that in face of the circumstances there was nothing better to do is unconvincing.

A reasonable conclusion may be that Prof. Rothbard acknowledges the fact that it is in the "deep" of financial markets (as the concept, more recently, has been utilized), i.e., in the complexity and extension of capital markets that a country may find the instruments adequate to finance emergencies, and that the "deepness" of a financial market is a direct function of the extension of the protection to private property rights and freedom of contract in that society; but, on the other hand, desperate times require desperate measures and it is not always that the political leaders are at leisure to think in any other time frame than the shortest time possible.

To distinguish between moments like, say, at the beginning of the Revolutionary War, a moment in which the situation could not seem more desperate, and the circumstances during WWI, in which no "greenbacks" were issued because it was not perceived as necessary, would be an exercise in casuistry; and Prof. Rothbard was not willing to engage in such exercise.

Or, perhaps, the result of such exercise would be that sometimes the interests of the community may be understood by the majority of the population, or by the political leaders, or the intellectual elite, or whoever, as a morally superior value to individual rights, and Prof. Rothbard was unwilling to engage this utilitarian reasoning as an acceptable guide for moral evaluation, at least, not in the HMBUS.

So, from the description by Prof. Rothbard of the different episodes in American history in which the federal government has intervened with money and banking in order to provide for war finance, it is possible to distinguish two different arguments against governments trumping private property rights in cases of emergencies: the first one is that it is not an efficient way to gather the recourses necessary to face the emergencies; the second is that it is not in the best interest of the community to do that in the long run.

The first argument can be easily granted, i.e., it is not so difficult to show how through the protection of private property the government may create the trust necessary to raise more resources than through rapacious means.

The second argument is more difficult to defend, i.e., what if there is really no time to gather the resources necessary to face the emergency by any means other than by confiscation? Does any individual have the right to refuse his property when the very survival of the community as an independent political body is at risk? Anyone acquainted to the thought of Prof. Rothbard knows his answer to this question, but what would be his answer to this question is far from consensual in America an, in any event, historically, the government in the US has not refrained itself of trumping private property rights in case of emergencies out of respect for individual rights. The way I see it, the limitations of American political institutions in preventing that is the main lesson left by Prof. Rothbard in dealing with war financing in HMBUS and a major challenge that remains unmet is to make consensual that a principled answer to these questions is possible.

References

Calzada Alvares, Gabriel (2005) "Mises and Rothbard on War Finance", in *Procesos de Mercado, Revista Europea de Economía Política*, Volumen II, Número 1, Primavera 2005.

Dickson, P. G. M. (1967) *The Financial Revolution in England, a Study in the Development of Public Credit 1688–1756*. London, UK: Macmillan.

Ferguson, Niall (2008) *The Ascent of Money, a Financial History of the World*. New York, NY: Penguin Press.

Friedman, Milton and Schwartz, Anna Jacobson (1993) *A Monetary History of the United States, 1867–1960*. Washington, DC: National Bureau of Economic Research, Ninth Paperback Printing.

Hamilton, Alexander, "Report on a National Bank", 1790, published by "The Executive Intelligence Review" (http://www.larouchepub.com/).

Higgs, Robert (1987) *Crisis and Leviathan, Critical Episodes in the Growth of American Government*. Oxford, UK: Oxford University Press.

Huerta de Soto, Jesús (2001) *Socialismo, Cálculo Económico y Función Empresarial*. Madrid, Spain: secunda edición, Unión Editorial.

Lachmann, L.M. (1970) *The Legacy of Max Weber*. London, UK: Heinemann Booksdon, 1970.

Menger, Carl (1963) *Problems of Economics and Sociology*. Chicago, IL: University of Illinois Press.

Mises, Ludwig von (2006) *Nation, State, and Economy*. Indianapolis, IN: Liberty Fund, Inc.

Oakeshott, Michael (1999) *On History and other Essays*. Indianapolis, IN: Liberty Fund, Inc.

Rothbard, Murray (2005) *A History of Money and Banking in the United States: The Colonial Era to World War II*. Auburn, AL: Ludwig von Mises Institute.

Smith, Vera C. (1990) *The Rationale of Central Banking and the Free Banking Alternative*. Indianapolis, IN: Liberty Fund Press.

Sylla, Richard, Tilly, Richard, and Tortella, Gabriel, editors (2007) *The State, the Financial System, and Economic Modernization*. Cambridge, UK: Cambridge University Press.