What lessons from the US dollar history?

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Outline

Muscial Introduction

Tony Award 2016

Section 1

The birth of the US dollar

The key elements

1. Wampun and Indian corn
2. Rhode Island as a foil for state currency
3. The accumulation of Independence war debt
4. Hamilton and the states debt assumption
5. Hamilton and its financial revolution

The US monetary union and the signing of the Constitution in 1789

- The US dollar is adopted as the national unit of account in 1792 (Coinage Act)
- The way the monetary union is designed draws on the Mint Report by Hamilton transmitted to Congress on 28 January 1791
- The Congress has the sole power to "coin money" and "regulate the value thereof"
- The US mint is established in Philly. It cannot supply all the country with enough dollar coins so the legal-tender status of foreign gold and silver coins lasted until the 1850s but the dollar becomes the preferred unit of account.
- The USA became a common market, an internal free-trade area with free movement of economic resources.

The dollar was not controversial

- Hamilton and Jefferson, political leaders who agreed on few matters of public policy, agree easily and support one another on the dollar monetary union
- After farmers upheaval in Rhode Island and Massachusetts, a monetary union was deemed a necessary prerequisite for a political union
- However the way to proceed became very controversial.
- So fierce debates that the union could break up.

A debate at the origin of the American politics

1. Jefferson, the Secretary of State, held the view of the (Democrat) Republicans.
   - He favored the states rights.
   - His group was composed of farmers from interior regions.
   - No need for a national bank that would benefit manufactures over farmers
2. Hamilton, the Secretary of Treasury, held the view of the federalists.
   - Advocated a strong government with a large republic to control factions
   - His group composed of manufacturers and financiers from New England
   - Called for a national bank to have a safe place to keep government money and issue loans.
   - Advocated the state debt assumption
   - Hamilton was perceived as the American Walpole (Brit PM)

The episode crystallized opposing forces that was to define American politics for decades (Chernow 2004).

The controversy over debt assumption

- State debt: \$25 million
- Federal domestic debt: \$42.1 million
- Federal foreign debt (France): \$11.7 million
- Total: \$79.1 million compared with nominal GDP in 1790 estimated at \$187 million (Sylla, 2011).
- Hamilton advocated the restructuring of federal and state debt obligations.
- A total assumption of the states debt by the central government

Arguments against state debt assumption

1. Reward speculators who bought debt securities at a cheap price
2. Empowers the general government- potentially distant and feckless, over Congress and States
3. Unfair to have careful States (Virginia and North Carolina) bailed out profligate States (Massachussets and South Carolina)

Hamilton's prime motivation

- During the Confederation (1783-1789), the Congress had no power of tax so could not service its debt
- Hamilton deemed that principle an "imbecility and injustice"
- The new Constitution would address that issue by giving states and the federal government the power to tax
- But it meant a concurrent access to the same tax base, which could have highly unstable implications on the US political situation
- Hamilton's controversial idea to assume debt war was motivated by the need to reduce the necessity of tax at the state level and prevent ruinous competition (Sylla, 2006).

Debt assumption and distribution of revolutionary war costs

1. Conversion of 98% of outstanding paper securities of the states and the federal government into securities at the official par of exchange.
   - Effective interest rate below the 6 per cent rate stipulated on most securities outstanding in 1789.
   - U.S. government securities became quickly accepted both at home and abroad
   - Yields fell to rates comparable to bonds of the leading European powers (Perkins, 1994)
2. 1790s: settlement of Revolutionary War accounts.
   - Equalize the costs of independence across states according to population
   - The creditors receive balances in the form of federal debt securities which yield interest revenues.

The debt assumption became a cornerstone of monetary union

- The debt assumption secured the allegiance of debt holders and bind the states to the Union
- Hamilton understood the importance to relate debt unification to monetary union
- By aligning the issuance of debt with tax base, he ensured sustainability and credibility of the monetary union
- It led to the creation of a U.S. government bond market, a key to long term sustainability of the U.S. fiscal union.
- It was also a way for the government access to international credit

A pilar of the monetary union: beyond the debt asumption, the establishment of a national bank

- Hamilton proposes the establishment of the BUS to reorganize the finances of the new government: help to manage the assumed federal debt, hold federal tax receipts, and provide inter mediation.
- Only three banks existed in 1789 (BNY and BNA) and state governments served as financial intermediaries.
- Development of the new financial system.
- Thomas Jefferson was fiercely opposed and argued strenuously that the bank was unconstitutional.

Hamilton's financial revolution

- The Bank of the United States was to be capitalized at \$10 million = several times larger than the combined capital of existing banks
- The stocks of the BUS were sold to private investors
- The federal government's shares and $\frac{3}{4}$ of private shares was to be paid in Treasury securities.
- \$8 million held by the private sector and \$2 million held by the US government.
  1. Capitalization of \$10 millions to the new national bank → the BUS supports the national debt
  2. The interest paid on the securities by the government supported the BUS.
- The IPO quickly sold out on 4 July 1791
- Chartering and investing in more banks and other corporations were profitable activities
- Hamilton was one of the few to understand the role of banks and **bank money** in a modern economy.

Why did the states accept to loose their monetary sovereignty?

- States loose the monetary seignoriage: possibility to buy goods and services by stamping money
- They lost the interest income
- They lost a democratic control over state economic situation (monetary expansion in time of recession)
- They lost the right to tax imports and exports

Because benefits outweighed the costs

- The loss of import and export tax revenues was largely offset by the federal commitment to assume defense costs
- The assumption of the state debt reduced the need for fiscal revenues
- For creditors, debt securities produced a interest payments.
- Half of the states revenues were derived from tax on banks, fees and bonuses for charters and renewal of charters (Sylla, Legler and Wallis, 1987).
- Granting charter was conditional on banks providing aid to government identified economic sectors

Take away

- None of the leading founders – Franklin, Washington, Adams, Jefferson, Madison and Hamilton – although they disagreed among themselves on many things, favored retaining state monetary sovereignty with fiat paper currencies.
- A common currency promoted free trade and capital mobility
- Beyond the economic benefits, they believed that a national currency was an expression of sovereignty and would promote national unity
- In sum the project of a political union was at the origin of the monetary union not an analysis of the macroeconomic benefits and costs

Take away

- Benefits and costs were gauged in term of debt assumption
- The American monetary union finds its deep roots in a debt crisis addressed by the arbitrage of a new central government
- The federal assumption of state debts and the launching of a BUS were key components of making the convertible-dollar monetary union work: in fact, the loss of monetary seignoriage was greatly offset by debt assumption and revenues derived from charters of incorporation
- But beside Hamilton, the founding fathers probably did not understand the importance of these two institutional arrangements.
- The implementation of a monetary union resulted from a rough and turbulent political process so much that the union could break

Hamilton Debt Asumption
Hamilton Carpool/ Lin-Manuel Miranda at the white house

Forward

- The monetary union was far from being complete in the early 1800's: still lots of turbulence, banking panics and uncertainty about the union all along the 19 century.
- The US were clearly not an optimal currency area
- How long did it take for the US to complete the monetary union?

Section 2

How long did it take the US to become an OCA?

Not a ride on a long, quiet river

- After the debt asumption and the financial revolution, the US is still not an OCA: no banking union, no fiscal union, lots of turbulence, banking panics and a poor integration across states line.
- Very severe crises along the 19th century

1. Free banking era and banking panics 1838-1863: monetary fragmentation
2. Battle of the Standard and the Great Depression of 1890: Real divergence
3. The Great Contraction: the completion of the Monetary Union

First Episode: Free banking era and banking panics

- An anti-establishment mindset brings Andrew Jackson into office (the D. Trump of the 19th century)
- 1836: non renewal of the charter of the national bank
- 1838: free banking Act liberalizes the banking business
- But very different banks regulation across states $\Rightarrow$ banking crises
- Between 1832 and 1863, a variety of state's currencies circulated, all called dollars $\rightarrow$ but a dollar note issued by one bank could be worth less than a dollar note issued by another bank depending on how much faith people had in their backing
- Western and Southern farmer States: monetary volatility, banking panics and banks failures.
- Northern strongly regulated states were more resilient

Monetary fragmentation and Civil War

Monetary fragmentation exacerbates asymmetric economic interests and lays the ground for the Civil War (Rockoff, 1974):

- Crisis in 1857: Failure of an insurance company in NYC spreads throughout the country
- Radicals in the South see in the crisis the reason to push their case for independent country with separate economic and monetary systems
- 1863: National Banking Act rationalized U.S. banking structure and diminished the importance of state banking differences

Take-away

- Monetary fragmentation lasts without necessarily triggering a break-up (it lasted 25 years in the US)
- However it exacerbates asymmetric economic interests and political tensions in the union
- The American free banking experience provides a counter-factual of what would have happened in absence of a Euro-wide payment clearing system
  $\Rightarrow$ The big takeaway: incomplete monetary union carries financial instability, a fact that undermines union's legitimacy

Civil War: 1861-1865

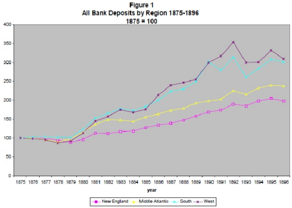
- The Civil War divided the country into 3 different monetary regions:
  1. East and Middle West on greenback
  2. South on confederate dollar
  3. Pacific on Gold
- From 1865 end of CW and 1879, North and South on greenback and Pacific on gold.
- No central bank: the monetary policy is mostly decided by the Treasury

Second episode: The Battle of Standards

- Resumption policy aims at returning to the prewar price level
- 1866: Contraction Act and silver is removed from the list of official coins
- But fierce regional opposition to the Gold standard: coalition of farmers and miners from Southern and Western states against Eastern bankers:
  - Eastern states (creditors) favor continued commitment to the gold standard for the sake of stability and credibility to assure American integration into world markets.
  - South and West (debtors and exporters) advocate the free coinage of silver, which implies money expansion and a devaluation of the US dollar
- One of the most famous speech in American history: Nebraska Democrat Congressman, runner for president William Bryan "Thou shalt not crucify mankind upon a cross of gold."

The impact of the Great Depression in 1890

- The US are hit by a severe depression in 1890: unemployment explodes from 3 in 1892 to 11.7% in 1893, peaking at 18.4% in 1894
- South and west suffer deflation and monetary contraction while only small imprint is left in the North
- Deposits movements are a good indicator of economic activity



- Dramatic impact in the West and South, the centers of the Populist revolt: - 18% between 1892 and 1893; in 1896 deposits are lower than in 1892.

The price of monetary union

- Scenario: separate currencies, for the East, the West, the South, and the Pacific Coast.
- The West and the South would have adopted a silver standard in the 1890s. The East and the Pacific Coast would have stayed on gold.
- Money stocks would not have fallen in the West and the South as much as they did.
- The pros: depreciation against gold, making it easier to sell and export wheat, cotton, and other agricultural products (Frieden, 1997)
- The cons: lots of uncertainty, wide currency fluctuations and bank panics

The price of monetary union

- Milton Friedman (Fall 1990, and December 1990) has argued that adoption of bimetallism earlier in the postbellum period would have produced a more satisfactory behavior of the price level. He concludes, however, that by 1896 the time for adopting bimetallism had passed.
- In the mid 1890's, new flows of gold begin to reverse the deflation.
- Eventually, the United States formalize its commitment to the gold standard with the Gold Standard Act of 1900.
- The US were lucky enough to receive new flows of gold which reversed deflation!

Take-away

- The gold standard was temporarily abandonned under the extreme conditions of the Civil War
- Fixed exchange rates facilitate business and communication in good times but intensify problems when times are bad: deflation trap.
- The absence of federal fiscal transfers prevents to smooth the business cycle of adversely hit regions, implying that hard pegs are maintained at extremely high social cost.
- Creditor states/ members, which could in turn inflate their economy to avoid painful adjustment in the periphery, do not do so because they are in a better position to impose the economic conditions in their favor.

  $\Rightarrow$ The big takeaway: the policies adopted under the constraint of a monetary union affect the growth path of their members. **Low growth and deflation undermines the union's legitimacy.**

The Wonderful Wizard of Oz: an allegory of the conflict

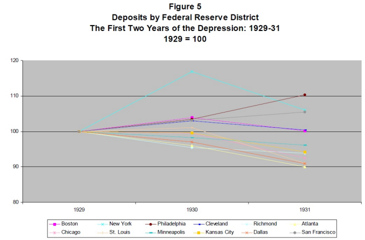
L. Frank Baum's classic 1900 children's book The Wonderful Wizard of Oz

- The story of Dorothy, Toto, and their friends is an allegorical rendition of the U.S. political struggle over gold.
- The yellow brick road represents the false promise of gold
- The name "Oz" is a reference to an ounce (oz.) of gold
- Dorothy's silver slippers — changed to ruby slippers in the well-known Hollywood colorfilm version — offer the true way home to the heavily indebted farming state of Kansas.

Third Episode: the Great Depression

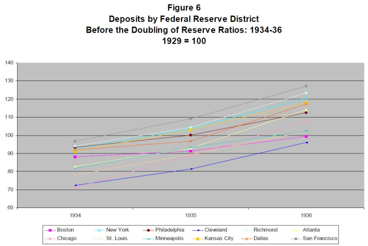
- No region was immune to the 1929 crisis, but there were significant regional differences.
- The Fed faced an optimal-currency-area dilemma in 1936: some regions needed stimulation; others needed restraint.
- It adopted a contractionary monetary policy
- In addition, there was no federal fiscal transfers prevents to smooth the business cycle of adversely hit regions
- Again differences in regional perspectives contributed to the paralysis

Regional deviations



- How is the recovery doing after 1929? Compare deposist in 1931 and 1929
- Above (= good recovery): San Francisco, Boston, and Philadelphia districts, New York district. Employment had also recovered well.
- Below (= bad recovery): Atlanta (Georgia), Saint Louis (Missouri), Minneapolis (Minnesota), Kansas City (Kansas).

Great Depression



- Cleveland district deposits still below the June 1929 level in 1936. Unemployment was still high.
- Hard pegs are maintained at extremely high social cost.

The achievement of a complete monetary union

The US become a smoothly functioning monetary union between the Depression and WW2.

1. Development of federally funded transfer programs
2. Labor mobility
3. Deposit insurance

Inter-regional transfers

- Development of federally funded transfer programs: unemployment insurance, social security, and agricultural price supports, cushioned regional shocks, and redistributed reserves lost through interregional payments deficits.
- Between 1929 and 1933, the Minneapolis Federal Reserve district lost $247 million in reserves on private transactions.
- This was offset, however, by a gain of $229 million on federal government transactions.
- On the other hand, the Boston Federal Reserve district gained $644 million in reserves on private transactions, while losing $575 million on federal government transactions.

Breakdown of long-term isolation of the southern labor market

- Postwar flow of migrants from the South to North
- Federal labor legislation: minimum wages and regulation of hours, conditions of work
- Federal incentives to mechanize agriculture, established during the 1930s added to the postwar flow of migrants from the South.

Financial integration

- In the aftermath of financial crises of 1907, establishment of the Federal Reserve System in 1914
- Traditional opposition between states rights proponents Republicans and federalist Democrats
- The democrat project is adopted in Dec 1913: 12 regional federal reserves under the oversight of the Board
- *Banking Act* in 1935 establishes the FOMC that coordinates the monetary policy
- Deposit insurance and monetary policies reacted quickly to economic downturns after the *Banking Act*
- Absence of major banking and financial crises until the liberalization of capital markets

Section 3

Lessons

Takeaway

- The history of monetary unification in the US has been agitated
- Temporary break during the civil war
- Many government policies, tariffs and special treatments survived for political reasons and not because they were favorable
- Numerous examples of regional shocks magnified by monetary reactions
- Very bad example for showing that benefits of monetary union overweight costs
- The dollar was eventually complete only with the institutional changes: inter-regional transfers central bank with a single deposit insurance
- It took 150 years for the US to become an optimal currency area!
- Strong political project underlying the monetary union

Monetary regimes and legitimacy

- The legitimacy of a monetary union draws from its capacity to deliver a balanced distribution of income, financial stability and growth.
- In the absence of such achievements, households and business may lose confidence in the monetary arrangement.
- They may look for an alternative, call for a break: it produces political instability and feeds tensions.
- To produce legitimacy, the regime needs to accommodate a diversity of interests
- The political governance of a monetary union is at the heart of the resilience of a monetary union.