Bauerle's Bank Notes

Cause and Effect

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Scientists, economists, historians, bankers and lawyers all seek to understand cause and effect in their fields of endeavor. Conventional wisdom has it that Fed Chair Ben Bernanke's extended academic study of the causes of the Great Depression led him and his colleagues to avert a replay in October 2008 by flooding the financial system with liquidity, putting the full faith and credit of the federal government behind all manner of non-bank financial companies including AIG and GE Capital, and infusing $250 billion into U.S. banks via purchases of preferred stock. The Fed also bought bonds in a quantitative easing program that expanded the Fed's balance sheet to $4.5 trillion. This "accommodative monetary policy" continues to this day.

The Fed's monetary policy has unquestionably created waves in the real economy. Negligible bond yields have led investors to favor equities and fueled expansion in high yield bond funds whose assets are now coming back to earth. Banks have struggled to make money on the spread between what they pay on deposits and what they charge for loans. Wall Street has circumvented limits on high risk lending by banks, instead floating shares of business development companies and campaigning in Congress to allow them to leverage their balance sheets. The Wall Street Journal has documented the difficulty small business borrowers have experienced obtaining credit.

In our quest to understand this moment, we recently studied an essay by economist Milton Friedman, "The Crime of 1873," published 25 years ago in The Journal of Political Economy. Friedman examined the Coinage Act of 1873 and its effects through the end of the 19th Century. Comparisons between that era and the present one are imperfect. But there are some interesting resemblances. Both periods saw rapid technological transformation of the economy and consequent struggle between a dominant old order (agriculture then, manufacturing now) and an upstart new one (manufacturing then, artificial intelligence now), unprecedented flows of international capital from developed nations into developing ones (the U.S. was on the receiving end in the 19th Century), and consequent personal income insecurity and political exploitation of that circumstance.

Farmers and industrial workers were the Sanders and Trump focus groups of the late 19th Century, as crop prices sagged and railroads cut wages (railroads were the nation's largest employer after agriculture). In 1877, after the third 10% wage reduction in a year's time, employees halted rail service and destroyed railroad property at a dozen locations in the East and Midwest. The greatest conflagration was in Pittsburgh, where strikers burned 39 Pennsylvania Railroad buildings, destroyed 104 locomotives and 1,245 passenger cars, and suffered 40 deaths at the hands of militiamen as a result.

In Friedman's analysis, the seeds of the economic friction of the late 19th Century included the Coinage Act of 1873. It was Congress's effort to return the U.S. to a metal-based currency following the Civil War. Pre-war, U.S. currency could be converted into either gold or silver, the so-called bimetallic standard. The war's cost far surpassed U.S. bullion reserves. So Congress in 1862 passed the Legal Tender Act. U.S. currency thereupon became fiat currency (as it is today), backed by the full faith and credit of the U.S. government, but not gold or silver.

Another war-driven law was the National Bank Act, designed to replace state-chartered banks that issued their own currency backed by their own reserves. These banks' currency was easily counterfeited, a wartime concern. And the banking system was a patchwork quilt, insufficient to the task of funding a protracted military campaign. So Congress provided for national banks, which would deal in currency issued by the Treasury Department and be supervised by the Department's newly established Office of the Comptroller of the Currency.

The Coinage Act of 1873 returned the U.S. to a specie standard, listing coins to be minted. Included were gold coins and subsidiary silver coins, but not the silver dollar of 371.25 troy grains of pure silver. Precedent included Britain's abandonment of specie-based currency during the Napoleonic War and return to a gold standard in 1819. Congress passed the Act by a vote of 110 to 13 in the House and 36 to 14 in the Senate after what Friedman says was

> lengthy, though superficial, committee hearings and floor debate. It attracted little attention at the time even from members of Congress (including Senator Stewart) who voted for it yet who later attacked it in vitriolic terms as a "grave wrong," a "conspiracy" perpetrated by "corrupt bargains," a "blunder which . . . is worse than a crime," a "great legislative fraud," and finally, "the crime of 1873."[i]

The Act's passage coincided with, but did not cause, the Panic of 1873. The Act did, however, contribute to the lasting damage from that crisis. According to Friedman,

> The most obvious, but by no means the most important, consequence of the return of the United States to gold rather than to a bimetallic standard was the sharp rise in the gold-silver price ratio. A far more important consequence was the effect on the nominal prices of goods and services in general. . . . [R]ising real income, plus the spreading monetization of economic activities, plus the declining price level [of silver] increased the downward pressure on prices by leading the public to hold larger cash balances relative to their income (i.e., velocity declined).

The outcome was deflation from 1875 to 1896 at a rate of roughly 1.7

percent per year in the United States and 0.8 percent per year in the United Kingdom, which means in the gold standard world. In the United States, the deflation from 1875 to 1896 followed the even sharper deflation after the Civil War. [ii]

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A 1.7 percent a year decline in prices may seem too mild to generate the kind of agitation that bedeviled the two decades from resumption [of metallic-based currency] to the end of the century. But several considerations argue otherwise. First, the 1.7 percent refers to a price index that covers all goods and services (the implicit price deflator). The wholesale prices of agricultural and other basic commodities doubtless fell at a greater rate (3.0 percent a year by one index). At least as important, we all want the prices of things we sell to go up, not down, so that sellers of goods and services are almost invariably inflationists. True, we want the prices of the things we buy to go down. But as consumers, we buy many things whose prices are moving in different directions, so we are far less acutely aware of what is happening to the price level than of what is happening to the specific prices of the things we sell.

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One paradoxical result of the agitation for inflation via silver was that it explains why *deflation* was more severe in the United States than in the rest of the gold standard world (1.7 percent vs. 0.8 percent). As Anna Schwartz and I concluded,

> This entire silver episode is a fascinating example of how important what people think about money can sometimes be. The fear that silver would produce an inflation sufficient to force the United States off the gold standard made it necessary to have a severe deflation in order to stay on the gold standard. In retrospect, it seems clear that either acceptance of a silver standard at an early stage or an early commitment to gold would have been preferable to the uneasy compromise that was maintained, with the uncertainty about the ultimate outcome and the consequent wild fluctuations to which the currency was subjected.[iii]

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Whether or not a verdict of "guilty" would have been appropriate in a court of law for "the crime of '73," it is appropriate in the court of history. . . . The act of 1873 cast the die for a gold standard, which explains its significance. Moreover, while the conventional view is Laughlin's, that "the act of 1873 was a piece of good fortune," my own view is that it was the opposite: a mistake that had highly adverse consequences.[iv]

Friedman concludes his essay judging Congress's decision not to return to a bimetallic standard as a policy failure.

> [A] silver standard almost surely would have avoided what Schwartz and I dubbed "the disturbed years from 1891 to 1897": encompassing the very sharp contraction of 1892-94, a brief and mild recovery from 1894 to 1895, followed by another contraction from 1895 to 1896, widespread bank failures plus a banking panic in 1893, and a run on U.S. gold reserves by foreigners fearful that silver agitation would force the United States off the gold standard.

Friedman's essay, and particularly its discussion of the deflationary effects of the Coinage Act of 1873, suggests the bullet we dodged by the Fed's monetary policy of the last eight years. As John Williams, President of the Federal Reserve Bank of San Francisco, has said, "It was Milton Friedman who taught us that when inflation is too low, monetary policy needs to do more than just lower short-term interest rates near zero. In particular, he said it can buy longer-term bonds to add additional monetary stimulus. That's what we've done and it's worked."[v]

Williams compared the experience to leaving a cast on a broken leg until one is absolutely certain the bone fracture has healed. To extend the metaphor, it appears we still have at least six months left to walk on crutches.

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[i] M. Friedman, "The Crime of 1873," 98 Journal of Political Economy 1159, 1160 (1990).

[ii] Id. at 1170.

[iii] Id. at 1171-72.

[iv] Id. at 1176-77 (citations omitted).

[v] http://www.frbsf.org/our-district/press/presidents-speeches/williams-speeches/2014/june/accommodative-monetary-policy/

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