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Jonathan Kirshner: Appeasing Bankers

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What Does Finance Want?

Is your money that good?
—*Bob Dylan*

Bankers dread war. More precisely, financial communities within states favor cautious national security strategies and are acutely averse to war and to policies that risk war. This general rule holds across time and place, in a wide variety of political and economic settings. This chapter explains why finance has these preferences. The chapters that follow probe and evaluate this argument, and consider its implications for contemporary international politics. The short answer is: finance wants macroeconomic stability. Because war is largely incompatible with macroeconomic stability, the financial community is especially leery of risking armed conflict. This disposition is an important influence in contemporary international relations and will remain so, especially for as long as financial globalization endures.

The principal argument of this book is that the caution of finance and its strong aversion to war are virtually universal traits; they are extraordinarily remarkable regularities that provide scholars of international relations with an important analytical tool for understanding world politics. The preferences of finance, especially since they are not felt with equal force in all states, affect the balance of power between states and influence the pattern of international conflict. Additionally, illustrating how the macroeconomic policy predilections of finance forge its foreign policy preferences enhances our understanding of the security strategies and choices that states embrace, by providing insights into how the definition of the national interest, and how best to advance that interest, is debated and contested by actors within societies.

For many inquiries, it would seem (and it often is) inappropriate to lump together a potentially diverse group of actors with occasionally divergent interests under the heading of finance. However, while acknowledging this, I argue that finance—meaning banks, the financial services sector, insurance companies, attendant financial institutions, various exchange markets (especially for currencies, bonds, and equities), and their allies and affiliates in government (almost always central banks and usually treasury departments)—share a deeply held set of preferences regard-

ing the basic domestic macroeconomic environment in which they operate. Thus only two claims are in effect here: these actors share a basic disposition regarding the management of the economy, and this disposition, this package of policy preferences, represents strongly held first principles that reflect the fundamental material and institutional interests of the parties concerned. I do not assume that members of the financial community are in agreement on other issues; nor do I argue that finance acts in concert to advance its shared interests.

This basic disposition of the financial community is common across disparate countries and consistent over long periods of time. Finance, above all else, wishes to operate in a macroeconomic environment conducive to its interests. In a phrase, the ideal playing field is one of “macroeconomic stability.”¹ In practice, this means low inflation and, just as important, policies designed to keep inflation low, robust and predictable real interest rates, stability in and maintenance of the value of the exchange rate and unfettered access to international financial centers abroad, balanced government budgets, modest government spending, low rates of taxation, and small and clearly sustainable levels of government debt.

WAR AND MONETARY DISORDER

The problem for finance is that war, and even policies that risk war, tends to undermine each and every one of these core preferences. War almost always results in inflation and the erosion of monetary discipline, gyrations in real interests (with negative real rates common as inflation outpaces nominal increases), exchange rate depreciation and instability, interruptions in international financial flows, and huge increases in government spending, partly offset by increased taxes but typically resulting in unbalanced budgets facilitated by expanding government debt and monetization (printing more money to pay the bills).

In the history of the United States, wartime inflation has been as American as apple pie. Indeed, militarized macroeconomic mayhem predates the establishment of the republic. Massachusetts racked up large debts and liberally issued paper money during King William’s War (1689–97) and Queen Anne’s War (1702–13). During the Seven Years’ (French and

¹ As one astute reader pointed out, both “macroeconomic” and “stability” are used imprecisely here. There are many key macroeconomic variables, such as output, growth, and employment, which are not of paramount concern to the financial community. Also, an annual inflation rate of 40 percent would technically be more stable than rates that bounced around from 1 to 5 percent each year, yet finance would prefer the latter outcome. Thus the phrase “macroeconomic stability” should be understood simply as shorthand for the package of policy preferences and outcomes described here.

Indian) War many of the colonies resorted to the issue of paper notes to meet expenses, but even those that faithfully retained hard currency standards experienced wartime inflation. These difficulties, acutely felt at the time, proved to be but a warm-up for the collapse in the value of the Continental Currency during the Revolutionary War, which led to the once-common idiom “not worth a Continental.”² Since independence, the American way of financing war has typically been to divide the effort between new debt, money creation, and some increases in taxes. A common consequence of this has been inflation and “debt that ultimately yielded large, negative returns to bond holders.” Runaway inflation from the issue of greenbacks in the North and Confederate notes in the South during the Civil War is well established in American lore; but it was the War of 1812 that led to the first issue of circulating treasury notes, and the economic management of that conflict caused “very near[ly] a financial breakdown.” In its wars of the twentieth century, America did not flirt as intimately with financial ruin, but the United States nevertheless emerged from its international conflicts carrying a legacy of inflation, larger government, and increased public debt.³

These wartime consequences and burdens do not pass unnoticed by the financial community. The costs and financial management of the Vietnam War weakened the dollar both at home, in the form of increased inflation, and abroad, by undermining the gold-dollar link at the foundation of the Bretton Woods international monetary regime (which collapsed in 1971). Even radical critics of U.S. foreign policy acknowledge that by 1968 the American financial community was very alarmed by the economic consequences of the war. Public statements by leading officers of major U.S. banks in a variety of venues linked the war with the problems of inflation,

² Robert J. Schiller, “The Invention of Inflation-Indexed Bonds in Early America” (NBER Working Paper 10183, December 2003), pp. 5–7, 11; Elmus Wicker, “Colonial Monetary Standards Contrasted: Evidence from the Seven Years’ War,” *Journal of Economic History* 45:4 (December 1985), pp. 872, 874, 876; Willard C. Fischer, “The Tabular Standard in Massachusetts History,” *Quarterly Journal of Economics* 27:3 (May 1913).

³ Lee E. Ohanian, *The Macroeconomic Effects of War Finance in the United States: Taxes, Inflation and Deficit Finance* (New York: Garland, 1998), pp. 3, 8 (quote), 12, 14, 62–63; Donald H. Kagin, “Monetary Aspects of the Treasury Notes of the War of 1812,” *Journal of Economic History* 44:1 (March 1984), pp. 69, 77, 85–86; Charles J. Bullock, “Financing the War,” *Quarterly Journal of Economics* 31:3 (May 1917), p. 360 (quote), 362, 366; Hugh Rockoff, “Price and Wage Controls in Four Wartime Periods,” *Journal of Economic History* 41:2 (June 1981), pp. 381, 386; Arthur A. Stein, *The Nation at War* (Baltimore: Johns Hopkins University Press, 1978), pp. 57, 77; James L. Clayton, “The Fiscal Cost of the Cold War to the United States: The First 25 Years, 1947–1971,” *Western Political Quarterly* 25:3 (September 1972), p. 389; George A. Lincoln, *Economics of National Security: Managing America’s Resources for Defense* (New York: Prentice Hall, 1954), pp. 419, 421–22; Milton Friedman, “Price, Income, and Monetary Changes in Three Wartime Periods,” *American Economic Review* 42:2 (May 1952), pp. 615, 618.

international monetary disorder, and attacks on the dollar; Federal Reserve chair William McChesney Martin warned that the management of the war economy had led to “an intolerable budget deficit and an intolerable deficit in our balance of payments.”⁴ While increasing dissent regarding the war could be heard from other members of the business community, it was finance whose interests felt the burdens of the war most directly and acutely.

What is remarkable about the American experience with wartime monetary upheaval is that it represents the rule, not the exception, across time and place. The association of war with macroeconomic instability is an enduring historical regularity, especially in the nineteenth and twentieth centuries, but with clear antecedents that stretch back throughout recorded history.⁵

From ancient times, debt, debasement (reducing the precious-metal content of coins in order to stretch the state’s purchasing power), and even early experiments with paper currency and its debauchment were common features of war as money-starved governments resorted to what-

⁴ Robert Buzzanco, “What Happened to the New Left? Toward a Radical Reading of American Foreign Relations,” *Diplomatic History* 23:4 (Fall 1999), pp. 593–94, 595 (Martin quote); Helmut Kramer and Helfried Bauer, “Imperialism, Intervention Capacity, and Foreign Policy Making: On the Political Economy of the US Intervention in Indochina,” *Journal of Peace Research* 9:4 (1972), pp. 291–92, 294; postrevisionist scholarship also describes the “intertwined . . . problems of the balance of payments, the Vietnam War, and the strength of dollar”; see Robert M. Collins, “The Economic Crisis of 1968 and the Waning of the ‘American Century,’” *The American Historical Review* 101:2 (April 1996), pp. 401, 406 (quote), 415; Kevin Boyle, “The Price of Peace: Vietnam, the Pound, and the Crisis of American Empire,” *Diplomatic History* 27:1 (January 2003), p. 71, and Francis J. Gavin, *Gold, Dollars and Power: The Politics of International Monetary Relations, 1958–1971* (Chapel Hill: University of North Carolina Press, 2004). See also Lawrence Klein, “The Role of War in the Maintenance of American Economic Prosperity,” *Proceedings of the American Philosophical Society* 115:6 (December 1971), pp. 507–8, 511–12, 516.

⁵ On the general relationship between war and macroeconomic distress, see R. Anton Braun and Ellen R. McGrattan, “The Macroeconomics of War and Peace,” in *NBER Macroeconomics Annual 1993* (Cambridge, MA: MIT Press, 1993); Earl J. Hamilton, “The Role of War in Modern Inflation,” *Journal of Economic History* 37:1 (March 1977); David Hackett Fischer, *The Great Wave: Price Revolutions and the Rhythm of History* (New York: Oxford University Press, 1996); Robert J. Barro, “Government Spending, Interest Rates, Prices and Budget Deficits in the United Kingdom, 1701–1918,” *Journal of Monetary Economics* 20 (1987); Daniel K. Benjamin and Lewis A. Kochin, “War, Prices and Interest Rates: A Martial Solution to Gibson’s Paradox,” in Michael D. Bordo and Anna J. Schwartz (eds.), *A Retrospective on the Classical Gold Standard* (Chicago: University of Chicago Press, 1984); Herschel I. Grossman, “The Political Economy of War Debts and Inflation” (NBER Working Paper 2743, October 1988); Willard L. Thorp, “Postwar Depressions,” *American Economic Review* 30:5 (February 1941); Henry Oliver, “War and Inflation Since 1790 in England, France, Germany and the United States,” *American Economic Review* 30:5 (February 1941).

ever techniques they could call upon or invent to support their armies in the field. The Peloponnesian War forced Athens to debase its coins due to the “stress of the war and its consequences.” (Arthur Burns compared the monetary disorder of that time to the terrible inflationary consequences of the First World War.) Some fifteen hundred years later, the stability of the unshakable Byzantine gold coin was lost to the financial strains of war; on the other side of the world, in the twelfth century, the Song dynasty in China resorted to paper currency to meet its mounting wartime expenditures; a century after that, the occupation of South China (with the fall of the Southern Song) was financed by a tenfold increase in the issue of paper money. The European wars of the late Middle Ages and the Renaissance, generally across the Continent but most notably involving Britain and France, were often long and expensive affairs that also led to considerable monetary disorder.⁶

In more modern times, especially with the more common use of paper currency and innovative forms of state finance, the relationship between war and macroeconomic distress became even more intimate. The Napoleonic Wars challenged state treasuries across the Continent: Spain borrowed heavily, expanded the issue of paper currency dramatically, and was left to wrestle with the consequences of inflation and depreciation. Even Britain, which avoided Spain’s financial blunders, was forced to break with gold and borrow money to fight and endure its own inflationary episode. Ironically, France, having previously shredded its credibility as an international borrower as a result of the hyperinflation of the assignats that financed the French Revolution, suffered relatively less macroeconomic distress, though at the cost of a dramatic increase in domestic

⁶ Arthur Burns, *Money and Monetary Policy in Early Times* (New York: Augustus M. Kelley, 1965 [1927]), pp. 377 (quote), 378, 365–66, 385, 392, 406; see also Thomas Figueira, *The Power of Money: Coinage and the Politics of the Athenian Empire* (Philadelphia: University of Pennsylvania Press, 1998), pp. 496–98, 508–11; Costas Kaplanis, “The Debasement of the ‘Dollar of the Middle Ages,’” *Journal of Economic History* 63:3 (September 2003), pp. 768, 782, 795; Richard von Glahn, *Fountain of Fortune: Money and Monetary Policy in China, 1000–1700* (Berkeley: University of California Press, 1996), pp. 51, 60–61; Nathan Sussman, “Debasements, Royal Revenues, and Inflation in France during the Hundred Years’ War, 1415–1422,” *Journal of Economic History* 53:1 (March 1993), p. 45; Akira Motomura, “The Best and Worst of Currencies: Seigniorage and Currency Policy in Spain, 1597–1650,” *Journal of Economic History* 54:1 (March 1994), pp. 105–6, 110, 117–18; Richard A. Kleer, “‘The Ruine of Their Diana’: Lowndes, Locke, and the Bankers,” *History of Political Economy* 36:3 (Fall 2004), pp. 533, 535; Harry A. Miskimin, *Money and Power in Fifteenth-Century France* (New Haven: Yale University Press, 1984), pp. 54–60; Carl Wennerland, “The Death Penalty as Monetary Policy: The Practice and Punishment of Monetary Crime, 1690–1830,” *History of Political Economy* 36:1 (2004), pp. 134, 150.

taxation, including the introduction of an income tax.⁷ Other wars left similar results. To help pay for the Crimean War, the Ottoman Empire expanded the production of the paper *kaime*, which in short order lost half of its value and generated considerable popular discontent. Throughout the second half of the nineteenth century, neighboring Greece suffered crisis-related spikes in defense expenditures that generated budget deficits, monetization, and inflation—its 1897 war with Turkey was financed by paper money creation and a further surge in inflation.⁸

Russia's troubled monetary history was deeply intertwined with its military adventures. From the late eighteenth century, Russia's ambitions as a great power brought about increased taxation but still did not raise enough revenue to avoid chronic budget deficits, financed by expanded emissions of paper money and foreign loans. Monetary instability accompanied the first Turkish war and the wars with Sweden, Poland, and Persia (and Turkey again) that followed. Contrapositively, the currency reform of 1839–43 was possible only after a decade of peace; this was washed away by the flood of rubles printed to finance the Crimean War (the money supply doubled during the conflict). The subsequent monetary rehabilitation of 1868–75 was set back by the military spending, monetization, inflation, and indebtedness caused by the war with Turkey in 1877–78, a pattern that was repeated during the Russo-Japanese War. As one scholar of Russian macroeconomic history concluded, “The [monetary] expansions of 1853–57, 1877–78, and 1905 resulted from budget deficits due to heavy expenditures for the Crimean, Balkan, and Japanese Wars, respectively.”⁹

⁷ Earl J. Hamilton, “War and Inflation in Spain, 1780–1800,” *Quarterly Journal of Economics* 59:1 (November 1944), pp. 36, 53, 55, 57; Michael D. Bordo and Eugene N. White, “A Tale of Two Currencies: British and French Finance during the Napoleonic Wars,” *Journal of Economic History* 51:2 (June 1991), pp. 303–4, 309–10, 314–15; Thomas J. Sargent and François R. Velde, “Macroeconomic Features of the French Revolution,” *Journal of Political Economy* 103:3 (June 1995), pp. 474–518.

⁸ Sevket Pamuk, “The Evolution of Financial Institutions in the Ottoman Empire, 1600–1914,” *Financial History Review* 11:1 (2004), pp. 18, 25–26; Sevket Pamuk, *A Monetary History of the Ottoman Empire* (Cambridge: Cambridge University Press, 2000), pp. 142, 211, 214; Christopher Clay, *Gold for the Sultan: Western Bankers and Ottoman Finance, 1856–1881* (London: I. B. Tauris, 2000), pp. 47–49; Haim Gerber and Nachum T. Gross, “Inflation or Deflation in Nineteenth-Century Syria and Palestine,” *Journal of Economic History* 40:2 (June 1980), p. 353; Sophia Lazaretou, “Monetary and Fiscal Policies in Greece, 1833–1914,” *Journal of European Economic History* 22:2 (Fall 1993), pp. 291–92, 297–98.

⁹ Olga Crisp, “Russian Financial Policy and the Gold Standard at the End of the Nineteenth Century,” *The Economic History Review*, n.s., 6:2 (1953), pp. 156–57; Haim Barkai, “The Macro-Economics of Tsarist Russia in the Industrialization Era: Monetary Developments, the Balance of Payments, and the Gold Standard,” *Journal of Economic History* 33:2 (June 1973), pp. 344, 345 (quote), 354, 357; William C. Fuller, *Strategy and Power in Russia, 1600–1914* (New York: Free Press, 1998), pp. 100–102, 269, 338–39, 405.

And, of course, no discussion of the macroeconomic consequences of war could be complete without reference to World War I, which overturned the preferences of finance one by one as if working its way methodically down a list—widespread suspension of convertibility, the disruption of international finance, ever greater government expenditures and accumulations of debt, more and more taxation, and finally an increasingly desperate expansion of the money supply when all other options were exhausted, leading to the complete collapse of the domestic and international European monetary order—which then contributed considerably to the crises of the interwar years.¹⁰

These pathologies have by no means been limited to the United States or to Europe and its periphery. South America's wars (more common before the remarkable long peace of the twentieth century, a puzzle worthy of further attention) visited the same macroeconomic consequences on their participants. War between Argentina and Brazil in the 1820s brought about a "monetary cataclysm" in Argentina; the Brazilian real lost half of its value. The real fared even worse during the War of the Triple Alliance (1864–70); while all of the combatants struggled with wartime inflation and Paraguay was left bankrupt and in ruins, Brazil, even in victory, faced the music of a fivefold increase in its money supply, generated to fight the war. The Pacific War (1879–83) caused monetization, inflation, depreciation, and a burdensome debt in Chile, and even more dramatic "intense monetary instability" in Peru, where inflation approached 800 percent.¹¹

¹⁰ T. Balderston, "War Finance and Inflation in Britain and Germany, 1914–1918," *Economic History Review*, n.s., 42:2 (May 1989), pp. 223, 237; Pierro Sraffa, "Monetary Inflation in Italy During and after the War," *Cambridge Journal of Economics* 17 (1993 [1920]), pp. 10–11, 14, 18–20; Boris Bakhmeteff, "War and Finance in Russia," *Annals of the American Academy of Political and Social Science* 75 (January 1918), pp. 192–93, 196–98; E. Dana Durand, "Currency Inflation in Eastern Europe with Special Reference to Poland," *American Economic Review* 13:4 (December 1923), pp. 593, 597; Hamilton, "The Role of War," p. 17; John Maynard Keynes, *The Economic Consequences of the Peace* (London: Macmillan, 1971 [1919]), pp. 148–57.

¹¹ Miguel Angel Centeno, *Blood and Debt: War and the Nation State in Latin America* (University Park: Penn State University Press, 2002), p. 132 (quote); I. Grinfeld, "Monetary Experiences of the Argentine Republic," *Political Science Quarterly* 25:1 (March 1910), pp. 110, 112–14; F. J. McLynn, "Consequences for Argentina of the War of the Triple Alliance 1865–1870," *The Americas* 41:1 (July 1984), pp. 89, 92; Norman T. Strauss, "Brazil after the Paraguay War: Six Years of Conflict, 1870–6," *Journal of Latin American Studies* 10:1 (May 1978), pp. 23, 35; Diego Abente, "Foreign Capital, Economic Elites and the State in Paraguay during the Liberal Republic (1870–1936)," *Journal of Latin American Studies* 21:1 (February 1989), p. 62; Vera Blinn Reber, "The Demographics of Paraguay: A Reinterpretation of the Great War, 1864–70," *Hispanic American Historical Review* 68:2 (May 1988), p. 316; Paul Gootenberg, "Carneros y Chuno: Price Levels in Nineteenth-Century Peru," *Hispanic American Historical Review* 70:1 (February 1990), pp. 6, 32 (quote); see

