William Graham Sumner: Monetary Theorist

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The pioneering sociologist William Graham Sumner (1840–1910) was a prolific and astute historian of the early American republic, whose work was informed by his classical liberalism and his understanding of economics. He authored seven major works including biographies and thematic studies concentrating on the vital subjects of currency, banking, business cycles, foreign trade, protectionism, and politics. Although his works are out of print, and hardly mentioned or referred to by historians or economists, they are quite valuable for understanding the politics and major economic issues of the first century of the republic.[1] They are: *History of American Currency* (1874), *Lectures on the History of Protection* (1877), *Andrew Jackson* (1882), *Alexander Hamilton* (1890), *The Financier and Finances of the American Revolution*, 2 vols. (1891), *Robert Morris* (1892), *History of Banking in the United States* (1896). As one can see, Sumner was most interested in the history of money and banking in America. He was a resolute opponent of inflation, inconvertible currencies, legal tender laws, bimetallic standards, and the American practice of fractional-reserve banking. His theory of the business cycle was built on the work of antebellum political economists such as Condy Raguet. Sumner's understanding of it is sophisticated and proto-Austrian.

Sumner's Epistemology

Sumner's historical work laid the basis for his understanding of economics, politics, and sociology. Unlike Mises and Rothbard who believed economic

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[1]One of the few studies of Sumner's economic thought is Dominick Armentano's 1966 doctoral dissertation, "The Political Economy of William Graham Sumner: A Study in the History of Free Enterprise Ideas." However, he devotes only 11 pages to Sumner's money and banking views, and his discussion of Sumner's understanding of the business cycle is quite superficial.

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law could be deduced from the study of human nature and reality through the praxeological method (i.e., building theory on a few self-evident axioms), Sumner believed that economics, politics, and sociology could be deduced from the systematic study of history. While Sumner was studying at the University of Göttingen in Germany, he discussed with his friends "whether there could be a science of society, and, if so, where it should begin, and how it should be built" (Sumner 1934, p. 8). They came to the conclusion that "social science must be an induction from history, that Buckle had started on the right track and that the thing to do was to study history" (Sumner 1934, p. 8). In his lectures on the history of protectionism, he insisted, "It is to history that we must look for the facts which teach us social and economic law" (Sumner 1888, p. 62). However, he would have agreed with Rothbard that these laws are immutable and not subject to modification due to changing historical circumstances. "We are living here under immutable and inexorable laws of the social organization. We cannot cheat those laws nor evade them. If we try to escape their operation in one point, they avenge themselves in another." He explicitly rejected "the ignorant empiricism in legislation" (p. 62) that characterized all efforts to regulate or promote the economy. However, Sumner insisted that the scientific method still applied to economics. Economic and social laws should be continually tested in the light of new historical knowledge and experience to make certain that the laws were correctly deduced and understood. "Practice is the test of theory, and shows that the general principles have been either correctly or incorrectly apprehended" (Sumner 1888, p. 37). He had "no confidence in any results which are not won by scientific method and I leave aside all traditional and dogmatic systems as scarcely worth noticing" (Sumner 1914, pp. 400–01). He rejected all *a priori* systems of thought.

> We ought never to accept notions of any kind; we ought to pursue all propositions until we find out their connection with reality. That is the fashion of thinking which we call scientific in the deepest and broadest sense of the word. It is, of course, applicable over the whole field of human interests. (Sumner 1992, p. 336)

Sumner made similar statements throughout his historical and economic works. In the conclusion to his history of American currency, he contended that "the currency question is of the first importance" (Sumner 1968, p. 226) and "the best way" to study it was "not by wrangling about speculative opinions as to untried schemes, but to go back to history, and try to get hold of some firmly established principles, from which we can proceed with some confidence and a certain unanimity" (Sumner 1968, pp. 226–27). However, he denied that the "circumstances" of any country were so distinct that "inferences from the history" (Sumner 1968, p. 225) of its currency and banking arrangements would not be of great value to others.

Sumner was neither an empiricist, who believes economic laws are in a continual flux and subject to varying circumstances, the introduction of new

production techniques, and changes in the policies or conditions of other nations, nor an historicist, who believes that economic principles must vary from country to country based on their different conditions and cultures. He treated economic law as immutable and invariable, equally valid in all countries, at all times, regardless of varying levels of economic development, prosperity, or deprivation. He insisted that economics was a science. While many mistakenly thought economics is a "domain of arbitrary and artificial action," its "laws" subject to "chance," "exceptions," and "control," "economic forces [are] simply parallel to physical forces, arising just as spontaneously and naturally, following a sequence of cause and effect just as inevitably as physical forces" (Sumner 1919, p. 187). He conceded that there were "peculiar difficulties to contend with, inasmuch as we cannot constitute experiments, and it is necessary to rely largely upon historical cases which present now one and now another force or set of forces in peculiar prominence" (pp. 187–88). Nevertheless, with these limitations in mind it was still possible to study "the force of legislation . . . just as we would . . . study friction in mechanics" (p. 188). Knowledge of economic laws does not equip men to control, shape, or "grow" the economy. They "only declare relations of cause and effect which will follow, if set in motion. . . . They simply instruct men as to the laws of this world in which we live that they may know what to expect if they take one course or another" (p. 189). Thus, although Sumner's theoretical starting point is inductive, he proceeds throughout his work to apply economic law in a deductive Rothbardian manner, and while he would have rejected the science of praxeology as a form of illegitimate *a priori* reasoning, he accepted as true most of the same economic laws as the Austrian School.

Intellectual Influences upon Sumner

As a young teen, Sumner devoured Harriet Martineau's (1802–1876) *Illustrations of Political Economy* (9 vols.), which was a popularization of the doctrines of Smith, Malthus, Ricardo, and Mill. He later claimed that these readings formed the foundation of his economic thinking (Sumner 1934, p. 9). His historical writings reveal another source for his ideas, particularly those on currency and trade. Sumner had read the American political economists from the early republic who wrote extensively on currency and banking from a hard-money perspective, especially Condy Raguet (1784–1842) and William M. Gouge (1796–1863). Sumner's *History of American Currency* has numerous quotations and references to Raguet's *Treatise on Currency and Banking*, his two Pennsylvania senate reports on money and banking, and Gouge's *History of Paper Money and Banking in the United States* (Raguet 1839, 1820, 1821; Gouge 1833). He praised Gouge as "[t]he best financial writer in the country at that time" (Sumner 1919, p. 392), and Raguet for producing "some of the best writing on financial and economic topics ever produced on this side of the water" (Sumner 1888, p. 49). Sumner's banking history is full of references to them. He also refers to, or quotes from, the hard-money writings

of Samuel Cox (1838) of Philadelphia, the New York banker Albert Gallatin (1841), and the Boston merchant and free trader Henry Lee (1844).

Sumner had also studied the history of banking and currency in England, Scotland, and Austria. He wrote essays on the Bank of England's 20 year suspension of specie payments (1797–1821) and on the history of paper money in Austria (both of which were appended to his history of American currency); he analyzed and reprinted the famous *Report* (1810) of the bullion committee of the English Parliament; and he studied the mid-century debate between the English currency and banking schools. Although he was familiar with the teachings of the French Physiocrats (e.g., Francis Quesnay) and their classical-liberal fellow-travelers (A.R.J. Turgot, Dupont de Nemours, and Jean Baptiste Say), it is unclear how closely he had studied them, for his references to them are few. It seems that he had read them, but in keeping with his historical method of economic analysis he relied upon American and British historians and contemporary writers to explain monetary phenomenon in those countries. Sumner was the product of an indigenous American hard-money tradition. His reliance upon the Anglo-American economic tradition may be one reason he never categorically repudiated fractional-reserve banking, only the American practice of it.

On the Definition of Money

Sumner defined *money* as a medium of exchange, a standard of market value, a measure of account, and a universally marketable commodity. Sumner regarded it as no accident that civilized and commercial nations over the centuries had chosen gold and silver as their money. These two metals had inherent properties that rendered them ideal as a medium of exchange and store of value. They could only be obtained through labor, commercial exchange, and mining. This meant that in the absence of large discoveries, their quantity would increase but slowly. Of all forms of money, they were the least subject to manipulation and inflation by government. He used the term *credit money* to refer to an instrument of exchange that constituted a claim on some person or institution for payment in *real money* (i.e., gold or silver). Forms of credit money included promissory notes, bills of exchange, federal treasury notes, convertible bank notes, and bank checks. He stressed that it was "a most mischievous mistake" to include these "various paper instruments" of exchange "in the definition of money. That introduces confusion at the first step and leads to fallacies at every step of deduction. The paper instruments abbreviate the processes and avoid the need of money" (Sumner 1971, p. 28), but they do not take its place. Sumner considered *fiat currency* to be a currency that was neither representative nor redeemable in precious coin and whose exchange value was largely determined by its quantity. In the American experience, forms of fiat currency included colonial and state bills of credit, the Continental dollar, and the Civil War Greenback. As state bank notes during the first half of the nineteenth century were not always redeemable on demand,

Sumner recognized that they sometimes had the character of a fiat currency. A hard currency was a paper currency immediately and actually redeemable in precious coin on demand.

On the Perpetual "Shortage" of Money

Sumner believed that the British-American colonists never freed themselves from a serious error as to the nature and function of money. The evidence was their recurring complaint that there was not enough money for the purposes of trade and economic development. The colonists complained of this incessantly. For two centuries now, historians have repeated the error, explaining to their students and readers that the lack of currency and banks among the colonists was a serious impediment to the progress of business, trade, agriculture, commerce, and manufacturing. Of course, as Sumner repeated over and over in his writings and lectures, what the colonists suffered from was a shortage of *capital*, not money, and this shortage was the natural situation of colonists clinging to the edges of an undeveloped continent, rich in resources but poor in the means by which these riches could be extracted, grown, and brought to market. When the colonists obtained precious coin through trade, they spent it on capital and consumer goods from abroad, leaving nothing for their domestic exchanges, relying on barter and credit currency to supply a circulating medium.

> The colonists began, soon after the settlement of Massachusetts Bay, to use a barter currency, ostensibly because they had not money enough: really because they wanted to spare the world's currency to purchase real capital, which was their true need. The currency history of this country has been nothing but a repetition of this down to the present hour. It has always been claimed that a new country must be drained of the precious metals, or that it could not afford so expensive a medium. The new country really needs capital in all forms. The only question is, whether, being poor and unable to get all that it wants, it can better afford to do without foreign commodities or without specie currency. No sound economist can hesitate how to decide this question. The losses occasioned by a bad currency far exceed the gains from imported commodities. The history of the United States from the landing of Winthrop to to-day [1874] is reiterated proof of it. (Sumner 1968, pp. 5–6)

When the colonists passed legal tender laws to remedy the deficiencies inherent in their barter currencies, they only hastened the departure of their specie. After such laws were passed, "[N]o one would pay debts in specie. It was hoarded and paid away in imports. . . . The more barter currency was used 'because money was scarce,' the scarcer money became. Prices rose to fit the worst form of payment which the seller might expect" (Sumner 1968, pp. 7–8). For example, about 1640, John Winthrop, the governor of Massachusetts, blamed the merchants for draining away the people's cash by enticing them with luxury goods. Sumner commented, "That he should not have

understood the case is not strange, but that people nowadays should not have learned from the experience of two centuries and a half, and the teachings of science, any better than to repeat the same theory, is astonishing" (p. 8). The "theory" to which he referred was the idea, dominant in the high-tariff decade of the 1870s, that foreign trade "drained" the importing country of its money and enriched the exporting country *at the expense* of the importing one.

The colonists next turned to fiat money to remedy the alleged scarcity of currency. Here they made a second conceptual error that would haunt and eventually capture the minds of their descendants. It was that money derived its essential nature by ascription, custom, or government backing rather than by any inherent quality it possessed. Many believed that there was no essential difference between various kinds of fiat money or credit money, on the one hand, and real money or commodity money, on the other. In 1690, Massachusetts was the first colony to experiment with paper money. It issued 7,000 pounds of bills of credit to pay its soldiers. These bills were paper notes denominated in money and receivable in taxes. (For the next hundred years, Massachusetts and other colonies would issue bills of credit, either by disbursing them to its creditors or lending them out on the security of land. They were often made legal tender, and they formed the principal circulating medium in the colonies in the eighteenth century.) A few months after its initial emission, Massachusetts authorities issued an additional 40,000 pounds of bills, and a year later (1692) they made them legal tender in the payment of all debts. These emissions and supporting laws had four effects: the bills depreciated, domestic prices increased, hard money disappeared from circulation, and complaints arose about a lack of currency (Rothbard 2002, pp. 51–52).

In 1715, with tens of thousands of bills already in circulation, the Massachusetts' assembly issued 100,000 pounds of bills (to be lent on the security of land and receivable for taxes). Their object was to revive the low state of trade and cure the scarcity of money. The issue seems to have stimulated a business cycle, for five years later prices had fallen, business was stagnant, and the legislature was urged to issue 50,000 pounds of bills to finance the construction of a bridge over the Charles River so as to employ workmen, enlarge the currency, and spur trade.

> Let it be observed how this complaint is heard again every four or five years, although the amount of paper was continually increasing. It is the best instance in history of the way in which a country "grows up" to any amount of currency. Here was a sparse population in a new country with untouched resources, and it seemed to them necessary to have recourse to artificial issues of currency to "make business brisk;" to get up enterprises for the sake of "making work;" and to lay bounties on products in order to enable the people to carry on production. (Sumner 1968, p. 23)

This sequence of events was repeated with depressing regularity in the New England colonies.

> We have seen in the history of Massachusetts colony that each new issue was followed in a few years by a new crisis, and an outcry about hard times and scarce money. The law which governs this, is apparent. The rise of prices and multiplication of credit operations will go on to absorb any amount of currency whatever. (Sumner 1968, pp. 219–20)

His discussion of the antecedents of the commercial crisis of 1837 made an additional point. By creating uncertainty as to the future purchasing power of the currency, inflation could drive up interest rates. "In the six months before the [general bank] suspension of 1837, although the amount of the currency was greater than it had ever been before in the United States, yet the scarcity of money was so great that it commanded from one to three per cent per month" (Sumner 1971, p. 265). Here was further proof that "there never can be a scarcity of currency except when there is too much of it" (Sumner 1970a, p. 188).

Sumner believed that the colonial experience demonstrated the validity of certain laws governing money. One was Gresham's law. Hard money would not circulate alongside paper currency of the same denomination, *regardless of whether the latter was legal tender nor not*. Another was the quantity theory of money. "The whole story," he wrote in conclusion to his history of American currency, "goes to show that the value of a paper currency depends on its *amount*" (Sumner 1968, p. 221). Sumner recognized that the law of excess currency did not operate mechanically, uniformly, or proportionately upon prices. Other factors could mitigate the effect of rising prices such as improvements in machinery and transportation or the exportability of the currency.[2] A third law was that there could never be a shortage of hard currency, for it was "the law that every community will have so much of the precious metals as it needs for its exchanges" (p. 1). He assured his readers, "If we had a currency of specie value, we should get just as much as we need" (p. 222). The question recurs. If Sumner understood this principle, then why did he insist that some *safe* form of fractional-reserve banking was useful and beneficial?

Fractional-Reserve Banking: Theory and Practice

Sumner thought banks served two important functions in a modern economy. They collected the surplus capital of the community and rendered it productive by lending it to entrepreneurs who used it to generate additional capital. He was aware that even without banks, much of this private capital would be

[2]"In general the history of this country shows that the doctrine that prices will respond promptly and proportionately to changes in the amount of the currency . . . cannot be accepted without important limitations" (Sumner 1971, p. 138); and, "An inflation or contraction of the currency does not have that prompt and direct effect upon prices and enterprise which they are popularly supposed to have" (p. 259).

lent out, but banks "enabled a more effective organization of capital, by which small and scattered amounts are so concentrated as to be made effective instead of being idle" (Sumner 1971, p. 22). Second, they economized the "investment" of specie by largely obviating the use of it, especially in large quantities. Checks and notes rendered it unnecessary to carry large bags of specie back and forth to conduct exchanges. They "greatly accelerate all the transactions both of exchange and production," and they speed "the advances and the returns of capital, and render production and exchange, in effect, continuous, where they would otherwise be broken by intervals at the successive steps of the operation" (Sumner 1904, pp. 168–69).

Sumner also praised them for enforcing promptitude in the payments of debts. He contended that before the era of banking commenced in the 1790s, commercial punctuality was common only in Philadelphia and that the banks had inculcated and spread it elsewhere. However, he conceded that banks refrained from enforcing punctuality on other banks (in paying balances in specie) and were not punctual when asked to redeem their liabilities in coin (Sumner 1971, p. 19).

Sumner never endorsed 100-percent reserve banking. He believed that fractional-reserve banking, *if properly managed*, could be both "useful and economical." However, his endorsement is tepid and highly conditional: "I am not prepared to take 'total abstinence' ground against paper issues, because I believe that they may be made useful and economical, though we have not yet learned how to do it" (Sumner 1968, p. 196). He also conceded that the advantages of that system have been negated by repeated "panics and commercial crises which they helped to bring about" (Sumner 1968, p. 197). The reader wants to ask him: "If you have not figured out how to manage safely a fractional-reserve system, and it repeatedly has caused great 'loss and mischief,' then why permit it? Could there not be an inherent flaw in the system." Sumner envisioned with favor hard-money banks that lent no more than their specie capital and some "safe" percentage of the specie deposits of their customers. They could do so because experience confirmed that not all depositors would seek to withdraw their funds at the same time and that withdrawals of deposit money would be compensated, more or less, with additional deposits or repaid loans. Sumner described such banking as both "sound and useful" (Sumner 1971, pp. 22–23). Other necessary conditions were that the banks should regularly (preferably daily) pay balances due other banks and collect those owed them. The banks should be legally bound to pay specie on demand to all depositors and certificate-holders and should have to do so as a matter of *regular practice* and *commercial custom* (i.e., actual convertibility). The banks should loan deposit money only on short-term commercial paper for commodities sold and transferred (i.e., the real bills doctrine or commercial banking principle). The bank managers must possess "moderation, sagacity, and scientific knowledge," for "without these qualities in the managers," "free banking . . . is as wild as any scheme of paper money" (Sumner 1968, p. 56).

As Sumner was aware, American banks during the first half of the nineteenth century failed to meet *any* of these conditions. Sumner unequivocally condemned them. They were privileged corporations protected by limited liability laws and empowered to issue notes to be used as currency both by the government and the people. They possessed no capital. The banks were paid interest on loans which cost them nothing but the cost of paper and printer's ink. They also resented being presented with their notes for redemption in coin, often refusing large demands and inventing various stratagems for avoiding or delaying repayment. When the banks suspended payments en masse (1814–17; 1837–38; 1839–41; 1857; 1861), the state governments allowed them to continue to make loans and pay dividends. "Ninety nine in one hundred of these banks were pure swindles" (Sumner 1970b, pp. 229–30). The custom from the beginning of fractional-reserve paper-money banking in the 1780s was for the stockholders to pay in government bonds or stock notes (i.e., promissory notes secured on the stock itself) in lieu of specie. As Sumner pointed out, this meant that in most cases the stockholders of the banks were actually debtors to it, which made them swindlers or confidence men.

> They take something out where they have put nothing in. They are not lending a surplus of their own; they are using an engine by which they can get possession of other people's capital. They print notes which have no security and make the public use them as money. They bear no risk of their own operations, but throw all the risk on others while taking all the gain. (Sumner 1971, p. 33)

Free bankers today argue for essentially the same type of banking system that existed in the 1810s and 1830s–50s. They insist that stockholders should be shielded by limited liability laws, that banks should be under no legal obligation to pay specie on demand for their notes, and there should be no circulation of gold or silver coin.[3]

Sumner observed that the popular conception of a bank from the 1780s through the Civil War was that of "an institution whose prime function was to issue circulating notes" (Sumner 1970b, p. 230). Thus, Senator Daniel Webster defined a bank as an institution having "the power to issue promissory notes with a view to their circulation as money (Sumner 1971, p. 28)." This was the common view. Albert Gallatin, a bullionist, regretted that "banking in America always implies the right and practice of issuing paper money as a substitute for specie currency" (p. 28). Most American bankers believed that banking "consists in making paper issues and loaning them, making them as large as possible and stimulating them by all artificial means, and discouraging conversion as much as possible." By these means, they have brought "down more ruin on the community by this engine than by any

[3]See the writings of George Selgin, Lawrence White, and others.

other" (Sumner 1968, p. 56). Sumner here condemned fractional-reserve banks for issuing *too much* money, but how much was too much? It never occurred to him that, given human nature, fractional-reserve banking cannot be managed safely or conservatively and that it is akin to granting absolute power to rulers and then trusting them not to abuse it. Nor was he ever able to free himself from Smith's view of specie sitting in the vaults of a bank as "dead stock."

MONEY IS NOT CAPITAL, NOR IS CREDIT MONEY REAL MONEY

Capital in the broadest sense is simply the wealth of the country that has been built up over time by human effort and labor. Infrastructure (roads, highways, railroads, bridges, power plants, water treatment facilities, and more) is capital, as are automobiles, trucks, tractors, ships, shipyards, auto factories, oil refineries, machine tools, homes, furniture, libraries, and clothing. The list is endless. By contrast, currency is merely a means of transferring capital and making economic exchanges. Sumner put it well:

> Capital is that portion of all the previous product of a nation which at any given time is available for new production. This will be a certain amount of tilled land, houses, buildings, stock, tools, food, clothing, roads, bridges, etc., etc., which have been made and are ready for use in producing, transporting, and exchanging new products. . . . Currency only serves to distribute this capital into the proper hands for its most efficient application to new production. . . . Currency, therefore, is not capital, any more than ships are freight; it is only a labor-saving machine for making easy transfers. (Sumner 1968, p. 171)

He pointed out that the various forms of capital "are all the product of labor, and require time for their production. Nothing but labor spent upon them can produce others, and time is required for this labor to issue in new and increased possessions" (Sumner 1968, p. 171). Sumner's grasp of the *time element* in production helped him understand the business cycle.

Real money (i.e., gold and silver coin) is likewise the product of labor and capital (either through the extraction of the precious metals from the earth and their conversion into coin, or through capital sold and transferred abroad). Under a hard-money system, the quantity of credit corresponds almost exactly to the pool of savings (i.e., deferred consumption) and the quantity of loanable capital. On the other hand, convertible currency and deposits are forms of credit money that can be multiplied until they are only partially representative of loanable capital. Even worse, inconvertible fiat currencies can be multiplied without limitation or restraint and are representative of nothing. Increasing the supply of currency and demand deposits beyond the specie capital of the country simply increases the number of bidders for existing capital goods, the dual effect of which is to push prices higher than they would be otherwise and consume capital faster than it can produced. Under the inflation system, people are empowered to acquire capital before they have produced an

equivalent capital for exchange, and that is why such systems produce endemic crises in production.

Sumner's history of American currency and banking is largely the story of what follows when currency is multiplied in the manner outlined above. My "history will do little more than to expose the errors involved in mistaking credit currency for money, and money for capital—errors which are repeated to-day [1874] by the new States—and to show the bad results of those errors" (Sumner 1968, pp. 6-7), which are the business cycle, malinvestment, the sinking of capital, bankruptcy, unemployment, and ruin.

On the Business Cycle

From 1800 to 1880, the United States experienced four major business cycles, one every 20 years (with smaller, less severe crises within those periods). Each one had three stages: inflation (1810s, 1830s, 1850s, 1860s); panic/crisis (1819, 1837-39, 1857, 1873); and liquidation (1819-23; 1839-43; 1857-58; 1873-78).[4] The panic of 1818-19 was precipitated by the contraction policy initiated by the Bank of the United States. The panic of 1837 was precipitated by a drying up of British credit, and the follow-up crisis of 1839 occurred when the commercial banks contracted en masse.

> That the system should have tended to these heats and chills seems a necessary consequence of its character. There was no limit to the bank note issue, except the utmost which each bank could keep afloat. The specie reserve was made as small as the banker dared to risk. The specie became the vital nerve of the entire economic system of the country. . . . When things seemed prosperous and the exchanges were favorable, the banker put out his circulation. When one did it, the others did it, and the consequence was a general inflation. Presently the issue became excessive. The exchanges turned and a little specie was shipped. Thereupon, the vital nerve being touched, a shock went through the entire system. Discounts were refused; loans could only be obtained through brokers at extravagant rates; the circulation was contracted very suddenly; the commercial system was arrested; then industry stopped; production was reduced; wages were lowered; and finally the farmers, so far as they were debtors, were reached. This severe remedy operated a cure, and all were ready to begin again. (Sumner 1971, p. 182)

[4]Sumner titled the chapters of his banking history after the successive stages of the business cycles. For instance, chapter five, dealing with the years 1812-17, is titled "Inflation on the Atlantic Coast;" chapter seven, dealing with 1818-19, "The Crisis on the Atlantic Coast;" chapter nine, the years 1819-23, "The Liquidation on the Atlantic Coast;" and so on through 1860 (Sumner 1971, pp. 63, 95, 112; the minor panics are listed on p. 181).

Sumner was describing the price-specie-flow mechanism. The expansion of currency drives up domestic demand and prices, resulting in rising imports and falling exports. This resulting trade imbalance is not sustainable. When foreign credit begins to dry up and merchants begin shipping specie, the banks are forced to contract to protect and replenish their dwindling specie reserves. The sudden contraction of credit and currency acts like a wet blanket on the whole economy. It ruins many of those whose enterprises are not earning a sufficient income to pay their debts. Others cannot raise sufficient funds to pay debts because of falling prices for commodities, real estate, land, and stock, and are forced into bankruptcy.

Sumner observed that the usury laws of nineteenth century America (legislating an interest-rate ceiling of six percent) worsened the severity of the cycle. Prevented from raising interest rates sufficiently to earn a sufficient profit, the banks increased their circulation.[5] The usury laws prevented the balancing of rising demand for credit with its shrinking legitimate supply.

> The banks being thus the transfer agents through whose hands the capital passes, are the ones to know and give warning when it is used up. This they should do naturally by raising the rate of discount, and the usury law, which makes this impossible, is fairly chargeable with a large share of the mischief which is usually ascribed to bank expansions. For, the capital passing out of the bank in the form of discounts and bank-notes, the bank has no means of profiting by the increased demand for, and value of, capital save by increasing these items, that is, by passing over to the most perilous forms of credit. (Sumner 1968, pp. 124–25)

While hard-money men applauded the mechanism for putting an end to the inflationary boom and worried about the day when the Continental countries adopted paper-money banking as well, which would destroy the mechanism by weakening the demand for specie abroad,[6] soft-money men tried to extend the boom by reflating during the crisis period. From the colonial period through the Civil War, business contractions were met with calls for public works projects (to put people to work and inject money into the economy), the establishment of land banks (to make loans on the security of land), emissions of bills of credit, federal treasury notes, the legal suspension of specie payments, and establishing a central bank as a lender of last resort

[5]"If they had been allowed to operate on their discount rate, they would have had less motive to operate on their circulation" (Sumner 1971, p. 182).

[6]Condy Raguet warned,

> Every movement made in Europe towards the establishment of banks of circulation, is a step towards that terrible consummation, when no domestic or foreign checks will longer exist to prevent those unlimited expansions, which cannot possibly exist without alternate contractions, subversive of the industry and prosperity of the whole civilised world. (Raguet 1839, p. 84)

(Sumner 1914, pp. 19–20). The paper-money party believed, and continues to believe, that inflationary booms can be continued indefinitely. They believed the credit contraction was the *only* cause of the crisis.

The most astute hard-money men of the nineteenth century (Raguet, Sumner) realized that while the contraction of credit and currency was the *immediate* cause of the bust, it was not the *ultimate* cause. They deduced from their theory of capital formation that during the boom the consumption of capital outpaced the production of new capital. Unless there were foreigners continually willing to lend their capital to such a country, a crisis was inevitable.[7] Sumner understood *speculation* in the dual nineteenth-century sense of buying in order to sell (for a gain) and investing in new capital ventures. When people spoke of "speculation," they often were referring to various forms of investments and enterprises. The problem, then, was not that inflation engendered speculation but that it fueled "over-speculation," which he defined as "speculation which outstrips the capital of the country" (Sumner 1968, p. 124). Bank projectors and paper-money advocates

> led the people to believe that the methods of a 'boom' could be successfully employed in the place of the methods of thrift, and their most far-reaching corruption and demoralization lay in the fact that, in practice, they only offered a chance for a favored clique to win at the expense of the community. (Sumner 1971, p. 316)

Sumner explained what happens when credit expansion exceeds the pool of savings, and money is inflated without a corresponding production of new capital.

> If, therefore, currency is multiplied, it is a delusion to suppose that capital is multiplied, or, if "money is plenty," by artificial increase of its representatives, it is only like increasing the number of tickets which give a claim on a specific stock of goods—the ticket holders would be deceived and could, in the end, only get a proportional dividend out of the stock. If banks not only lend capital but also lend "coined credit," some time or other a liquidation must come, there must be an effort to touch the capital which the notes pretend to convey. Then it is found that they represent nothing; then "credit breaks down," and there must be a settlement, a liquidation, a dividend, and a new start. . . . The real amount of capital which

[7]Condy Raguet, the pioneer American business-cycle theorist understood that a reaction was inevitable because the inflation of money and credit fueled not only excessive personal consumption but an unsustainable number of capital projects. See his famous Pennsylvania Senate report on the crisis of 1819 (reprinted in Raguet 1839, pp. 300–01, 305). He argued the point even more clearly in an 1829 essay where he described the characteristics of an inflationary boom as rampant "speculation," an increase in "extravagance and luxury," and the over-expansion of capital investments in commerce, manufacturing, and agriculture. The crisis revealed that "consumption had been increasing whilst production had been diminishing" (Raguet 1829, p. 7).

> we possess is divided up, and we have to make up our minds that we possess only 50 to 75 per cent of what we thought we possessed. We put smaller figures for everything, and reconcile ourselves to smaller hopes, but the experience is soon forgotten, and the old process of inflation and delusion begins again. (Sumner 1968, p. 172)

The American investor who lost 40 percent of his wealth during the stock market correction of 2001 and 2002 will recognize the truth of Sumner's analysis here.

Sumner clearly recognized the problem of malinvestment in which capital was misallocated to unproductive, premature, or overdone fields of industry. "Industrial disease is produced by disproportionate production, a wrong distribution of labor, erroneous judgment in enterprise, or miscalculations of force. These all have the same effect, *viz.*, to waste and destroy capital" (Sumner 1919, pp. 219–20). In his discussion of the causes of the panic of 1837, Sumner explained that the inflationary banking system of the time inspired and fueled a "mania for improvements," which were "unwisely planned and attempted without reference to the capital at command" (Sumner 1919, p. 391). The same had happened during the period of the English Bank Restriction (1797–1821), during which the Bank of England would not pay specie for its notes. As a result, "[S]peculation under inflated paper issues" had fostered the "most extravagant [enterprises]" (Sumner 1968, p. 252). They were extravagant because they were more than the economy could support.

THE PANIC OF 1837 AND THE CRISIS OF 1839

Sumner's analysis of the panic of 1837 and its aftermath is proto-Austrian. He believed the initial cause was President Jackson's 1832 veto of the re-charter bill for the Bank of the United States and the removal and distribution of the government's funds in 1833. He believed these actions spurred an inordinate expansion in banking, as speculators and bank projectors combined to form new banks either to get a share of the public deposits being shifted out of the national bank, to fill the competitive void created by closing of the federal branch banks, or "to participate in the carnival of credit and speculation" which began in earnest in 1835. The bank war changed the public psychology back "again to a mania for banks" (Sumner 1970b, p. 318), such as had previously raged in the 1810s.[8] That the public mind was susceptible to a recurrence of banking fever and inflationism only ten years after the liquidation of 1819–23 proved that the public memory was short and the level of economic knowledge remained low.

[8] "Banks were organized in great numbers all over the country to take the place of the great Bank and to get a share in the profits of handling the public money" (Sumner 1919, p. 374).

"With the increase of banks and bank issues speculation began. It became marked in the spring of 1835 and went on increasing for two years."[9] In the southern states, the new bank money funded an enormous expansion in cotton cultivation. In the mid-western states, the banks funded a boom in canal and railroad construction. It also sparked an urban real estate boom in commercial centers like New York City, Philadelphia, and New Orleans, and a western land boom, the proceeds of which, being received in the government's land offices, then transferred to the deposit banks and lent out again, furthered the speculative mania. Sumner understood perfectly that the currency and credit inflation was spurring a misallocation of resources toward an excessive number of long-term capital projects (new cotton plantations, canals, railroads).

> These enterprises were . . . in their nature, investments, returns from which could not be expected for a long period. In the mean time, they locked up capital. It appears that labor and capital were withdrawn for a time from agriculture, and devoted to means of transportation. Wheat and flour were imported in 1836. (Sumner 1970b, pp. 322–23)

In addition, Americans were contracting a great debt in Europe. They were borrowing capital by issuing securities in exchange (e.g., state bonds and corporate stock). Foreign credit had the effect of holding down the price of foreign bills of exchange and protecting the domestic inflation from the usual corrective in such situations, an outflow of specie. In other words, as long as foreign merchants and creditors were willing to accept bonds and stocks in lieu of commodities, merchandise, or specie, the banks could go on inflating the money supply and Americans could continue to plunge further into debt without the price-specie-flow mechanism kicking into effect; and both did so, to their ruin. "The whole anomalous condition of things here rested upon the fact that a great debt was being contracted in Europe, which depressed the exchange and protected the whole system of inflation here" (Sumner 1971, p. 264).

As long as the British were willing to lend capital to the Americans, the boom could have continued, but by mid-1836 that credit began drying up. The British were experiencing their own inflationary boom. The gold reserves of the Bank of England had shrunk to dangerous levels, and the Bank had to retrench. It raised interest rates, called in some loans, and refused to discount American bills of exchange. The demand for cotton now fell, and British merchants began calling for specie instead of extending more credit or buying American securities. The fall in cotton prices and the rise in foreign exchange hit the American economy hard. The real estate, cotton, and canal-bubbles all burst and by the spring of 1837 the country was in the grip of financial crisis

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[9]Between 1830 and 1837, the number of banks increased from 330 to 634, the total volume of loans from $200 million to $525 million, and the volume of bank notes from $61 million to $149 million (Sumner 1919, p. 374).

marked by spreading mercantile failure, soaring interest rates, falling stock and real estate prices, and runs on the banks for specie. In May, the banks of Philadelphia and New York City suspended payments, and were soon followed by banks all across the country (Sumner 1968, pp. 132, 135; 1919, pp. 378, 380).

According to Sumner, what the country now needed was a reduction in imports and debt, the liquidation of redundant banks and enterprises, the reallocation of capital and labor from cotton and canals back to foodstuffs and necessities. It was not to be. The liquidation was postponed, as the banks and state governments together attempted to reflate the economy and revive the boom. Although it no longer had a federal charter, the still powerful Bank of the United States led the reflation effort by buying surplus cotton, borrowing heavily in Europe, selling bills of exchange to depress the exchanges, and lobbying against a return to specie payments. As a result of these policies, the liquidation was arrested, and the banks resumed inflating. After shrinking slightly in 1837, the money supply increased in 1838, imports rose, cotton prices recovered, and American securities were again being marketed in Europe (Sumner 1968, pp. 140, 147–48, 153). It was not to last.

In the fall of 1839, the boom came to a sudden and sharp end. The Bank of the United States had not the means to go on propping up cotton prices, and there was a limit to British credit. The money market again tightened and the exchange market rose. Merchants and others began calling for specie from the banks (which had resumed payments in the summer of 1838), but they were overextended and did not have it. In October, most of the banks south and west of New York City suspended payments and called in their outstanding loans. "[The] suspension was the real catastrophe of the speculative period which preceded [it]. A great and general liquidation now began" (Sumner 1919, p. 388). Outside of New York City and New England, the nation's banking system collapsed. Sumner estimated that 343 out of 850 banks closed entirely. Even the great Bank of the United States failed. Work was stopped on many canals and railroads. Cotton fields were abandoned. "The stagnation of industry lasted for three or four years. The public improvements so rashly begun were suspended or abandoned" (ibid.). Many of the state governments defaulted on their bonds. As the banks of the states held most of their capital in the form of government bonds, they both went down together. Sumner's judgment on the inflation boom of the 1830s is harsh but just. "It was necessary to arrest the movement of the whole system and to proceed to a general liquidation, before starting again" (Sumner 1919, p. 220).

> The grand promise of ten years before was now entirely obscured. . . . All the natural advantages of the country were present unimpaired, but the haste to realize them had brought ruin which time only could repair. The year 1843 was one in which the ideal of some economists was realized. We exported forty millions more merchandise than we imported, and we imported twenty million more specie than we exported, but the significance

> of these facts was simply this: we were paying up for the grand times of the years before. It was like the spendthrift living low to recover his position, and we were doing it by producing mainly for export, at prices low enough to suit the creditors. (Sumner 1968, pp. 153–54)

He added that, however necessary, "liquidation[s] cannot be accomplished without distress and loss to great numbers of innocent persons, and great positive loss of capital, to say nothing of what might have been won during the same period but must be foregone" (Sumner 1919, pp. 220). He pointed to 1857–58 when Pennsylvania sold her public works (e.g., canals, turnpikes) for $11 million; they had cost her $35 million to build (p. 391).

In the fall of 1857, the country experienced another panic, general bank suspension, and business contraction. Yet, in contrast to 1837–43, it was mild and quick.

> The pressure [for money] passed away in the course of the winter. The liquidation was rapid, and by spring business was again in motion. The New York banks resumed on the 12th of December, and others followed gradually and informally. In the spring money was very easy. (Sumner 1968, pp. 186–87)

Here was a bank suspension lasting only several months, instead of several years, and a corrective period lasting only six months instead of dragging on four years. Why the difference? First, monetary inflation during the 1850s was much less than in the 1830s. Second, there was no effort by the federal or state governments, or by the large banks, to reflate the economy, refloat debts, and save marginal enterprises. The country had learned its lesson. Too bad it forgot them in the twentieth century.

In America, the wealth-creating potential of the country was so great that the cycles occurred less frequently and with less severity than the amount of inflation should have caused. "[T]he future which we discount so freely honors our drafts on it. Six months' restraint avails to set us right, and our credit creations, as anticipations of the future product of labor, become solidified" (Sumner 1968, p. 173). Nevertheless, even here, inflation creates a cycle that must run its course with the unerring certainty of fate. Sumner developed a generational theory of the business cycle as well. Unmindful of the past, each generation repeats the currency errors of its predecessors.

> So long as we understand that we have anticipated future production, and must apply that production to make good the anticipations, we run on without very great risk, but whenever we lose our heads in the intoxication of our own achievements, look on the credit anticipations, which are only fictitious capital, as if they were real, use them as already earned, build other credit expansions upon them, do away with our value money and export to purchase articles of luxurious consumption, then we bring a convulsion and a downfall. The mistake is then realized, the lesson is taken to heart for a little while, but a new generation grows up which forgets or

> never knew the old experience, and the mistake is repeated. (Sumner 1968, p. 173)[10]

THE INFLATION DELUSION

Sumner understood that inflation schemes had great appeal to human nature because they promised a shortcut to the prosperity and wealth that can only be produced by years of labor, thrift, and patient capital accumulation.

> [T]here is no delusion which it seems so hard to stamp out of the minds of men as this, that in business we can make something out of nothing, although we cannot in chemistry or mechanics. Nothing more surely tempts the man without capital to his ruin than the easy credit which accompanies the first stages of inflation. (Sumner 1919, p. 396)

Closely related was the idea that the inflationary period could be continued indefinitely as long as people maintained their "confidence" in the currency and the banks. This idea went back at least as far as the Revolution during which many American leaders (e.g., Madison, Adams, and Hamilton) contended that the depreciation of the Continental dollar was more or less due (not to its excessive quantity) but to psychological factors. Sumner noticed that during the crisis of 1857–58, the newspapers were filled with editorials urging people to have "confidence" in the currency, the banks, and the stock market, but a lack of confidence was not the problem; it was *the recognition* of the problem. During a panic the "confidence, so long entertained, is now recognized as unfounded. It is the force of the truth which makes the trouble, and how can it avail to try to make men still delude themselves?" (Sumner 1968, p. 186). In other words, excessive currency had produced inflated prices for stocks, land, and commodities. The same exhortations to confidence followed the panic of 1873, which represented the long-deferred reaction to the destruction of capital wrought by the Civil War, the enormous debts incurred to finance it, and the war inflation. "The collapse of 1873, followed by a fall in prices and a general liquidation, was due to the fact that every one knew . . . that the state of things which had existed for some years before was hollow and fictitious. Confidence failed because every one knew there were no real grounds for confidence" (Sumner 1919, pp. 223–24).

Sumner recalled with frustration how before the panic of 1873 little attention was paid to the vital questions of currency, coinage, and banking, even in

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[10]Raguet held to the same theory.

> Experience has demonstrated that the present generation will not profit by the sufferings of the past, for we have seen new charters granted to banks, at a moment when the recollection of the awful calamities produced by their mismanagement was fresh in the memories of all who voted for them. (Raguet 1829, p. 1)

Congress (Sumner 1919, p. 173). When he tried to discuss with contemporaries how much the country had suffered from monetary fallacies, wild-cat banking, and currency inflation, he found that people minimized the significance of these things by pointing to the prosperity and wealth of the country. Some even cited paper money and fractional-reserve banking as the engines that drove America's economic growth. Sumner knew they were wrong. The country was wealthy *in spite of*, not because of, paper money inflation and bad banking.

> We often boast of the resources of our country, but we did not make the country. What ground is there for boasting here? The question for us is: What have we made of it? No one can justly appreciate the natural resources of this country until, by studying the deleterious effects of bad currency and bad taxation, he has formed some conception of how much, since the first settlers came here, has been wasted and lost. (Sumner 1968, p. 227)

The real causes were a favorable geographic position, a temperate climate, the fertility and abundance of land, a cornucopia of natural resources, intelligent and sustained labor, and legal and political institutions that protected private property, private contracts, commercial exchange, and the accumulation of wealth.

Conclusion

Sumner was the product of an indigenous American hard-money tradition that embraced free markets, free trade, and sound banking—a tradition that has much in common with the Austrian School in its theoretical and political orientation. His understanding of economic theory came from his reading of classical economists and the works of American theorist Condy Raguet, and his political convictions from his study of the American monetary experience, particularly the errors of the Hamiltonians. With these influences and his own hard-money views, Sumner arrived at positions on money, banking, and business cycles, economic policy that can be described as proto-Austrian in many ways. In particular, he saw credit-fueled booms as inherently unsustainable because they give rise to "fictitious capital" as versus real wealth.

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