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Kentucky's Debt Relief Attempt

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Kentucky's debt relief attempt
By Stephen E. Lile
Special to The Courier-Journal

According to the author of Ecclesiastes, there is nothing new under the sun. It is interesting to contrast policymakers' responses to current "sub-prime" problems with the debt relief plan attempted in Kentucky during the 1820s. A review of the earlier period, often referred to as the Panic of 1819, shows that current debt relief proposals pale in comparison to the 1820s proposals.

The economic environment of the two periods differs drastically. Per capita GDP today, adjusted for inflation, is almost 30 times the level of 1820. In addition, the nature and extent of the debt problems differ. Today's problems are centered in the housing industry; the problem was more general in the 1820s.

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Moreover, the events that created the debt problems differed. Former Federal Reserve chairman Alan Greenspan lays most of the blame on the recent "speculative bubble" in the U.S. housing market, and there is evidence that fraudulent appraisals and failure of loan originators to validate borrower income are contributing factors. Unlike the 1820s, deflation at the present time has been limited to the housing market. In contrast, the problem in the 1820s was economy-wide deflation following the War of 1812. Between 1814 and 1829, prices -- at both consumer and wholesale levels -- fell by roughly 50 percent. Deflation harms debtors by forcing them to repay dollars which have increased purchasing power and that are more difficult to earn. In a very real sense, deflation increases the debt burden borne by debtors. In the 1820s, a movement arose in Kentucky and other states to provide relief to people who had incurred debt when prices and wages were higher. The pro-relief forces in Kentucky's General Assembly enacted "replevin" legislation that gave debtors two additional years to repay loans if creditors refused to accept commonwealth bank notes in payment.

Accepting paper money was not an attractive option for creditors because by June 1820, the value of commonwealth of Kentucky bank notes had fallen, relative to gold, to 50 cents on the dollar. The Kentucky Court of Appeals ruled the replevin legislation unconstitutional. But the court's ruling was not popular, and the Kentucky General Assembly enacted legislation creating a new Court of Appeals to replace the old court.

(Ron Formisano, William T. Bryan Professor of American History at the University of Kentucky, includes this period in his latest book, *For The People: American Populist Movements from the Revolution to the 1850s.*)

Public opinion in Kentucky was split between the new court faction, composed of those who favored debt relief, and the old court faction, made up of those who opposed debt relief. The "New Court-Old Court" controversy in Kentucky raged for some time. Kentucky author Robert Penn Warren used this conflict as a sub-plot in *World Enough and Time*. A common thread both in the 1820s and in the present-day "sub-prime" controversy is the inherent conflict that arises between the interests of debtors and creditors during a period of deflation, which currently is limited to housing prices. The willingness of policy makers and politicians to encourage, if not require, that creditors give debtors

more time to repay and/or lower interest rates may be appropriate in cases involving fraud or in cases where debtors have not fully understood the loan agreements they signed.

In this regard, the Fed's proposals requiring that loan originators fully disclose the terms under which loans must be repaid and its attempt to curb loan originators' inclination to sign up people with questionable ability to repay appear appropriate. While the goal of protecting debtors from exploitation is a noble one, the sanctity of contracts cannot be ignored.

The debate over the gold standard associated with William Jennings Bryan's candidacy for president in 1896 may be viewed as the high point in populist influence in our nation's history. Kentucky's experience in the 1820s illustrates the intensity of the conflict between the interests of debtors and creditors during periods of deflation. Recent events suggest that populist sentiment at the present time does not approach the level seen in these earlier periods.

Stephen E. Lile is professor of economics at Western Kentucky University and a past president of the Kentucky Economic Association.