Monetary Order for a Free Society

By

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What role does money play in generating an overall order in society? Is a monetary order necessary for a free society? S. Herbert Frankel (1977: 12) argued that "there is an intimate relationship between money and freedom; between the keeping of promises and the certainty of contracts; between social function and the rule of law." While many would agree with his statement, modern monetary theory and practice is at odds with it.

In examining the question of a monetary order for a free society, I will draw on a variety of sources. Not all fit neatly into the natural law tradition, but almost all are consonant with that tradition. I focus on two inter-related issues. First, are there laws of monetary development? Second, is there a morality of money?

Economic Law

In the history of economics, there have been contentious debates over whether there can be laws of economics. The mid-19th century saw the emergence of the German Historical School. Caldwell (2004: 43) observed that "central among the beliefs was a rejection of natural law doctrines." Members viewed each society as developing according to its own culture and historical situation. No general laws of economics were possible. Empirical-historical knowledge was the research program (Caldwell 2004: 51).

The rejection of the concept of economic laws brought a reaction from within the broad tradition of German economics. In 1871, the Austrian economist Carl Menger published the *Principles of Economics* (Menger [1950] 1981). In Caldwell's (2004: 47) words, "what was most striking in Menger was how he put things together, how he gave a new and thoroughly systematic structure to various previously expressed notions concerning the effects of human action." Menger and those who followed in his footsteps consciously sought a sound philosophical basis for developing economic laws of human action. Moreover, from the beginning the Austrian School (as it came to be called) was pre-occupied with the laws by which money operated.

Before proceeding further, I want to clarify my own understanding of natural law. The adjective refers to the nature of man and the law to the order that acting men evolve. As clarified by the Spanish Scholastics of the late 16th century and then Grotius, there is nothing theological about natural law (Rothbard 1982: 4-5). It is discovered through reason, not revelation.

In the 20th century, Mises (1966) is most identified with pursuing Menger's program of developing the laws governing human action or purposeful behavior. Yet Mises (1966: 720) at one point dismissed natural law out of hand, saying the idea "is quite arbitrary [and] such discussions are not open to settlement." Yet shortly afterwards, Mises (1966: 761) equates economic law with the "laws of nature" (e.g., physics and biology) and argues that man must recognize these regularities "if he wants to succeed." Incredibly, he then articulates "the reality of natural law, namely, the fact that [man's] power to attain chosen ends is restricted and conditioned."

Mises is thoroughly modern in his ambivalence toward natural law. I would maintain he was correct when he implicitly equated natural law with the "laws of nature." He accepted what Schumpeter (1954: 111) characterized as "explanatory natural law" and Chafuen (2003: 20) characterized as “analytical natural law” or “the laws of nature”. We would now say that Mises accepted the positive analysis of natural law. He rejected “normative natural law,” a subject to which I return later. For now, let us return to Menger and his analysis of the origin of money.

The Evolution of Money

Menger (1963: 146) analyzed the development of money in the larger context of the evolution of institutions. He asks what he describes as “the most noteworthy” problem of the social sciences: *“How can it be that institutions which serve the common welfare and are extremely significant for its development come into being without a* common will *directed toward establishing them?”* He employs invisible hand reasoning not just to endogenous variables, such as prices, wages, and interest rates, but also to institutions.

Menger (1963: 158-59) argued that institutions develop not as the result of human design (“not the result of socially teleological causes”), but as the outcomes of individual human actions (“the unintended result of innumerable efforts of economic subjects pursuing *individual* interests”). Among modern Austrians, Hayek most consistently followed Menger to explain undesigned social institutions (O’Driscoll 1986: 606).

Into this framework, Menger fit his theory of money as the product of evolution.

> As *each* economizing individual becomes increasingly more aware of his economic interest, he is led by this *interest, without any agreement, without legislative compulsion, and even without regard to the public interest*, to give his commodities in exchange for other, more saleable,

> commodities, even if he does not need them for any immediate consumption purpose. With economic progress, therefore, we can everywhere observe the phenomenon of a certain number of goods, especially those that are most easily saleable at a given time and place, becoming, under the powerful influence of *custom*, acceptable to everyone in trade, and thus capable of being given in exchange for any other commodity. These goods were called *Geld* by our ancestors, a term derived from *gelten* which means to compensate or pay. Hence the term *Geld* in our language designates the means of payment as such.

This single paragraph is packed with theoretical issues. "More saleable" commodities are those with smaller bid-asked spreads, which are, hence, more liquid. Before taking up the "Theory of Money," Menger had developed "The Theory of the Commodity," an analysis of the holding of stocks of goods for sale. The willingness to do so depended on the progress from economic self-sufficiency, to production for the market on order, to production for the market on speculation (O'Driscoll 1986: 608-09).

Menger outlined an historical process by reasoning through the consequence of the pursuit of individual interests. Historically, silver and gold have generally been the goods that became the "means of payment" (with many variations along the way). Gold and silver are valuable and highly marketable. He solved a theoretical problem that has eluded even modern theorists, the simultaneous determination of the money good and its market value. In Menger's analysis, what became money was always a good with prior market value. Its use as money enhanced the demand for it and increased its value in a gradual process over time (O'Driscoll 1986: 609-10).

German philosopher Georg Simmel, influenced by Menger's analysis, also analyzed money as the outcome of voluntary exchange. In *Two Philosophies of Money: The Conflict Between Trust and Authority*, Herbert Frankel analyzed and elaborated upon

Simmel's contributions. In Frankel's (1977: 12) words, "money is not a consciously created artifact, but grows out of, reflects, and in turn affects the ever-changing relationships between individuals and the society which they compose." That view, which also captures the essence of Menger, contrasts with the State Theory of Money, first articulated by Georg Friedrich Knapp and adopted by John Maynard Keynes. In its simplest form, it rejects any market (or "catallactic") analysis of money in favor of a command theory. The state determines what will serve as money. The state's power is often ascribed to its ability to determine what is legal tender for obligations owed it (Mises 1971: 73 and 463-69).

Frankel (1977: 43) quoted Keynes (from the *Treatise on Money*) on point: "…the Age of State Money was reached when the State claimed the right to declare what thing should answer as money to the current money-of-account – *when it claimed the right not only to enforce the dictionary but also to write the dictionary.* To-day all civilized money is, beyond the possibility of dispute, chartalist" [italics added by Frankel].

Frankel (1977: 43) has sport with Keynes over the idea of the State being able to write a dictionary and enforce its usage on the public. "Nobody has ever been able to force a single word on to society which the individuals composing did not wish to use." Money and language each evolve spontaneously. The State has been most influential over money when it places its stamp of approval on a commodity or money already chosen by economic transactors. Silver coinage is an ancient example and dollarization is a modern one.

There is no question, of course, that modern States now exercise a degree of control over money exceeding that in almost any other area of developed economies.

And the Chartalist Theory of Money under-girds most modern monetary theory. The question for the remainder of this paper is whether the modern theory and practice of money produces a monetary order that is consistent with a free society.

A Free Monetary Order

The money good evolves and with it a monetary system. The monetary system is an undersigned social order. That order is originally evolved and has been described by Hayek (1973: 36) as *"a state of affairs in which a multiplicity of elements of various kinds are so related to each other that we may learn from our acquaintance with some spatial or temporal part of the whole to form correct expectations concerning the rest, or at least expectations which have a good chance of proving correct."*

O'Driscoll and Rizzo (1996: 86) present the idea of "pattern coordination," in which "there is coordination of plans but not actual activities." Two co-authors agree to meet each week to discuss a book project. They are coordinated, but there is an inherent unpredictability of what exactly will transpire. It is inherently impossible to predict the exact contents of the discussion in advance. The meeting is predictable, but not its contents. There is coordination and order, but not equilibrium.

Menger points us in the direction of a free monetary order: it is the product of money freely chosen. Frankel (1977: 4) tells us that such an order "implies the possibility for individuals of choosing between a multiplicity of conflicting goals or ends." It is an abstract order in that it is not oriented to the achievement of specific goals, but the maximal possibility of achieving individual goals. Michael Polanyi (1951: 159) and Hayek (1960: 160) have referred to it as a "spontaneous order." Hayek quotes Polanyi: "The actions of such individuals are said to be free, for they are not determined by any *specific* command, whether of superior or public authority; the compulsion to which they are subject is impersonal and general." That notion of "compulsion" comports with the concept of law in the natural law tradition.

Frankel (1977: 4) goes on to describe the free monetary order as having "principles, enforced by custom, convention and law, which ensure that its operation will not be arbitrarily, capriciously, or lightly altered in favour of particular groups, individuals , or interests." Quoting A.I. Melden (1959: 13), Frankel (1977: 4) says that a free monetary order implies "the maintenance of the moral structure of the relations between all of the parties concerned." Following Simmel, Frankel is making an essentially moral case for a free monetary order.

The order "implies that contracts freely made in money do, as such, carry society's guarantee that the measuring-rod of money in terms of which they are made will not be deliberately tampered with by anyone, *not even by the Government itself*" (Frankel 1977: 40). That guarantee is an essential part of the rule of law.

Frankel (1977: 39) contrasts a free monetary order with a system of monetary discretion in which "money increasingly becomes an *instrument* of sectional political or economic action." Frankel attributes monetary discretion to the rise of the State Theory of Money under the spread of Keynesian economics. That is perhaps too facile an interpretation of how the change in the philosophy of money came about. Knapp had no catallactic theory of the demand for money. Despite endorsing Knapp's approach, Keynes had a demand for money derived from market behavior (a distinction ably drawn by Roger Garrison in comments on this paper).

But the sharp contrast between the classical liberal view of money and the modern or contemporary view is accurately drawn. As Frankel (1977: 33) observes:

> Thus for Simmel and for Menger, as also for most liberal economists of the nineteenth century, the monetary order was not something to be left to the whim of the Government or the State. Indeed, Menger pointed out that Governments had so often and so greatly misused their power that it was forgotten that a coin is nothing but a piece of metal the fitness and full weight of which was guaranteed by the mint. The fact that Governments had treated money as if it were merely the product of the convenience of men, and particularly of their legislatures, simply multiplied errors about its nature.

The issue Frankel raises here, in the name of classical liberalism, was analyzed within the natural law tradition. Can the state "declare what things should be used as money," and legitimately alter its value to suit the state's needs? It was addressed most directly by one of the late Jesuit Spanish Scholastics.

Can the King Debase Money?

But for later works of great controversy**,** Juan de Mariana, S.J. (1536-1624) would have been most known for his history of Spain, which was published in a new edition as late as 1854. His *De Rege et Regis Institutione,* published in 1599 was intended for the education of future kings. Despite defending tyrannicide, the book was not proscribed by either the civil or religious authorities. It was the subject of great controversy, though more in France than Spain. His 1609 work, *De Monetae Mutatione*, eventually led to his imprisonment and seizure of all of his papers (Lehmkuhl 1910).

In his monetary essay, Mariana proceeded in Scholastic style. In the "Argument," he set out the facts: "the treasury was completely exhausted by long and drawn-out wars in many places and by many other problems…." In other words, the king needed additional revenue. How could it lawfully be obtained? Mariana next asks "Does the King Own His Subjects' Goods?" Citing Aristotle, the treatise, *Novellas Constitutiones*, and the Old Testament, he answers no.

He then poses the next question, "Can the King Demand Tribute from His Subjects Without Their Consent?" He concludes that "the established principle" is that "the prince is never permitted to oppress his subjects with new burdens, without the consent of those concerned, at least of the leaders of the people and State." He even cited a chapter from a Papal Bull, *In Coena Domini*, excommunicating those who impose new taxes.

Mariana's strong conclusion may seem at odds with our notion of royal absolutism. But there had been a period of parliamentary ascendancy in Spain. Pipes (1999: 152-53) recounts that "by the fourteenth century, the *cortes* of Castile, Aragon, Catalonia, and Valencia won the right to approve all extraordinary taxes as well as to participate in the drafting and implementation of laws." He then repeats the Aragon oath of allegiance to the king: "We who are as good as you swear to you who are no better than we, to accept you as our king and sovereign lord, provided you observe all our liberties and laws; but if not,

not." Parliamentary powers had been eroded by Mariana's time, but had left a powerful intellectual legacy.

Perhaps Juan de Mariana had a "vehement character" that led him to take strong positions (Lehmkuhl 1910). But his reasoning was the culmination of a long line of inquiry on political and economic issues beginning with Aquinas and continuing down through his Scholastic successors (Schumpeter 1954:73-122 and Rothbard 1976). Mariana reminded the reader that "here we are not discussing what is happening, but, rather, what right reason demands." That is classical natural law reasoning.

The king cannot tax without consent. Nor can he engage in subterfuge. He cannot "fraudulently establish a monopoly without consent of the people." For a monopoly accomplishes precisely what taxation does by taking revenue from citizens without their consent. Mariana folds in political economy with his moral reasoning.

Finally he arrives at his central question: "Can the King Debase Money by Changing It Weight or Quality Without Consulting His People?"

> One concludes, therefore, that if the king is the director – not the master – of the private possessions of his subjects, he will not be able to take away arbitrarily any part of their possessions for this or any other reason or any ploy. Such seizure occurs whenever money is debased: For what is declared to be more is worth less. But if a prince is not empowered to levy taxes on unwilling subjects and cannot set up monopolies for merchandise, he is not empowered to make fresh profit from debased money. The strategies aim at the same thing: cleaning out the pockets of the people and piling up money in the provincial treasury. Do not be taken in by the smoke and mirrors by which metal is given a greater value than it has by nature and in common opinion. Of course, this does not happen without common injury.

Mariana employed a political-economic argument to buttress a moral case against debasement and inflation. The positive and normative analysis is conceptually separate, but practically intertwined.

Our historical excursion brings us full circle back to Menger's concern that governments had so abused their power that it had long been forgotten that government, by its stamp on coins, was guaranteeing the fineness and full weight of the coin. That captures Simmel's sense of money being built on trust. When that trust is violated, it disturbs all the economic and social relationships established on that trust.

We have abandoned any concept of trust in money, or perhaps in government guarantees whatsoever. In such a world, there is no morality in money. That is the consequence of passing from the world of evolved money, money built on trust, to one in which money is an artifact to be manipulated by the prince, or his agents, to suit his purposes. As in the passage quoted above, "money increasingly becomes an *instrument* of sectional political or economic action" (Frankel 1977: 39).

Keynes understood that entering "the Age of Chartalist or State Money" entailed abandoning morality in money. Citing Keynes (1949: 97), Hayek (1973: 26) quotes him: "So far as I am concerned, it is too late to change. I remain, and always will remain, an immoralist."

Money Today

We have moved far from the world of Menger, much less Mariana. Monetary policy is viewed as the province of technocrats and central bankers. The monetary order is no longer abstract, permitting individuals to coordinate their activities within it. Money is now consciously controlled by government in pursuit of specific policies and identifiable interests. Only after a longer period of monetary abuse do investigators go back to basics. Hayek once said that historically the best monetary theory has been the product of the worst monetary practice.

It is paradoxical, to say the least, that economists almost casually concede dominion over money to the State. In modern times, a few classical liberal economists have felt the need to question why government should be involved with money.

Friedman (1960: 4) asked “whether monetary and banking arrangements could be left to the market, subject only to the general rules applying to all other economic activity.” He first points out “that monetary arrangements have seldom been left entirely to the market, even in societies following a thoroughly liberal policy in other respects…” Friedman reasons that it is inevitable that paper money will come to displace a pure commodity standard. Competition cannot be relied upon to limit the supply of paper money. That justifies government intervention (Friedman 1960:4-9).

Friedman and Schwartz (1986) revisited government's monetary role and reconsidered the case for gold and free banking. In a later assessment, however, Friedman (2006) seemed to favor a monetary rule and central banking. Hayek (1960) accepted the state's involvement, though Hayek (1976) questioned it.

Others, including White (1984 and 1989), challenged Friedman's reasoning. But Friedman's 1960 view generally holds sway among even free-market economists. In later years, Friedman did come to question government's role in education. That is another area that even classical liberals have largely ceded to the State.

Ask the average economist about the effects of fixing the price of bread, establishing minimum wages, or imposing usury laws, and you will get analysis of shortages and surpluses in the affected markets. Ask about the desirability of government establishing a monopoly on food distribution or producing automobiles, and you will get a lecture on incentives and the role of free prices and profits in allocating resources.

If you ask most economists today why governments should control money, you will be looked at as if you were daft. Yet money is the most significant good in a market economy. It is one side of every trade. To control money is to influence *every* price.

And it is not just the price of goods and services, but, through its influence on interest rates, monetary policy inevitable affects the allocation of capital. "The interest rate" is shorthand for a complex array of intertemporal prices that guide the allocation capital and production across time (O'Driscoll 1977). The temporal allocation of capital is a vital function in a market economy. Mises (1935) argued that command economies cannot rationally allocate capital, which he correctly predicted would be the reason for their failure.

Ceding money to the state does not just abandon the monetary order, but disorders the market economy. A disordered monetary (and banking) system has been the source of great disorder in the broader economy. Monetary excess has historically sown episodes of booms and busts, including the current one (Leijonhufvud 2007 and 2009; O'Driscoll 2009; Taylor 2009).

Many monetary theorists have placed their hope for sound money in the independence of central banks. But central banks were never independent *of* government. Their "independence" was operational. Government set the goals of monetary policy. In the European Union and elsewhere, the central bank was given the mandate to control inflation. In the United States, the Fed has the dual mandate of maintaining full employment and controlling inflation.

The Federal Reserve System was designed as a bankers' bank, and the 12 regional reserve banks are legally owned by their commercial bank members. The employees of the reserve banks are not U.S. officials. The Fed has consequently retained a certain legal independence, which has helped preserve its operational independence.

In the current economic crisis, however, the Fed has increasingly coordinated its actions with the Treasury. Its special lending programs involve credit allocation and constitute a form of fiscal policy. Independent central banks are not supposed to engage in fiscal policy, i.e., the allocation of resources for specific purposes and to aid specific groups. Schwartz and Todd (2008: 171) argue that the Fed is on a “slippery slope” that will politicize monetary policy.

The Fed perhaps still possesses nominal operational independence. But it is independence in name only. So the government today has further extended its domain over money.

Money Tomorrow

Mises accepted natural law reasoning for positive economics, but rejected it for normative reasoning. In the context of economics, that is a very fine distinction. As he himself observed, man must accept certain regularities “if he wants to succeed.”

This essay has not focused on the technicalities of monetary policy, but on whether there is a law of monetary development, and presented an affirmative case for it. And it has examined whether there is a morality of money. It presented a case for the presence of morality in a free monetary order built on trust. In that, the essay follows the approach of James (2008) on globalization. The present essay has further suggested an absence of trust and morality in the current monetary system.

Some economists believed they had discovered a new period of economic stability and “Great Moderation” in the volatility of housing and the broader economy beginning in the 1980s (Taylor 2009: 2). Instead, we have reaped a whirlwind of volatility and economic decline. In the United States, the economic disorder has not spilled over into political and social disorder. But in other countries, even Western European countries, it has done so. As this is written, there have been major marches, demonstrations, hostage takings, and even riots in Greece, Britain, France, Ireland and Iceland. All are partly the fault of failed monetary policy and flawed monetary institutions.

O'Driscoll (2009) argues that it is time for fundamental monetary reform and the restoration of monetary order. Whether and how that would come about is unpredictable. It cannot be surprising, however, that an untrustworthy monetary system should produce economic, political and social disorder.

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