

## COVER STORY

# How to Pay for What We Need

CONGRESS COULD CREATE MONEY, AS IT DID  
DURING THE CIVIL WAR, FUNDING PUBLIC PROJECTS  
THAT SHOCK THE ECONOMY BACK TO LIFE

RICHARD STRINER

JUST AFTER THE ELECTION OF 2008, the Nobel laureate liberal economist Paul Krugman made a prophecy: we will not restore prosperity, he warned in *The New York Review of Books*, “unless we are willing to think clearly about our problems and to follow those thoughts wherever they lead.” But as Krugman’s thoughts drifted back to the maxims of John Maynard Keynes—maxims he called “more relevant than ever”—our thoughts could be turning to the older and in some respects wiser innovations of President Lincoln and the Republican Congress during the Civil War. Here’s the gist of it: using the monetary methods of Lincoln, updated to employ the inflation-fighting tools of the Federal Reserve, we could pay for a faster recovery and a great many worthy projects without higher taxes, without more national debt, and believe it or not, without inflation. How? By letting Congress exercise a little-known power that is used (very quietly indeed) by the Federal Reserve: the power to create new money.

If you’re skeptical about this assertion, ask Federal Reserve Chairman Ben S. Bernanke. In an interview with *60 Minutes* on March 15, 2009, Scott Pelley asked Bernanke to state the cost to American taxpayers of the Fed’s attempts to prop up banks.

Bernanke: “It’s not tax money. The banks have accounts with the Fed ... so, to lend to a bank, we simply use the computer to mark up the size of the account that they have with the Fed. It’s much more akin to printing money.”

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Pelley: "You've been printing money?"

Bernanke: "Well, effectively."

If the Federal Reserve can create new money, couldn't Congress do the very same thing? The answer is yes, and here's the precedent: the Legal Tender Act of 1862, in which the Republican-controlled Congress authorized creation of "United States Notes," known as greenbacks, that were printed up and spent into use.

The U.S. Constitution has no provision for this practice, but it does authorize the minting of coins. Most delegates at the Constitutional Convention distrusted the idea of paper money because, with the important exception of colonial Pennsylvania (whose currency succeeded), the creation of paper money by several colonies had led to hyperinflation. So did the issuance of "continental currency" by the Continental Congress during the American Revolution.

The most spectacular American example of "printing-press money" and a resulting hyperinflation was Confederate currency during the Civil War, which became worthless, or very nearly so. Even the use of printing-press money by Lincoln and the Civil War Republicans—who funded their side of the war through a combination of taxes, bonds, and greenbacks—was accompanied by serious inflation. Yet the inflation rates of the rival systems were extraordinarily different. Over the course of the war, the Confederate rate grew 9,000 percent while the Union rate rose to 80 percent. That's double-digit inflation with a vengeance, but the tremendous difference between the two rates suggests that a range of factors can determine the side effects of spending printing-press money. In the view of historian James M. McPherson,

Three main factors explain the success of the Legal Tender Act. First: the underlying strength of the northern economy. Second: the fortuitous timing of the law. It went into effect during the months of Union military success in the spring of 1862, floating the greenbacks on a buoyant mood of confidence in victory. The third reason was the enactment of a comprehensive tax law on July 1, 1862, which soaked up much of the inflationary pressure produced by the greenbacks. The Union ultimately raised half again as much war revenue from taxes as from the issuance of paper money—in sharp contrast to the Confederate experience.

Notwithstanding the overall success of the Union greenbacks—and notwithstanding the importance of the 1871 Supreme Court decision in the case of *Knox v. Lee*, which declared the Legal Tender Act constitutional—Civil War greenbacks were slowly withdrawn from circulation (and were redeemed in gold beginning in 1879). Some people, many of them farmers who wanted government and not banks to control the currency, protested against this policy and founded the Greenback Party in 1874. Some social reformers recommended financing federal relief measures with greenbacks during the

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Gilded Age. In 1894, a maverick Ohio businessman named Jacob Coxey led an “army” of unemployed Civil War veterans to Grover Cleveland’s Washington in the middle of an economic depression. They demanded a multimillion-dollar “Good Roads” bill that would wipe out unemployment through job-creating public works. The finance method they proposed: greenbacks.

But the concept of money created by the government descended into widespread disrepute by the turn of the 20th century—and it stayed that way until an economic emergency of the greatest proportions, the Great Depression, led some distinguished American economists to recommend reviving the greenback method. Their program was trumped by the influence of John Maynard Keynes, whose *General Theory of Employment, Interest, and Money* hit the shelves in 1936. The result of our adherence to some form of Keynesianism ever since has been a staggering national debt.

Conservatives and liberals alike should step back from conventional thinking in the face of our current conditions. None of the prevailing economic orthodoxies—neither the liberal ones of Keynes nor the conservative counterorthodoxies of Milton Friedman or Arthur Laffer—touch sufficiently on the central point that we ought to be considering now: the nature of money as an economic thing-in-itself, because modern money is a fluid—an evolving—construction.

This is not an esoteric line of inquiry. Indeed, if we pursue these thoughts “wherever they lead,” as Paul Krugman suggests, we might find that we could usher in a greater (and a better) financial revolution than his great hero, Keynes, was able to deliver.

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THE CONVENTIONS of our money supply are so arcane that explanation is daunting. Journalist William Greider once observed that the American process of money creation is “a powerful mystery to most citizens.” Indeed, he wrote, it is a mystery to most elected leaders, who tend to believe that the process is best “left to the experts, a forbidden area where politicians [are] not supposed to intrude.” In *Secrets of the Temple: How the Federal Reserve Runs the Country*, Greider quoted the head of the Federal Reserve Bank of New York, who went so far as to assert that “no President really understands these things.”

If that’s true, it’s nothing less than a major civic tragedy, one we should not allow to continue. Why should we tolerate a state of affairs in which people use economic jargon instead of giving an intelligible answer to the following conceptual questions: Where does modern money come from? And what does it consist of?

Generations ago, the coined money created by our government consisted of gold and silver—precious metal that was clearly private property—an internationally portable treasure that was brought to the mint on occasion by its owners, then stamped into coin and given back. Then this “monetized” metal circulated through



*Ben S. Bernanke testifying before Congress in October 2011. If the Fed can create money, why can't the legislative branch?*

the economy. A small amount of our contemporary money supply can be traced to that long-ago process. In 1934, when monetary gold was largely removed from circulation through the Gold Reserve Act (it was melted into bullion and eventually shipped to Fort Knox), its possessors got paper currency in exchange. But the precious-metal standards are defunct as the basis for our money. And even in their heyday, money created by the gold and silver standard amounted to less of the total money supply than that created in a different way. The ineffable truth is that most of our money supply is not created by the federal government, as most people seem to believe, but instead by banks.

Centuries ago—as early as the founding of the Bank of England in 1694—money-lenders figured out a clever way to make double, triple, or quadruple use of the coin deposits that they received from their customers. The bankers made loans in the form of paper bank notes emblazoned with a clear-sounding promise: “payable to the bearer on demand.” But bankers issued far more of these notes (via loans) than they could ever redeem at one time. That is to say, the volume of bank notes in circulation vastly exceeded the coin deposits “on reserve.”

The bankers figured it was unlikely that everyone possessing a banknote would storm into the bank at the same time, demanding redemption in cold hard coin. Under normal circumstances (“banker’s hours” of course improved the odds), these money-lenders won their gamble. But when a bank panic happened, their gamble went spectacularly wrong. The bank would go into default, and then (depending on the nature

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of the banking laws) the depositors might be left empty-handed. In any event, the privately issued bank notes expanded the money supply, not as legal tender (under law, people weren't required to accept them) but as a purchasing power that functioned as a surrogate for money. In the first decades of the republic, notes from thousands of these different banks were being used as currency for small everyday transactions.

In the United States by the 1870s most banks began to shift from the issuance of bank notes to "checkable deposits"—modern-day checking accounts. Instead of giving a borrower a loan in the form of bank notes, bankers would give borrowers a checkbook and say that the loan had been credited to their account as a new deposit. All they had to do was write checks, and then the bank would redeem the checks in coin from its cash reserves when the checks were presented at the bank.

But it was still the same basic system.

From checking deposits, this practice evolved into the lines of credit that we all know and use every day, with our credit cards, cash cards, online bill paying, and so on. But along the way, through banker alchemy, credit evolved from the legal-financial denotation of a promise to pay to the functional-dynamic equivalent of actual payment. Consider how it works. Write a check, and then presto, you have paid: you have made a real purchase. A sale has been recorded in the books and in cyberspace, well before the check has been cleared. Swipe the credit card, and once again, you have paid. When the bank extends credit, it creates new purchasing power.

But the mechanics of the process are as deceptive as they were long ago, when many people who read the promise "payable to the bearer on demand" presumed that behind every banknote was cash, real coin of the realm, in the very same amount. In fact, cash is unimportant in the ledger transactions that constitute the juggling act today.

Consider an example of present-day banking practices, carefully expounded by a widely used economics text, *Economics: Principles and Policy*, by William J. Baumol and Alan S. Blinder. "Even a single bank can create money," these economists explain, and they give a quick example to illustrate. A man deposits \$100,000 of cash in his checking account. So "the bank now has acquired \$100,000 more in cash reserves, and \$100,000 more in checking deposits." It would sound as if these two different monetary terms—the \$100,000 worth of "cash reserves" and the \$100,000 of "checking deposits"—are interchangeable ways of referring to the same amount of money. But they are not: these banking terms of art represent an accounting trick whereby the \$100,000 can be doubled into two equal units of \$100,000 apiece.

Since the Federal Reserve's "reserve requirement" is (in this example) represented to be 20 percent, the bank's "required reserves rise by ... \$20,000, leaving \$80,000 in excess reserves." And so the bank lends the \$80,000 to another customer. But remember: the original depositor can still write checks to the tune of \$100,000. What has happened here is pure sleight of hand, and the two economists sum it up quickly: "There is

now \$100,000 in checking deposits and \$80,000 of cash in circulation, making a total of \$180,000. The money-creation process has begun.”

Thus commercial banks are allowed in our system to make double use of checking deposits. The legal principle is simple: like insurance companies, the banks are obliged under law to pay money on demand to their customers in certain situations. Consequently, as long as these banks can make good on their promise to pay—never mind how—the methods they use to shift money around are almost none of our business, at least in the eyes of the law.

Of course the law can be changed, and for many years in early American history the fear of reckless banking caused states to clamp down. Banking regulation at the federal level has a long and interesting history. It began with the chartering of banks by Congress: The First and Second Banks of the United States (chartered respectively in 1791 and 1816), the national banks chartered by Congress in 1863 (which were regulated by the Comptroller of the Currency), and the Federal Reserve System, created by Congress in 1913. The Fed was (and is) a hybrid public-private institution that was designed to be a “lender of last resort” in a banking crisis. The regulatory powers of the Fed (as applied to member banks) would be steadily increased down the years. A turning point was reached in the 1930s, when federal deposit insurance gave the taxpayers interest in preventing, by law (through bank regulation), the unsound practices in banking that can generate public emergencies requiring a special taxpayer bailout.

In any case, most of our money is created by the banks, in the process of lending. The tangible stuff that we keep in our pockets and use as legal tender—the coins produced at the U.S. Mint and the Federal Reserve Notes produced at the Bureau of Engraving and Printing—gets furnished by the Treasury to banks (when they need it) in exchange for securities that function as collateral. Such physical money plays a secondary role in our economy. The cash transactions that we make in the course of the day are insignificant compared with our direct electronic transactions.

So, through the method that is known in economics as fractional reserve banking, this creation of our money supply by the banks takes place with Uncle Sam as a cooperative assistant. The term *fractional reserve* refers to the existing money that the banks have to keep on hand to pay depositors and creditors, which constitutes a fraction of the brand-new money that the banks are creating through their lending and credit operations.

Consider the extraordinary magnitude of this process. Recall our first example: a deposit of \$100,000 generates \$80,000 more. Now suppose that the borrower who takes out the loan—the \$80,000—deposits this newly created money in a different bank. Presuming the same reserve rate of 20 percent, this \$80,000 could support yet another loan to the tune of \$64,000. And so on, until at last, at the end of the chain, the first deposit has led through a multiplication of loans to \$400,000.

But the principle starts at the top, with the Federal Reserve, which can add to

the “excess reserves” of the system by creating new money through “credit.” The staff of the Federal Reserve once explained the process in a 1939 guidebook titled *The Federal Reserve System: Its Purposes and Functions*. One sentence in the book, deleted from subsequent editions, reads, “Federal Reserve Bank Credit ... does not consist of funds that the Reserve authorities ‘get’ somewhere to lend, but constitutes funds that they are empowered to create.” And this was the method that we used to beat the Axis in World War II. As economist Seymour Harris once wrote, “in World War II ... the task of the Federal Reserve was to manufacture money.” Indeed, our money supply was nearly doubled during the war through the methods of deposit creation.

The Fed created credit that was used to buy bonds—preexisting bonds—from the portfolios of banks. The money that was paid for these bonds led to larger excess reserves in the banking system, and these excess reserves led to purchases of newer government bonds: war bonds. Commercial banks made loans to buy the bonds, but the bankers often purchased them in the course of their own investing. According to economic historians Gary M. Walton and Hugh Rockoff, “by 1945, about \$24.3 billion in [war] bonds were owned by the Federal Reserve system and some \$84.1 billion by commercial banks.” William Greider describes the almost circular mechanics of the process:

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**Most of our money is created by the banks, in the process of lending. The stuff we use as legal tender plays a secondary role in our economy.**

To ensure a successful bond sale ... the Fed expanded bank reserves by buying up outstanding government securities. The commercial banks lent the expanded money supply to private customers who would in turn lend it to the government by buying the new Treasury issues. The customers then sold their new government securities to the commercial banks—and they eventually sold them back to the Fed when the central bank was again required to expand the money supply. In a roundabout way, the government was borrowing its own money—and paying a fixed fee to middlemen for the privilege.

Marriner Eccles, the chairman of the Federal Reserve from 1934 to 1948, was uncomfortable with this circularity. He would have liked to reform the whole system. But he could not persuade either FDR or the Treasury secretary, Henry Morgenthau, to go along with changes in the process. So Eccles himself went along—with regrets.

A long tradition of protest has challenged the way in which our bankers are allowed to “make money.” From the Greenbackers and Populists of 19th-century America all the way to the online conspiracy theorists of today—if you type “fractional reserve”

into a search-engine box, a strange netherworld of websites emerges—American radicals and ultra-conservatives have steadily protested the conventions of our money supply. The almost violent antipathy of many Tea Partiers toward the Fed is a good case in point. Some of the antibanker culture down through the years has been openly anti-Semitic, but some of it has been intellectually reputable and even distinguished.

During the Great Depression several important American economists protested against fractional reserve banking. One was Irving Fisher of Yale, a theorist gifted enough to prompt the famous Austrian economist Joseph Schumpeter to call him America's foremost "scientific economist." In 1936, Fisher wrote that "everyone except the banker who lends money lends pre-existing money, not money of his own creation. ... The government should take away from banks all control over money creation." Henry C. Simons of the University of Chicago condemned "the usurpation by private institutions (deposit banks) of the basic state function of providing the medium of circulation."

John R. Commons, a past president of the American Economic Association, recommended in 1934 that "in order to create the consumer demand, on which business depends for sales, the government itself must create ... new money and go completely over the head of the entire banking system by paying it out directly to the unemployed, either as relief or for construction of public works." Lauchlin Currie of Harvard, who went to work for FDR, Richard Lester of Princeton, and other economists joined in this call for direct creation of money by the federal government.

Lester did some research on the methods employed by Benjamin Franklin and others in colonial times—methods whereby the Pennsylvania magistrates printed up money and lent it into public circulation. According to Lester's findings, inflation was never a problem under this system: "The price level during the fifty-two years prior to the American Revolution and while Pennsylvania was on a paper standard was more stable than the American price level has been during any succeeding fifty-year period." As late as the 1970s, the eminent economist John Kenneth Galbraith agreed that colonial Pennsylvania "handled paper money with what must now be regarded as astonishing skill and prudence."

Greenback spending could have made a great difference in the way Roosevelt's New Deal was financed. An amendment to the Agricultural Adjustment Act of 1933 gave the president authority to issue new greenback currency, but the doctrines of John Maynard Keynes prevailed with FDR—very slowly at first but definitively by World War II—while the "radical" proposals of Fisher and Simons were forgotten.

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THE GREENBACK TRADITION these days is little more than a relic. Now and then a heretical writer has attempted to revive the tradition; in the 1990s, for example, a retired businessman and engineer named William F. Hixson wrote that "*it never makes sense for the*

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government to permit banks to create money and then borrow it from them at interest, since the government can create money just as cheaply and efficiently for itself and then have the use of it without a debt to repay and without any burden of interest.”

The orthodox reply to such reasoning is simple: the elimination of bank-created money would destroy any basis for monetary policy and lead to catastrophic inflation. After all, among the powers that Congress has granted to the Federal Reserve—beginning with the Banking Act of 1935—is the power to set the reserve requirements for banks. In 1980, this authority was expanded to include the reserves of all “depository institutions,” from commercial banks to savings and loans to credit unions. By raising the reserve requirements (as the Federal Reserve began to do under Paul Volcker’s chairmanship in the early 1980s), the Federal Reserve can counteract inflation by pulling more money out of the excess reserves, which will tighten up the money supply by reducing banks’ power to lend, thus fighting inflation.

Most economists reject any notion of fundamental change in our monetary system, and for reasons that command some respect. Major structural changes can initiate frightening sorts of chain reactions. If we toppled our existing financial apparatus, what system would we put in its place? And what risk of major mischief would we run?

But we shouldn’t have to choose between the all-or-nothing options of bank-created money and money created by the government, not if we can employ the best of both. Instead of canceling the power of banks to create new money, we could add to the expansion of our money supply with new money that the government creates. The very same monetary tools the Federal Reserve uses to prevent or counteract inflationary pressures could be used to mitigate the side effects of money created by the government.

Here is how the process might work. Congress would legislate a limited creation of money to be spent through direct appropriation. The new appropriated funds would then be sent by the government through direct electronic deposit to employee or vendor accounts in commercial banks, where the funds would immediately be convertible to cash through the methods of the Fed. As these deposits augment the excess reserves of the banking system—creating some potential for inflation—the Federal Reserve would begin to raise reserve requirements in proportion to the increase in excess reserves if inflation began. As deposits increased, the banks would place more money off-limits in required reserves. The offset would prevent inflation.

The Federal Reserve already has the ability to pull money out of nothing, as its 1939 guidebook admitted. Credit flows electronically now; it is the ghostly “energy” that drives the goods-and-services economy. It constitutes a pure liquid power to purchase. And bankers created it.

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American citizens, represented by Congress, should have the same power. This amounts to the system that we have in place now, except that Congress—in addition to the Fed—would have the power to create new money out of nothing. This would constitute a very neat division of labor: the Fed would create the new money for private investment, and Congress would create the new money to underwrite our public investments. Through direct electronics, these channels for creating new money would converge, then mix and overlap into a great common monetary pool.

The best way to launch such a system—to give it a low-risk test—would be to start small. Have Congress create just enough money to pay for some public necessities—say, a few billion dollars' worth—and then see what happens. If inflation develops that can be traced to the small increase in the money supply, corrective action by the Fed could quickly counteract it. And if the action by the Fed succeeds in counteracting the inflation, the scale of this experiment in fiscal and monetary policy could be increased.

Novel as it is, a mixed system such as this could work well through responsible management. Its management would not be simple or foolproof, but neither is the system that we have in place now. If it works, the new infusion of government funds could be a shot in the arm for the private sector, building up purchasing power that would stimulate production, employment, and sales.

The United States is not broke—and we should laugh at the delusion that we are. The potential for abundance is everywhere around us, but it stagnates for sheer lack of funding. We have contracted our nation's power to produce and consume just to prove that we can live within our means. And that's a formula for economic ruin. There are some (the economic historian Niall Ferguson, for instance) who think we ought to sell our public assets, like our interstate highways, to increase our nation's stock of hard currency. That's preposterous. There's a better course of action once our citizens and leaders understand what money is, once they understand that hard currency—the Federal Reserve Note, for instance—is just a representation of a force that has been summoned by bankers out of nothing. We can summon it ourselves, and use the great power of the Federal Reserve—in partnership with Congress—to preempt the threat of inflation.

Why shouldn't the American people have additional funds to be used for such impeccable purposes as national security, infrastructure maintenance, public safety, environmental protection, and research to counteract global climate change—funds created by the government without more taxes or debt? Does the principle seem too good to be true—a mere mirage, something for nothing? Think it over, for the system that we have right now is an exercise of mind over matter. The system I propose would give the people and their leaders an equal share in money creation with the bankers who are seeking private profit. It's a profitable game, the creation of money, and we need more players at the table. ●

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