ECONOMIC HISTORY

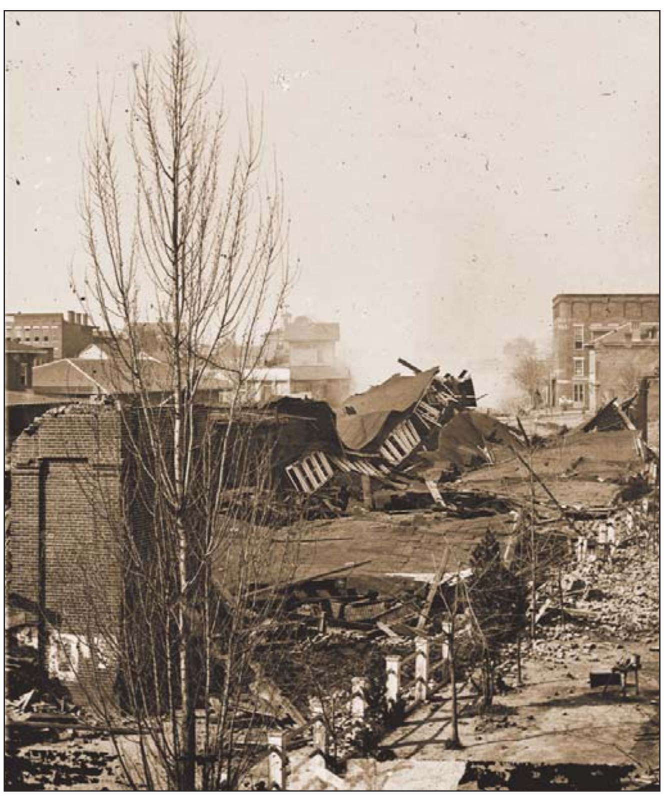
Monetary Policy in the Confederacy

BY ERIC NIELSEN

Unable to finance the war effort through taxation, the South turned to the printing press, and the result was hyperinflation

Wars may be won or lost on the battlefield, but generalship, bravery, and organization are of little use to an army if its government can't pay its expenses. The ability of a government to finance a war is often critical to the war's outcome, even if the effects of financing seem far removed from military action. In turn, a government's voracious appetite for resources to fund its military and the peculiar strain on production that characterize times of war further complicate good monetary and fiscal policymaking. These tensions clearly played a significant role in the conduct of the American Civil War.

The need for wartime funding in the North and South led to policies that illustrate basic tenets of monetary economics while precipitating a dramatic restructuring of the national financial system, changes that had repercussions long after the war ended. The conduct of monetary policy in the Civil War is not simply of interest to historians. The era also provides important lessons for monetary policymakers and researchers. The experience of the Confederacy in particular illustrates the consequences of poor financial infrastructure and governance. It also shows the power of a generally monetarist explanation of inflation.



After the fall of Atlanta in July 1864, the Confederacy's prospects looked dim. Southerners started spending their Confederate notes rapidly, increasing money velocity — and with it, prices.

At the start of the war, the Confederacy faced many daunting barriers to the conduct of sound monetary policy. Perhaps most important of these was the decentralized power structure of the Confederate government. The Southern states had seceded under the banner of states' rights and were reluctant to obey the economic policies of President Jefferson Davis or Secretary of the Treasury Christopher Memminger. The South also lacked a well-developed financial infrastructure since in the antebellum period most large banking operations were in the North, where most of the gold was held.

Each state could charter banks, and there was considerable heterogeneity in banking and regulatory practices across the Southern states. Since each bank could issue its own currency notes, the government had limited ability to conduct coordinated monetary policy. Further, the absence of a central bank to act as a lender of last resort made the banking industry prone to liquidity crises. The only source for centralized economic policy was the Confederate Treasury under Memminger, but this office was subject to the vagaries of the executive and legislative branches of government, meaning that policy could be influenced for political, not economic, reasons as argued by economist Eugene Lerner.

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The structure of the Southern economy also impeded effective monetary policy. Heavily dependent on agriculture, the South had little industrial capital and few liquid assets. The lack of liquidity made tax collection in the rural South very hard, while the lack of economic diversification made the economy prone to adverse shocks in its few export goods such as cotton. Finally, the South had a relatively uneducated population which led to constant worker shortages in the Treasury's office in Richmond and in other posts requiring a high degree of literacy.

The combination of these structural problems coupled with shortsighted policymaking by the Confederate Congress meant that taxation and borrowing ultimately failed to raise sufficient funds to conduct the war. So the Confederacy had to finance itself through the excessive printing of money, which led to hyperinflation.

Increased taxation, the most direct and obvious way of raising additional revenue, failed to finance a significant portion of the war for the Confederacy. Only 8 percent to 11 percent of all wartime revenue in the South came from taxation, despite the introduction of many new taxes on income, professional licenses, and property. In addition, a new excise tax on cotton, the most significant export crop in the South, also failed due to the surprisingly effective naval blockade orchestrated by the Union.

Prior to the Civil War, the Southern states enjoyed one of the lightest tax burdens in the world; when the war started there was thus no infrastructure in place to efficiently levy and collect taxes except for duties on imports and exports at major ports. Many state governments were very hostile to collection efforts by the Confederate government and actively aided their citizens in tax evasion as documented by Lerner in his classic study of Confederate economic policy. For instance, only South Carolina paid for the Tax of 1861 by collecting duties from its citizens; the other states simply took out loans to pay their share.

As more and more tax bills were passed, the tax code became increasingly complicated, further hindering collection efforts. Indeed, the only taxes that could reliably raise revenue were taxes-in-kind, which meant that goods were confiscated directly. But Lerner argues that this practice ultimately led to a decline in market activity, as farmers began to produce only enough to support themselves, fearful that their surplus crop would be captured by taxation agents.

Jefferson Davis and Secretary Memminger were also stymied in their attempts to raise revenue through borrowing. Though their initial bond offering of 50 million Confederate dollars sold well, subsequent issues did not sell well except in some foreign markets. One problem with these later bond issues was timing — the war started in April just as farmers were planting and strapped for cash. Also, the 6 percent to 8 percent coupons paid by most of these bonds were more than eaten up by high inflation.

Throughout the entire course of the war, the South managed to secure only one overseas loan, from Erlanger & Co. in Paris. The loan had a face value of $15 million and was issued at a time when things looked bright for the South, on the eve of the battles of Vicksburg and Gettysburg. The Confederacy's defeats at these two pivotal battles caused the value of the loan to plummet so that after commission, Erlanger likely netted the South only $3 million in real terms, not enough to make much of a difference to the war effort.

With no other avenue open, Secretary Memminger reluctantly turned to the printing press to meet the Confederacy's financing needs. Memminger was aware that such a move would likely cause a rise in the price level and warned the government repeatedly about this danger, to no avail. The Treasury bills issued during the war had a peculiar feature: They were redeemable for gold two years after the war ended, which meant that the value of the bills was partially tied to expectations of victory for the Confederacy. So rapid was the expansion of the Confederate money supply that at one point during the war, the orders for new currency exceeded the printing capacity of the Treasury's presses. To fill the order, the Treasury began to accept counterfeit currency as valid to further expand the supply of money.

The enormous increase in the quantity of currency precipitated an era of hyperinflation in the Confederacy as more dollars chased fewer goods. The price level in the South rose by roughly 10 percent *per month* during the conflict and by the end of the war, the price level had increased in the Confederacy by a factor of 92, though imports tended to inflate more quickly and exports more slowly. At the same time, the blockade, military destruction, and the loss of workers to the war caused real wages and output to fall dramatically, with per-capita consumption falling by 50 percent in real terms. Indeed, if banks had not sharply increased their reserve ratios for fear of bank runs, the inflation created by excess money in the South would likely have been even more severe.

Hyperinflation had a number of negative effects on the Southern wartime economy. As currency became useless as a store of value, the rate at which people spent their cash reserves — the velocity of money — increased, driving prices still higher. In many areas of the South, Confederate dollars became worthless unless accompanied by some valuable underlying commodity such as cotton or leather, impeding the smooth economic exchanges on which healthy economies depend. In border areas, the Union greenback currency became the preferred medium for exchange due to its superior stability. Faced with the danger of imminent invasion and the burden of supporting and hosting the military, the border areas tended to be particularly harmed by the war.

The Confederate government passed the Currency Reform Act of 1864 in an effort to stem the rampant inflation ravaging the South. The Act effectively removed one-third of all currency in the South from circulation by mandating that all large denomination bills be converted to 4 percent Treasury bonds before April 1, 1864, and imposing a 3-to-2 redemption ratio for small bills after the deadline. As people tried to get rid of their large notes, velocity spiked and in the months prior to the deadline, inflation rose to 23 percent a month. In the summer of 1864, though, price levels in the Confederacy finally stabilized and even declined slightly, just as monetary theory would predict following a contraction in the money supply. However, in the face of continuing pressure to meet war obligations, Congress authorized the printing of an additional $275 million in August of 1864, mostly reversing the effects of the Currency Reform Act.

In contrast with the South, the Union successfully raised the $2.3 billion necessary to fund its war effort without causing hyperinflation. Though inflation was high in the North during the war — prices doubled in most Northern cities — it paled in comparison to the hyperinflation that plagued the Confederacy. The North drastically changed its tax collection system and financial infrastructure to accommodate the burdens of a long, expensive war. These wartime changes ultimately helped reshape the economic face of America.

Whereas the South was mostly unable to raise funds through loans, the North financed roughly 65 percent of its war effort through borrowing. Wealthy Philadelphia financier Jay Cooke successfully orchestrated the sale of huge numbers of war bonds. In order to sell these issues, Cooke launched a massive advertising campaign aimed at middle- and working-class families who traditionally were not seen as a major source of funds. His campaign was a success, with almost 1 million working families purchasing war bonds. This advertising effort presaged the modern era in which bond issues to the general public were used to help pay for wars.

During the war, the Union also managed to expand its tax base and revamp its collection system. After some initial tax measures in 1861, including the first federal income tax in U.S. history, the Union passed the Internal Revenue Act of 1862 which raised the income tax, enacted luxury and consumption taxes, and created the Bureau of Internal Revenue. In contrast to the Confederate bureaucracy where central control was weak and administrative capability lacking, the Bureau of Internal Revenue streamlined federal tax collection, a process so effective that the North raised 20 percent of its wartime revenue through taxation.

The Union Congress also passed several important pieces of financial legislation during the Civil War. In 1861, the financial demands of the war began to deplete the gold reserves of both the banking sector and the Treasury. In response, private banks ceased redeeming currency for gold, and soon the Treasury followed suit. The government passed the Legal Tender Act of 1862, which allowed the issuance of legal tender currency not backed by gold. This marked the first time in U.S. history that a fiat currency, or a currency not backed by some underlying commodity, was used as legal tender. A year later the Union government passed the National Banking Act of 1863 which created a system of nationally chartered and regulated banks to ensure a market for Union war bonds. Preexisting banks were given very strong incentives to become nationally chartered. Once chartered they were subject to federal reserve requirements, had to accept all other national banks' currencies at face value, and had to hold federal bonds as collateral against note issue.

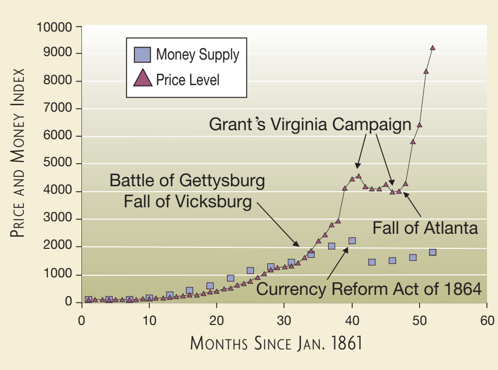
Both the Legal Tender Act and the National Banking Act were intended to be temporary measures to meet the exigencies of war. However, both sets of reforms lasted long after the conflict ended. More broadly, these acts, coupled with the expansion of taxation and the creation of the Bureau of Internal Revenue, marked an important shift in the power of the U.S. government. After the Civil War, the federal government had much more control over banking regulation and monetary policy, and much more power over the states generally.

In hindsight it is easy to point out where the South went wrong and what the government could have done better. However, at the time the situation was much less clear to government officials. Politicians and generals on both sides of the conflict began the war with extremely optimistic assessments of its outcome and duration. Southern confidence in a quick victory, coupled with a political climate that distrusted taxation and centralized authority, meant that short-term expedients were repeatedly selected as fiscal problems arose. Had the Confederates known that the war would take years instead of months, they may well have seriously attempted to overhaul their banking and tax collection systems instead of relying so heavily on the printing press.

One major reason the South was reluctant to reform its financial system was the faith its leaders and citizens placed in the ability of

Money Supply and Inflation in the Confederacy

As the South increased its money supply during the first three years of the war, inflation followed. Later, battlefield events led to soaring prices.



SOURCE: Roger Ransom, "The Economics of the Civil War"

"King Cotton" to win the economic side of the war for them. The South had planned to use the good to finance the war and to induce Great Britain, heavily dependent on cotton for its textile mills, to grant the Confederacy diplomatic recognition. The effectiveness of the Union blockade prevented the South from realizing either of these goals.

The Confederate experience lends considerable support to the thesis that inflation is largely a function of the growth in the supply of money. Economists Richard Burdekin and Marc Weidenmier of Claremont McKenna College have taken advantage of a geographic peculiarity after the 1864 Currency Reform Act to further examine this relationship. The act removed one-third of the currency in circulation once it went into effect. However, by this time the South had lost the battle for Vicksburg, and with it the Mississippi River, thus isolating the eastern and western halves of the Confederacy. After the Currency Reform Act went into effect in Richmond, inflation slowed and even reversed for a short time as the currency stock decreased. Yet in Houston, the major Confederate financial center in the West, inflation continued virtually unabated since transportation difficulties severely muted the effect of the currency reform.

Given that by mid-1864 the military situation had begun to look rather grim for the Confederacy, it is particularly notable that the price level fell in Richmond. As Sherman and Grant steadily fought their way into the Confederacy, expectations of a Southern victory must have fallen. People should then have become more eager to spend Southern notes (trading a potentially worthless currency for real goods), thereby raising inflation by increasing velocity. Even with the external military threat looming ever larger, a reduction in the currency stock halted and then reversed inflation.

However, it should be noted that following the fall of Atlanta in September 1864, inflation grew very rapidly despite relatively stable growth in the money supply. It had become clear that the Confederacy was on the verge of collapse, so Southerners wanted to spend their currency while it still had some value. In April 1865, Robert E. Lee and his Army of Northern Virginia surrendered at Appomattox, effectively ending the war.

In many ways, the Civil War was a watershed in U.S. history. It brought a sudden end to slavery in the South, and wrought tremendous destruction in the South and border states. The war was also extremely expensive, and the enormous and unprecedented expenditures severely strained the financial systems of both governments, spurring innovation and centralization in one and monetary suicide in the other. The wartime finance policies of the North set the stage for much more modern currency and banking systems. At the same time, the defeated Confederacy showed the dangers of excessive money creation. Shortsightedness, political resistance to taxation, and a lack of liquidity led the South down the disastrous path of the printing press. The Southern experience should serve as a cautionary tale to policymakers about the dangers of bad financial institutions and rampant money creation. **RF**

The vignette in the center of this 1862-issued $5 Confederate note shows the Capitol building in Richmond. The portrait on the right is of Secretary of the Treasury Christopher Memminger.

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