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Money (p. 3)

James Madison

**The Debasement Puzzle:
An Essay on Medieval
Monetary History** (p. 8)

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In This Issue

What determines the value of money? This is a question debated among economic scholars for centuries, including those writing in the *Quarterly Review*. (See <http://woodrow.mpls.frb.fed.us>.) In this issue, we present two articles that provide some historical perspective on this question.

The first article is written by James Madison, who later became the “Father of the Constitution” and the fourth President of the United States. Madison’s essay, “Money” (p. 3), was written around 1779 and published in 1791, but it rivals the best writing on money today. (We thank Jerry Jordan, president of the Federal Reserve Bank of Cleveland, for bringing this essay to our attention.)

Madison wrote at a time when the newly formed American government was financing its war of independence with, literally, pieces of paper. Since Americans were united on the principle of no taxation without representation, their central governmental body, the Continental Congress, could not easily levy taxes on them. Moreover, since the Congress faced a highly uncertain future, it could not easily borrow either. Therefore, to pay for the war, the Congress finally resorted to issuing pieces of paper money, commonly known at the time as *bills of credit* and later as *continentals*. Ostensibly, holders of continentals could someday exchange them for specie. However, as the war progressed, the war bills mounted, and more and more of this type of money was issued. As that happened, the value of continentals dropped precipitously, until eventually it became virtually zero (hence the expression “not worth a continental”).

The simple quantity theory of money might appear to offer the best explanation for the continental’s depreciation. That is, the value of the continental decreased because the number of these types of pieces of paper increased. But Madison rejects this explanation and argues for a more fundamental theory of the value of money. Such a theory, Madison says, should recognize that an individual nation is just a small part of the world economy. And the theory should recognize that what matters to the value of paper money is not the number of the pieces of paper, but rather the date the government promises to redeem them for specie and the credibility of that promise. In the first article in this issue, speaking from the

18th century, Madison presents a convincing alternative to the simple quantity theory of money.

The second article in this issue reaches even further back into history to attempt to understand money and its value: "The Debasement Puzzle: An Essay on Medieval Monetary History" by Arthur J. Rolnick, François R. Velde, and Warren E. Weber (p. 8). This essay examines a time when kings of England and France profited by *debasing* the currency, or by reducing the amount of silver and gold used to mint the coins of the realm. In the 13th–16th centuries, despite such debasements, people did not stop bringing old coins to the official mint to be turned into new coins. In fact, after debasements, people seem to have brought more old coins to the mint, even though the new coins they received in exchange contained less silver and gold. How could this have happened? Why did people in effect voluntarily give away silver and gold to the sovereign?

This study finds that standard economic theory cannot explain the profitability of medieval debasements. The study considers the most plausible explanations and finds that none can satisfactorily confront the facts. The study concludes that efforts to solve the medieval debasement puzzle will help economists improve their modern models of money.

Arthur J. Rolnick
Editor