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Ethics and Monetary Theory: Is There a Common Middle Ground?

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Abstract
The current bust has brought a boom to at least one area: the subject of business ethics. While ethics in the general business realm is hotly debated, the monetary sphere is woefully neglected. Jörg Guido Hülsmann's (2009) *The Ethics of Money Production* has revived interest in applying an ethical foundation to monetary theory – specifically, bouts of inflation. Given that Central Banks – those institutions entrusted with the control and issuance of a country's currency – regularly "earn" profits far in excess of what conventional deposit banks report, an ethical assessment is in order. Pushing economics back to its original position as a "moral science" is a welcome move. Monetary economics may be the area most in need of this shift, and will yield the greatest advancements when it is finally achieved.

0. *Introduction*

The recent financial bust has brought a boom to at least on area – the subject of business ethics. Yet, while much literature focuses on the individuals at corporations that have been primarily responsible for reaping such financial ruin, little attention has been paid to focusing on the more strictly monetary factors at play. Jörg Guido Hülsmann's *The Ethics of Money Production* provides one such attempt at melding the fields of monetary economics with ethics to create an in depth look at whether the monetary practices that were central to the recent boom-bust episode have deeper philosophical implications in light of ethical considerations.

Hülsmann's ambitious project delves into the production of money from three main viewpoints. The first concerns the origin of money, and assesses from an economic point of view how this omnipresent, yet oft-misunderstood, element originally arises. From this theoretical foundation, he provides a look at the implications of inflationary monetary policies, critically assessing two aspects. The first are the economic implications from expansions in the money supply, which Hülsmann argues can breed extremely detrimental effects. Second are the ethical implications of changes in the quantity of this element. Redistribution effects are outlined, with changes in the relative positions of each involved individual thoroughly examined. Lastly, Hülsmann provides an historical analysis of three monetary regimes – the post Franco-German War banking cartel of the late 1800s, the distinct gold standard regimes until 1971, and the post-Bretton Woods regimes after 1971 – in light of the economic and ethical analysis previously established.

In many ways, Hülsmann's book is a continuation of his predecessors, notably the14th century philosopher Nicholas Oresme, and more recently, economists Murray Rothbard and Jesús Huerta de Soto.[1] Hülsmann surpasses these authors by delving deeper into not only the ethics surrounding the production of money, but the results that such practices will breed. In fact, the interested reader will find these points, mainly contained in part II, as the most novel and notable contributions of the book.

Hülsmann provides the most comprehensive analysis of the ethical implications concerning the production of money in print today. CEOs, boardmembers, and investors have all come under fire lately for their questionable usage of loans, compensation, stock options and other financial products during the recent boom. It is time we turned our attention to the root cause of the problem, and critically assess the ethics of money production. Few works successfully manage to integrate both economic and ethical considerations into a coherent whole. While this omission remains unnoticed among many in the economic community, ethicists are well aware of this missing link.[2] Hülsmann's *The Ethics of Money Production* will go far in rectifying this neglect from the former group.

1. *Money and Its Production*

The book's first part concerns itself with the origin and evolution of

1 See Oresme (1956), Rothbard (1983; 1994) and Huerta de Soto (2009).

2 One recent example may be found in Moriarty (2009) who notes that the discussion on executive compensation seems focused primarily on economic aspects, at the neglect of ethical considerations.

money. By combining two well-known economic principles – David Ricardo's law of comparative advantage and Friedrich Hayek's work on spontaneous orders – Hülsmann is able to show money's origin as a social institution. In the first case, it is owing to the fact that individuals in isolation produce less physical goods and services than through coordinated efforts that leads Ricardo's insights to evolve into a medium of exchange that facilitates trade between different actors. Secondly, Hayek's evolutionary orders are implicitly used to demonstrate the tendency towards a perfection of established money over time through the inherent competitive forces of individuals working within the aforementioned social cooperation. The result is what Hülsmann defines as "natural money" – that which arises through the voluntary actions of individuals, and which will continue to circulate until forced out of existence by an exogenous impetus.

Deviations from this natural money result in what Hülsmann has termed "forced money." With this deviation, no longer has money evolved according to individual preferences shaped by societal norms, but an imposition occurs with welfare reducing effects. Indeed, as Hülsmann describes the process, such money must be tainted from an ethical perspective. Although still having great economic use as a facilitator in exchange, these monies must necessarily be less social beneficial than natural monies, as they owe their existence to violations of individuals' right to free-choice and association.

Using this dichotomy between natural and forced monies, Hülsmann is able to run the gamut of different monetary embodiments. Credit money – that which is issued as a claim to money in the future – is shown to be fundamentally valued according to the trust placed in an individual's declaration to repay this money in the future. Owing to the continual risk that credit will not be repaid, circulation of this type of money is shown to forever be less than that of natural money.

Paper money, in contrast with a direct commodity embodied medium of exchange, is shown to have dubious origins. In fact, owing compulsion, coercion and legal privileges, Hülsmann elucidates that we are faced with the empirical reality that paper money has never spontaneously arisen as a direct response to individuals' welfare improving preferences or needs. Legal tender laws are at this point brought into the discussion – discussing both their origin and effects. Indeed, owing Sir Thomas Gresham's famous law - "bad money drives out good" - an imposed paper money of lower quality than the previously established natural money will be driven out of circulation lacking a protective law to ensure its maintained demand. Using the specific American experience with the introduction of paper money, Hülsmann illustrates how "greenbacks" displaced the previously circulating gold and silver monies owing its legally protected status in the use of debt settlement. Similar stories have been documented dating back to at least 12^{th} century China.

Legal considerations aside, there are numerous arguments to be made in favor of the adoption of credit or paper money. Reduced storage costs, ease of use, simple transportation, and lower minting fees all serve to create significant arguments to ratify these forced monies. However, as the book's title suggests, mere economic considerations are insufficient as to which produced exchange medium should be adopted.

One significant historical failing of these imposed and legally protected monies is the incentive that has existed for profit through devaluation. Hence, lacking a competitive check, inflationary tendencies proliferated as minters found that the secured demand for their product resulted in no trade-off between product quality and price. Great increases in money production were enabled, as no adverse effect in the form of a corresponding drop in marginal value could result due to a legally established value. Under normally competitive market conditions the production of money would proceed until its marginal profit rate equalized with that prevailing in other goods and services' industries, thus imposing an important limit on the extent of money production. Legal tender laws are shown to disrupt this process, resulting in an industry with sustainable and artificially high profit rates. America's own Federal Reserve System has regularly earned almost 100% on its capital over the past decade, and in 1980 alone netted more than 500% return on capital! Similar cases are found in other economies with a legally protected monetary authority.

In addition, Hülsmann briefly outlines what are commonly referred to by economists as "Cantillon effects" after the early 18^{th} century economist of the same name. Money production must be introduced into the economy as a sequence of exchanges, with some participants gaining first access to the newly created liquidity, and others receiving it later. The production of each additional unit of money reduces the value that each previously existing piece has, thus entailing a redistribution from both money savers to borrowers, and from later receivers of the new monetary units to the initial users. Individuals who gain access to the newly created money first are able to use it on goods priced with the old quantity of money, before the inflationary effects become known and prices adjust upward in compensation. In fact, Hülsmann clearly outlines why it is that this process breeds such deep inequities (i.e., between individuals on fixed incomes, savers, etc., and those who choose to live their lives more flippantly through heavy debt exposure via borrowing). The effects that this process has bred over the past 20 years of debt accumulation are now the topic of much debate at the personal, as well as corporate, level.

This first section of the book adds much to the primary works existing which focus on the ethics of money production. A dearth of attention to this important topic has proceeded almost unnoticed since the 14^{th} century French philosopher Nicholas Oresme and his fellow Scholastics. Hülsmann has surpassed their analyses, relevant as they remain today, by questioning the ethical implications of producing money. While the earlier Scholastics limited their analysis to questions concerning specific ethical guidelines concerning newly produced money (i.e., that it must be identifiable *vis-à-vis* existing coins), Hülsmann questions the more fundamental concern – whether any additions to the money supply are ethically sound despite adhering to these guidelines established previously by the Scholastics. Much relies on his previous economic analysis, which surpasses many monetary economics textbooks in its depth and scope of its investigation into money's origin and evolution. This scrutiny allows Hülsmann to clarify the stance on money's production that has remained in force since the days of the classical economists whereby any amount of money is an optimal amount. In light of the legal and ethical considerations outlined by Hülsmann, the question of money production becomes much more complex, and is able to be categorized and assessed in much more detail than previously was the case.

2. *Inflation and ethical considerations*

Ethicists may find the book's first section a little too methodological in the sense that it contains much theoretical background not directly related to their specific field. However, the book's title, *The Ethics of Money Production*, suggests that prior to assessing the profound ethical implications of the topic, we must first learn the processes surrounding this very occurrence. With that taken care of, Hülsmann is able to center the reader's attention on deeper rooted ethical problems throughout the second section.

Money's existence *per se* does not involve an ethical element. However, the production of it is the focus of study, specifically that monetary expansion which occurs, as Hülsmann notes, through a violation of rights (p. 86). Indeed, this process breeds controversial opinions as:

> Economists are reluctant to dwell on the moral dimensions of social facts, and rightly so, because moral questions are outside their customary purview. But one does not need to be a moral philosopher to know that certain incomes are illegitimate; that they derive from a violation of the fundamental rule of society. (p. 87)

This fundamental rule of society represents, for Hülsmann, a respect for property rights. As the previously established theoretical foundation suggests, inflation diminishes the marginal value of each existing unit of money. As a result, any holder of money will see an invasion of their right to this property's value as a result of a forced decline in its value through inflationary measures.

A brief historical excursion into the past looks at the primary form of debasement of previous societies. Ancient Rome and nearly every dynasty of medieval Christendom, for instance, practiced inflation exclusively through debasement. Hence, either the content of fine metal represented by a coin was reduced, or the marking on the coin was altered so as to indicate a higher nominal metal content than was the case. Both instances result in the same outcome – a redistribution of wealth occurs which benefits the individuals who enact the debasement, while continually eroding the accumulated wealth of those who are left to the whims of these fraudulent bankers.

Later, a new form of debasement was created with even farther reaching effects owing its increased efficiency. The issuance of coins in excess of that available in the bank – fractional reserve banking – is shown to have emerged from three sources. First is the perversion of the warehousing institution, a function that banks served prior to the late 1700s. The Bank of Amsterdam, for example, served as a warehouse bank from 1609 to 1781, charging its customers to safe-keep their deposits until the need arose for them to be withdrawn. As the Bank started fractioning its reserves in the late 1700s, a "run" occurred as depositors realized that there was insufficient funds available to payout *all* deposits. Second is the perversion of credit banking. As bankers inform their customers that they are safe-keeping their money, but instead choose to use it for loans, depositors are deceived as to the true use of their savings. Last, we are shown that fractional reserve banking is a natural response to the threat of government expropriation. Hence, in times past when Kings of dubious nature ruled the world, the continual threat that a King would confiscate banks' holdings led to a tendency for banks to loan out their funds to avoid such an event.[3]

Hülsmann fails to address one important question at this juncture despite asking it, namely, which one of these three alternatives has been the most prevalent historical case. Although "leaving it to future research" may be the more reasonable answer, the reader cannot help but feel that there is a missing link providing the impetus for all of these aforementioned tendencies – a break-down in the rule of law. Indeed, although the monetary realm may be one with the most loosely defined governing laws, at times there have been strict legislations with the intended purpose of avoiding previous monetary calamities. Periodic amendments and loosenings of these laws have resulted in the above-mentioned cases, which would do well to be developed further; perhaps future editions can rectify this omission.

Hülsmann proceeds to describe the ability that individuals have to combat the unscrupulous individuals who practice debasement of the money supply. Indeed, as he eloquently states regarding the 'weapon' available to do so:

The function of counterfeiters resembles the function of the many viruses that subsist in a healthy human body. Fighting the virus keeps the body alive and strong. Similarly, the ever-present danger of counterfeiting stimulates vigilance in monetary affairs and thus helps to preserve sound money. People watch their gold and silver coins closely because they know

3 Indeed, even today a debate is alive and well between monetary theorists as to whether fractional reserve banking is fraudulent, or an outgrowth of voluntary interactions. Selgin and White (1994; 1999) have argued that fractional reserves are a healthy outgrowth of any market economy, while Huerta de Soto (2009: 675-712) and the present book have argued on legal and ethical grounds its fundamental illegitimate nature. The addition of legal and ethical considerations provides an essential missing ingredient in the debate, one often overlooked in favor of conventional pecuniary and efficiency considerations.

that counterfeiting affects them directly. They strive to learn more about distinguishing good coins from bad coins, and good banknotes from bad ones. They apply such knowledge and teach it to their families and others. And once they discover any sort of fraud, they stop using the fraudulent coins and banknotes, and switch to other certificates. (pp. 97-98)

A market of vigilant individuals stands guard, prepared to avoid using newly debased monies available in favor of money that is a more faithful representation of its stated value.[4]

This particular vigilance is inhibited by a legal privilege bestowed on monetary institutions. Legal tender laws are those that force payments to be made in a certain money against the will of at least one of the partners of exchange. Through this legal edict, debased monies enjoy a continual demand, as they are guaranteed to be required for exchange and trade to occur. This privilege – the legalization of false or debased money certificates – becomes instrumental as it provides the foundation for all other monetary privileges. As matter of illustration, it would be impossible to establish a legal tender currency based on a debased coin, if the latter was already illegal. Hence, one particularly egregious result is that the ethical case for all further monetary privileges relies on the ethical precedent of a previously legalized falsification.

Legal tender laws, no matter how ethically lacking they may be, usually entail minimal economic consequences for three reasons. First, falsifying falls into the realm of tort, punishable by law. Second, as falsifications are discovered, individuals will elect to utilize distinct money (despite legal tender forcing one to accept a falsified money). Finally, in the worst-case scenario, individuals can make payments in other commodities, and verify each transaction personally, a tedious, but by no means impossible, solution. Legal tender laws only eliminate the first defense from occurring, leaving the other two to combat widespread inflation.

A foray into an oft-neglected area of banking provides interesting fodder for debate. Historically, banking institutions have often times employed what is referred to as an "option clause" to combat bank-runs. Hence, as depositors became weary of the bank's ability to honor their withdrawal requests, typically a "run" occurs with each depositor trying to become the

[4] Hülsmann has held this line of thought for some time: "the flight from money is a great force of liberty" (2003: 57). Indeed, as we have previously noted, "in monetary matters, it may be our greatest liberty" (Howden 2008: 174).

first to redeem their money at the expense of latecomers.[5] Such runs, if based on false information concerning a bank's solvency, force it into insolvency if enough depositors simultaneously attempt to make withdrawals. In defense, banks have staved off looming bankruptcies by enacting the "option clause" which enabled them to refuse withdrawals for a set period, provided they reimburse the depositors with an interest payment during the period in question. These clauses have received scant legal or ethical attention until now, and Hülsmann is able to relate them directly to the economic *and* social function of bankruptcy, which arises from any of three reasons. First, fraudulent activity results in bankruptcy, in which case the banker is faced with criminal prosecution. Second, bankruptcies occur when firms utilize more resources than they have available. Under this second scenario, bankruptcy serves to eliminate wasteful management practices from repeating. Lastly, bankruptcies may arise from cases of temporary financial mismanagement.

It is for this last reason that the option clause originated to provide short-term reprieve to illiquid, but solvent, banking institutions. However, as is often the case in the legal and political worlds, "suspended payments" through option clauses became a euphemism. While it may sound sensible and generous, the reality is that the legal system was altered and no longer enforced banks to make the payments they promised to their creditors, while at the same time continued enforcing payments these same banks *received* from their debtors. As a result, an asymmetry of legal privileges obtains, with depositors and other bank debtors at the losing end of the discrepancy.

In what is the most novel and innovative section of Hülsmann's book, chapter 13, "The cultural and spiritual legacy of fiat inflation", introduces several important points for consideration. Inflationary monetary authorities are shown to alter individuals' habits, as well as the institutional arrangements in society which is illustrated with several examples. First, inflation as an indirect and mostly hidden tax has resulted in "hyper-centralized governments", as the central monetary authority (usually a federal government institution) becomes the recipient of these proceeds at the expense of other secondary and tertiary levels of

5 Although these are more of an historical phenomenon from the days prior to deposit insurance, the interested reader may remember back to the September 2007 when the British bank "Northern Rock" was near insolvency, and news articles were ripe with pictures of depositors waiting outside branches to withdraw their savings.

government. Second, also as a result of the hidden and only slowly apparent taxing power of inflation, societies have partaken in an increased number of wars under these monetary regimes. Hence, when governments had to finance war expenditures through direct taxation, political backlash severely limited the ability to allocate appropriate funds. With the creation of an inflationary monetary authority, governments are able to inflate their monetary needs when needed, and only indirectly tax their citizens, to fund wartime activities. Third, inflation is shown to alter business owners' propensity to finance growth through equity, by adopting the cheaper debt option. One significant point that will surely raise much discussion is Hülsmann's position that an entrepreneur who has financed, for example, a firm through 90% debt is no longer an entrepreneur, but a paid employee of the lending institution, which will now make all essential decisions to maximize their likelihood of repayment. Lastly, Hülsmann looks at socioeconomic considerations, especially those that pertain to "youths" of the inflation-generation. Inflation is demonstrated to breed a mindset sympathetic towards instant gratification, scorning those who plan for the future with long-term investment horizons. This is a direct result of inflation's reduction in long-term *real* capital values, as well as the added element of uncertainty as to what the future value of a present good will be.

Whether one agrees with Hülsmann on these cultural shifts driven by inflation will be sure to entice much debate. This reviewer, for one, thinks the cultural ills are overstated despite agreeing with the general economic/legal/ethical implications raised. However, in a field that has seen little spirited debate in hundreds of years, any dose of controversy would be a welcome addition to bring much needed attention to a neglected area – the ethics of money production.

3. *Concluding Remarks*

Philosophers of the ancient world took a generally negative outlook toward labor, commerce and money. As a result, money and its institutions were the topic of much scorn until the medieval Scholastics applied a more favorable perspective towards commerce, which resulted in the fertile growth of economic science deeply rooted in ethical considerations. Unfortunately, economists of today have regressed from this position, preferring to ignore ethical implications in light of alternative criteria. This is an unfortunate deterioration as it is only a relatively recent occurrence. Indeed, many classical economists from the time of Adam Smith have considered economics to be a "moral science." Despite this distinction, few have successfully filled this gap between ethics and economics. Jörg Guido Hülsmann's *The Ethics of Money Production* is a welcome addition to what is becoming a growing field of economists trying to do so.

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