The Lustre of Gold

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Introduction

At the Democratic Party Convention, in July 1896, William Jennings Bryan delivered a famous speech on the gold standard. "You shall not press down upon the brow of labor this crown of thorns," he orated. "You shall not crucify mankind upon a cross of gold." Many years later John Maynard Keynes, in a speech delivered before the House of Lords, in May 1944, called the gold standard a "barbarous relic." Other economists continue to echo the Keynesian damnation.

Why is a monetary standard viewed with such disfavor? What is it that causes politicians and economists to disparage and decry a monetary system which has been man's standard for thousands of years?

The gold standard is a monetary system in which gold is proper money and all paper moneys are merely substitutes payable in gold. It is as old as man's civilization. Throughout the ages it emerged again and again because man needed a dependable medium of exchange and gold was found to be such a medium. Gold was the most marketable good that gradually gained universal employment—and thus became money. Its natural qualities, i.e., its use as ornaments and jewelry, its easy divisibility, great durability, storability, transportability, and availability made this metal most useful in exchange. The merchants of ancient Greece made payments in gold and silver coins some 2600 years ago. The Romans struck gold coins as early as 217 B.C.

Throughout the ages the gold standard signified sound money. It made the value of money independent of any one government. Surely, it could not achieve the unattainable ideal of an absolutely stable currency. There is no such thing as stability or unchangeability of purchasing power. Nevertheless, gold served remarkably well throughout the ages, which makes it all the more perplexing that it is the center of much heated controversy today. Politicians assail it, cry out against it, and cover it with a smoke screen of ambiguity and confusion which leaves most observers amazed and confused.

In the common confusion the vocal critics of the gold standard may actually aim their aspersion at five different targets: (1) the gold standard in its broadest sense which springs from monetary freedom; (2) the gold standard of the nineteenth century which evolved from diverse currency legislation in the Western World; (3) the gold-coin standard in which gold coins actually are in the people's cashholdings; (4) the gold-bullion standard in which governments keep the gold in their vaults and manage it according to political objectives; (5) the gold-exchange standard in which most of the world's stock of monetary gold is hoarded by one or two governments while others keep their reserves in the form of claims against the former.

Most defenders of the gold standard think of the nineteenth century standard, commonly called the "classical gold standard," when they argue their case. The issuers of money substitutes, whether private or public, kept their currencies at par with gold through unconditional redemption. Where there was a central bank it bought any amount of gold against its currency or deposits at the parity rate, and sold indiscriminately and on demand any amount of gold against its notes or deposits. It thereby rendered no national service, nor "defended" or "protected" the national currency. It merely fulfilled the promise it made when it issued the money substitutes.

The international gold standard evolved during the nineteenth century without intergovernmental treaties and institutions. No one had to make the gold standard work as an international system. When the leading nations of the world had adopted gold as their currency the world had an international money. True, the coins bore different names and had different weights. But this hardly mattered as long as they consisted of gold and could be exchanged freely. After all, an ounce of gold is an ounce of gold whether minted in francs, marks, or sovereigns. The gold standard united the world as international payments ceased to be a problem. It facilitated foreign trade and finance, promoted world-wide division of labor, and thus gave birth to a "world economy." Without the fears of devaluation losses or transfer restrictions, European capital eagerly sought profitable employment opportunities on all continents, developing commerce and industry and thus improving the living conditions of millions of people around the globe.

The classical gold standard made inflationary policies rather difficult and thereby avoided the progressive dissipation of purchasing power to which we have grown accustomed today. In contrast to the fiat standard which builds on ample supplies of government paper, the gold standard forced the issuers of money substitutes to avoid exceeding very narrow limits. Professor William Graham Sumner, the great Yale economist of the pre-Federal Reserve era, vividly described several American experiences with government paper: "Scheme after scheme has been proposed and tried for realizing the gain which it was believed that cheap money could produce for the public; that is, for those who buy and use currency. This gain has been pursued as the alchemists pursued the philosopher's stone, by trial and failure. Whether there be any such gain or not, our attempts to win it have all failed, and they have cost us, in each generation, more than a purely specie currency would have cost, if each generation had had to buy it anew.... The revulsions to which the system was subject overwhelmed us in every decade. The notions on which the system was based are proved to have been delusions, disastrous to everybody concerned, including those who tried to profit by them."

The schemes to which Professor Sumner referred were the calamitous issue of the Continental Dollar by the Continental Congress, the deplorable printing of greenbacks by the Lincoln Administration, the ruinous credit expansions by the First and Second Banks of the United States (1791–1811 and 1816–1836 respectively) and, finally, the silver inflations launched by the Bland-Allison Act of 1878 and Sherman Silver Purchase Act of 1890.

The gold standard that builds on freedom does not fail of its own accord. It springs eternally from freedom but succumbs to force and violence. Its implacable enemy is government in search of more revenue. Gold cannot be made to cover hundreds of billions of dollars of annual budget deficits and support trillions of dollars of federal debt. To facilitate such financing, the government cannot do without a paper money monopoly supported by legal tender legislation which forces everyone to accept the paper issues.

A few foes of the gold standard who do not sanction deficit spending believe that the choice of monetary system is a purely technical question. The monetary arrangement that is most workable on technical grounds, whether fiat money or gold standard, is said to deserve our preference. It is significant that these economists then promptly conclude, "on purely scientific grounds," that the fiat standard is more "workable" and, therefore, more desirable. We readily agree that the fiat standard is more workable for economic planners and money managers. But this is the very reason we prefer the gold standard, preferably the gold-coin standard; its excellence is its unmanageability by government officals. We also deny that the fiat standard compares favorably on purely scientific grounds. Out of the ashes of fiat money the gold standard always springs anew because it is no technical creation of a few expert advisors, but a social institution that flows from individual freedom and inexorable economic principle.

The detractors of the gold standard never tire of arguing that there is just not enough gold in Fort Knox to accommodate the monetary needs of mankind. How can some $400 billion of currency in circulation be redeemed by an official gold stock of $11.054 billion? And how can some $1.15 trillion of demand deposits be payable in gold? These critics do not believe that the paper money now in the cashholdings of the people would remain in use. It would not be replaced by gold but be permitted to function as money side by side with gold. For hundreds of years, both gold coins and silver coins served simultaneously although the exchange ratio varied greatly over the centuries. One metal did not replace the other as long as governments did not fix their prices and set into operation Gresham's Law. Similarly, gold coins would not replace Federal Reserve notes and Federal Reserve notes would not displace gold coins if both were treated equally under law and their exchange rates left to the judgments of the market. One would always be exchangeable for the other.

No sober economist wants to revolutionize economic life through a radical monetary reform. He would not want to make gold the only money, forbidding government issue of any kind and suppressing banknotes and demand deposits used as media of exchange. Such a reform would require radical government intervention and greatly reduce the country's stock of money. Prices and wages would have to be cut drastically, which no modern society could withstand in an orderly fashion.

To reflect upon a return to any type of gold standard is to engage in daydreaming. Yet, as dreams have no true perception of time, we may yet reflect on the return without a precognition of the time of its return. It will come, we are convinced, as soon as the present fiat standard has run its natural course of chronic inflation and depreciation and the apparatus of state and politics has spent its last batch of worthless legal-tender paper.

We may ponder about the triumphant return of gold by studying its vivifications in the past. After all, it has been the monetary standard for more than 2000 years. We know of four particular situations from which it rose again and again: (1) monetary freedom, (2) failure of the bimetallic standard, (3) passage of resumption acts, and (4) government substitution of gold for other monies.

The last situation existed in a few countries which endeavored to imitate the financial success and progress of the gold standard nations. When the industrialized countries, such as Great Britain and France, prospered with the gold standard, others adopted it through quick *substitution*. Their approach was that of latecomers who for good reasons imitated the successful leader. In 1875 Germany turned to Great Britain, the chief commercial nation, and largely copied its banking the value of the notes, the Federal Reserve System may want to make its own money freely convertible into gold. It may adopt the going exchange ratio between the two as the legal parity and then secure unconditional convertibility of its money into gold. This step, which does not materially enhance our monetary freedom, would merely subject government currency to the discipline of the gold standard.

Step by step the federal government has assumed control over our monetary system. It thus captured a potent source of revenue and a vital command post over the economic lives of its people. This is why every friend of freedom is dedicated to the restoration of free money which is also sound money. It is the gold standard.

—HANS F. SENNHOLZ

I. THE REJECTION OF GOLD

What's Missing from This Picture?

by Mark Skousen

The New York Times

BUSINESS Digest

The Markets Last Week

DOW	DOLLAR	OIL	BONDS
30 Industrials	vs. Japanese Yen	Nymex Spot	30-Year Treasuries
3,773.45 +1.23	103.60 Yen -1.75 Yen	$18.48 +$0.36	7.31% +0.04

The New York Times, that bastion of conventional wisdom, is missing a key element in its digest of financial markets. It leaves out the single most significant asset that each day reflects accurately the level of economic, political, and military stability around the world.

The commodity? Gold!

Instead, *The Times* uses oil, a crude and misleading substitute commodity, to measure inflation. Apparently the Midas metal doesn't "fit" the *Times'* definition of headline news.

The New York Times isn't the only establishment publication to fundamentally misread how the world works. *The Wall Street Journal's* front-page summary of the markets highlights stocks, bonds, currencies, and commodities, including oil. There's plenty of room to list the yellow metal, yet gold is omitted deliberately.

The reason is simple: The establishment prefers fiat money over

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the gold standard. It wants government rather than the market to maintain authority over money. It doesn't want to legitimatize a "non-performing" asset that might be warning of trouble down the road. The establishment is quite happy that the "barbarous relic" has been relegated to the commodity trading pits. "Gold is just another commodity," they say.

Oil—A Misleading Substitute

The majority view is that gold is an impractical monetary metal unrelated to real economic activity. Oil is a much better choice, they say, because energy is a critical determinant of the ups and downs of the economy. After all, didn't the energy shocks precipitate the recessions of 1973–75, 1979–82, and 1991–92?

Well, not exactly. All major industrial nations suffered sharp economic downturns in 1973–75, the time of the first energy crisis, but since then the relationship between the price of oil and economic performance has been cloudy. For example, Japan, which imports virtually all its oil, avoided the 1979–82 recession even though crude prices more than doubled. Germany, also a heavy oil importer, escaped relatively unscathed, while the United Kingdom, a net oil exporter, suffered the worst recession among industrial nations in 1979–82.

In 1986, crude prices fell by half, from $28 a barrel to $14. According to the establishment view, lower oil prices should have boosted economic growth. "If energy were an important ingredient in business cycles, you should have had a worldwide boom," declares energy economist Douglas Bohi. "There wasn't one." (*Forbes*, January 31, 1994, p. 66)

Bohi, director of the energy and natural resource division of Resources for the Future in Washington, D.C., is one of the few economists who have studied carefully the impact of energy costs on economic growth. After examining the evidence in the United States, Japan, Germany, and the UK, he concludes that oil prices did not have the impact on economic activity that most economists believed.[1] Bohi discovered that energy accounts for only 3–4 percent of the total cost of producing goods and services in the United States. Oil itself accounts for only 2 percent. The cost of energy is simply too small to have a significant impact on economic growth. Also if the oil price goes from $18 a barrel to $14 a barrel, that's a 22 percent drop for oil—but the reduction in costs for the economy as a whole is less than one-half of 1 percent. By the same token, Bohi does not expect the current increase in oil prices to reduce economic growth.

The Tie Between Money and Gold

If oil isn't the driving force behind economic boom and bust, what is? Bohi is convinced that monetary policy has a much broader influence on economic activity. Higher energy prices often reflect a general inflation, forcing most central banks to tighten money and bring about a recession. But not always. In 1979–82, when most world economies were suffering a recession, Japan did not impose a tight money policy and therefore escaped recession.

What better monitor of monetary inflation exists than the price of gold? There has been a strong correlation over the years between monetary policy and the price of gold. When central banks adopt easy-money policies, gold tends to rise. When they impose tight money, gold tends to decline.

The Midas metal is an ideal compass for monetary policy. Gold has certain unique features that make it the most sensitive measure of inflationary fears. It is not just another commodity. Unlike oil, soybeans, or pork bellies, gold is indestructible and is never consumed. Thus annual production is only a tiny fraction of the world's total stock. Annual production seldom exceeds 2 percent of the outstanding gold supplies. The fiat money supply may rise rapidly or fall sharply, depending on the whims of central bankers (usually more the former than the latter). But gold supplies never decline and seldom increase significantly. Even during the gold rushes in California, Alaska, Australia, and South Africa, world gold supplies never increased by more than 5 percent per year.[2]

In his exhaustive historical and statistical study of the purchasing power of gold, Berkeley economist Roy W. Jastram concludes, "Gold does maintain its purchasing power over long periods of time. . . . Its purchasing power in the middle of the twentieth century was very nearly the same as in the midst of the seventh century."[3] A $20 St. Gaudens gold coin would buy a tailor-made suit in the 1920s. That same coin, worth over $500 today, can still buy a tailor-made suit.

In short, gold is as steady as a rock, a standardbearer by which all currencies can be accurately measured. If the price of gold is volatile, it is not because gold itself is volatile, but because government policy is reckless and unstable.

Sharply rising gold prices are a sign of trouble ahead, whether it be inflation, war, or some other man-made crisis. Lower prices mean a return to normalcy and the avoidance of chaos or war. Stable gold prices suggest genuine prosperity and stability. Skyrocketing gold prices in the 1970s reflected a high level of inflation and financial crisis. The decline in gold in the 1980s suggested a disinflationary environment. The recent rise of gold in the 1990s implies a growing fear of more inflation. It is not surprising that Alan Greenspan and other central bankers are using the price of gold as an important gauge of inflationary expectations. Take heed, Wall Street!

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1. Douglas R. Bohi, "On the macroeconomic effects of energy price shocks," *Resources and Energy* 13 (1991), pp. 146–62.

2. See chapter 11, "The Gold Standard," in my book, *Economics on Trial* (Irwin Professional Publishing, 1991, 1993), pp. 128–44. In this chapter, I outline all the arguments for and against the gold standard, and expose several common myths about the yellow metal.

3. Roy W. Jastram, *The Golden Constant: The English and American Experience, 1560–1976* (New York: John Wiley & Sons, 1977), p. 189.

Gold Has Risen—But Remains the Same

by Donald H. McLaughlin

Not very long before his untimely death, Jacques Rueff in his fluent but slightly accented English commented that further debates on the status of gold in the monetary system seemed hardly necessary for "events were taking over." And indeed they have.

With surprisingly little fanfare, gold is maintaining its firm place in the world's reserves where it commands a respect far greater than any of the fiat currencies that pass for money these days. That this could happen in spite of the persistent anti-gold position of successive United States Administrations over more than four decades still further emphasizes its durability as money and the firm faith all manner of men have in it—apart from those who rule in Washington and bankers whose skill is largely in manipulation of the technicalities of increasingly complex instruments of credit.

The long record of human history surely reveals that when money, whether in the form of precious metal or credit, is debased and abused, a nation or even the entire world suffers. Today we are in a period of such misbehavior and mismanagement but the persistent strength of gold even under these trying conditions offers hope that, if it is used wisely and effectively, order can eventually be restored.

The principle currently known as Gresham's Law has been recognized for tens of centuries. It is as sound today as it was when Aristophanes used it in a metaphor to illustrate how good men were driven from public life in Athens in the same way that untrustworthy money forced better money out of circulation. At about the same time, Aristotle stated the concept more logically perhaps, but less poetically. Today, the principle is well understood in most high circles in Europe. In 1973, Milton Gilbert noted that gold remained unused in the vaults of the central banks—but not unloved. In America, unfortunately, the money managers and politicians seem less familiar with the classics.

Since then, eighteen governments (but not the United States) are valuing their official gold stocks closer to market prices—or more

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rationally expressed are putting the currencies they hold in a realistic ratio to gold. Furthermore, by utilizing gold at a market-related rate, the recently created European Monetary System has provided the Common Market countries with a mechanism for employing their gold reserves effectively in foreign exchange transactions. These wise moves tend to reduce the discrepancies that tend to immobilize gold in response to Aristophanes' or Gresham's Law, even though they do not remove all fears arising from the continued depreciation of fiat money.

According to our official policy, gold has now been demonetized and henceforth flat currencies and credit instruments will be relied upon exclusively to perform the services expected from money. Their most distinctive quality unfortunately appears to be a tendency to decline in purchasing power, a very troublesome defect in anything that claims to be money.

"Paper Gold"

To overcome the restrictions imposed by national sovereignty and political borders, a strange device known as Special Drawing Rights was created by the International Monetary Fund, at first vaguely attached to gold and now defined in terms of a "basket" of currencies, all of which are depreciating in real value though at different rates. In essence, the SDRs were an attempt to create an international form of fiat money. For a time, their enthusiastic supporters even referred to them as "paper gold." So far, their acceptance even under duress has been restrained, to put it mildly.

Even though "demonetized" by the dictum of the United States, nearly a billion troy ounces of gold are still firmly held in the official reserves of the Western nations, rather a substantial amount to declare was no longer legal money. This obvious preference for gold should be rather disquieting for those who regard Gresham's Law as obsolete.

A monetary system based exclusively on credit possibly could be made to function, if managed by a small group of knowledgeable men of intelligence and integrity, with complete political independence and power, as well as mastery of the technical intricacies of money and finance and unprejudiced understanding of both national and international conditions that influence policies. Until such paragons can be brought into existence, however, it will be safer to retain the discipline of gold as an element of the monetary system than to expect that those who manage money based on credit and on government fiat will do so with sufficient skill that it will in time attain the confidence now commanded by gold. From the record of centuries this can hardly be regarded as even a forlorn hope.

Significant Experiments

In the natural sciences, ideas and hypotheses are tested by controlled experiments and confirmed or rejected by their outcome. In the social sciences such definitive tests are rarely possible. But with regard to gold's place in the monetary system there have been episodes that have provided results of unusually positive sort.

The first that should have been regarded as a significant experiment was the effort of several governments at the instigation of the United States 22 years ago to maintain the official price of gold at $35 per ounce by making gold available at this rate on the London market to all who desired to purchase it. It was a costly experiment. After several billion dollars had been spent with little effect, except to transfer gold into hands eager to accept it at a bargain price, the drain on gold reserves soon became too apparent and excessive to be tolerated and the sales were abandoned close to the Ides of March in 1968, with self-serving explanations that the mission had been accomplished. It was accompanied by the abrupt announcement that sales and purchases of gold by the participating governments would be discontinued at the official rate except between Central Banks.

The restrictions on ownership of gold were not repealed but miners and others with gold to sell were permitted to do so on the market to specifically authorized purchasers for whatever price their metal might command. In spite of predictions by several prominent economists and politicians that without the support of the dollar the gold price would sink to much lower levels, this didn't happen. After a short period of little change, the price started to rise, and this trend has continued with the usual market swings but with each new peak rising above the last. The results of this experiment alone should have been accepted as proof that the price of gold can not be tied to an unconvertible currency, subject to manipulations that cause it to depreciate in value.

A second test with equally decisive results occurred during the international financial turmoil in 1971 that led to the closing of the "gold window" on August 15th, when the United States Administration announced that it would (or could) no longer redeem dollars held by Central Banks in gold at the official price which by that time had been raised from Roosevelt's $35 an ounce to the strangely precise figure of $42.22 per ounce. The magnitude of claims in dollars had for some time made it apparent that the pledge to honor them in such terms had become impossible to meet. In effect, the United States admitted bankruptcy, as far as its obligation was concerned to redeem such dollars in gold at the official rate. Again it was made clear except to those whose anti-gold fixation made them blind to realities that a fiat dollar can not control the worth of gold.

The third experiment was the attempt to check the rising price of gold on the market and the weakness of the dollar that it revealed by substantial sales of gold from the reserves of the United States Treasury and the gold held by the International Monetary Fund. Whatever those who initiated this policy had in mind, it is unlikely that they anticipated or desired that the market price of gold would rise in spite of the large quantities they disposed of.

Furthermore, in the course of these sales, the Central Banks of Europe have not reduced their stocks of gold and indeed have firmly held the gold returned to them by the IMF which hardly seems in accordance with the decision, sponsored by the United States, that gold had been demonetized. Even a number of the Developing Countries have preferred to accept their allotment of the IMF sales in gold rather than in the paper in which the so-called aid would have presumably been paid to them.

In the natural sciences, when the outcome of a series of experiments is so definite, even the most ardent advocates of the ideas being tested usually accept them as conclusive. Unfortunately, the anti-gold group in power in Washington continues to ignore their clear message.

An Encouraging Sign

Restoration of the gold standard, which would require redefinition of the major currencies in terms of gold and establishment of unrestricted convertibility at new fixed rates, hardly seems attainable until the abuses of credit and the increasing worldwide inflation have been corrected and ended. It is still an objective worth striving for but to achieve it would require more drastic and disciplined action than our electorate and our politicians seeking re-election are likely to accept in the foreseeable future.

Even though restoration of the gold standard for the time being may be ruled out, a new monetary system appears to be evolving in which gold will continue to have an important place and be a strong and stabilizing element. Progress toward this end is revealed, not only by the firm retention of gold stocks by the major reserve banks—with the exception of the ill-considered sales by the U.S. Treasury and its sycophant, the IMF—but also by the removal of restrictions on ownership of gold by citizens and the issuance by many nations of gold coins whose worth is primarily determined by their weight in gold. Among them, the one-ounce Krugerrand, various handsome Mexican coins with gold content stated in metric units, and new coins struck from old dies such as the Austrian Krona are notable examples. The designations in national currency units that some still bear are obviously meaningless. The principal contribution by the issuing government is its seal that justifies confidence that the gold content is as stated.

A timely step that would simplify and create better order, as well as strengthen the function of gold in the evolving monetary system, would be the creation and dissemination of a coin of uniform gold content, fineness and size that could become a standard by which other monetary devices could be measured.

A Coin of Uniform Weight

With one gram of gold adopted as the basic unit, a coin containing 10 grams of gold (0.322 ounces troy), in the 90 percent alloy with copper commonly used in coinage to provide hardness, would be a convenient size, slightly larger than the old American five-dollar gold coin or the British sovereign.

The acceptance of such a golden unit would probably be facilitated if the coins were minted by each of the major nations and their authenticity established by them. Uniformity in design would not be necessary. Their essential quality would be the common gold content. Competition in beauty and esthetic appeal would have much to commend it.

If an appropriate name for such 10 gram gold coins could be found that would be easily comprehended internationally, so much the better, but if not, there would be no harm in each nation using a term based on some aspect of the design in which it took pride.

The unit of measurement, however, should be one gram of gold which could be abbreviated as 1 gm Au, a designation that would be understood and translated into any language in this age of common scientific nomenclature. The 10 gm Au coin which could be acquired and handled would give the unit a tangible reality. This is a quality that Special Drawing Rights can never acquire, in spite of the presumption of their creators in calling them "paper gold."

Leave It to the Market

The rigid discipline of the gold standard, however, need not be imposed until desired. No tie need exist between any national fiat currency and the golden units. Any country would be completely free to indulge in whatever political, social or economic policies (or nonsense) it desired. The only restraint imposed by the gold in the reserves and the golden coins would be the effect on the market price of the currencies expressed in grams of gold. The objectionable term "the price of gold" could be abandoned, with currencies, as well as commodities and services, priced on the market in a unit containing a specific weight of gold. The plethora of quotations of currencies—dollars, marks, francs, yen, sovereigns, and the like—expressed in each other, all variables measured by other independent and sometimes erratic variables—could be eventually abandoned. It would do no harm to continue such exchange quotations as long as the momentum of tradition required. But they should be accompanied by quotations in the proposed gold units, which would reveal the status of each national currency in one common standard.

Abuses of credit and excesses in creation of fiat currencies based on debt could hardly be concealed, for they would be promptly revealed in the price of the paper in gold. The economy obviously needs both elements—credit and stable money—but with gold effectively utilized in the monetary system a badly needed base would be provided upon which deficits, changes in quantity of fiat money and inflation, among other evils of the times, could be clearly revealed.

The Individual's Choice

The individual should of course have the privilege of acquiring the golden coins at rates determined by the market price of the currency he possessed. The denial of such a freedom by any government would in all probability be immediately and unfavorably reflected in the price of the currency.

The right to buy gold—especially coins—actually puts into the hands of anyone desiring to do so, a very special commodity that has long possessed the essential qualities of money, viz., a medium of exchange, a means of measuring the relative value of other commodities and services, and a safe way to store wealth. The latter quality is not possessed today by any national currency.

The existence of a dominant gold coin—such as the one proposed, containing 10 grams of gold—would provide a simple constant, so to speak, against which all currencies could be measured with ease and confidence. It would, of course, not be a constant of value in the strict sense the term is used in mathematics and the physical sciences, but it would at least stand for a fixed quantity of gold. No commodity—not even gold—can claim to be invariable in worth and to provide an unchanging base for measurement of values of materials and services, but over the centuries gold has come nearest to doing this, as Roy Jastram has so well demonstrated in his recent book, *The Golden Constant: The English and American Experience, 1560–1976* (John Wiley & Sons, Inc., 1977).

Three years ago, the title of a speech I gave at an annual gathering in a redwood grove in California was "The Resurrection of Gold Without Benefit of Clergy." Since then, in spite of the high priests in the Treasury and elsewhere in the government, Gold Has Risen as the dollar and other fiat currencies have deteriorated, and yet its worth, expressed in the cost in gold of a good dinner, a suit of clothes, a haircut, or even a barrel of oil has not changed much. The Resurrection of Gold should now be regarded as demonstrated and as an important advance toward a sounder monetary system, with clear distinction between the status of money based on the relatively stable worth of the traditional monetary commodity gold and the variable national currencies that represent nothing more than credit in one form or another.

If this is coming about without formal conferences and long debates, so much the better. The open market even for currencies is a masterful device and one that is essential for economic freedom. It will continue to prevail and exert its influence even over the value of unconvertible currencies. With the variety of trustworthy coins now available, gold is already gaining more and more recognition as money in which currencies can be measured, and if a gold coin of established quality gains wide acceptance, the monetary system will be approaching a status in which there will be far better hope of attaining stability than has existed since World War II.

Fiat Money Rejected

How the present uncertainties will end is hard to predict. In the last few months, the market "price" of gold has risen at an unexpectedly rapid rate. There are undoubtedly some undesirable factors involved, such as excessive transactions in gold futures, but by and large the accelerating rate at which gold has risen is to a much greater extent a result of the growing concern about the domestic economy and the deteriorating international situation, not to mention the persistence of deficit financing and the resulting unavoidable inflation. If the price of currencies were quoted in units of gold rather than the other way around, the instability attributed to gold by some of its detractors would be more clearly revealed as weaknesses in the artificial devices we now must use as money.

I do recall, however, that a few years ago when I was asked in a radio interview how high the price of gold would go, I replied that it had approached infinity in German marks in 1923. That need not and should not happen in America but with a few more years of persistent deficits and unwillingness to forgo extravagances in our way of life, it is a possibility that should not be lightly dismissed.

Stop Deficit Spending and Monetization of Debt

The first essential step to prevent such a disaster is to keep expenditures by the government within its income and to end monetization of debt. The second even more serious need is to find the least painful means of dealing with the tremendous and still mounting debt—domestic and international—that has now reached magnitudes that make its retirement by conventional means practically impossible. Reduction by default and/or by inflation are unfortunately much easier. Repudiation of debt in a more dramatic way would be the substitution of a new dollar for a number of existing dollars. Unfortunately this procedure is not without precedent. In 1926–28 Poincaré and in 1958 Charles de Gaulle created new francs for the then current francs that became known as "ancien francs." The creation of the Deutsche Mark is another example. These procedures were drastic though probably unavoidable. Such moves, however, in general are likely to be a mixture of good and evil—probably more of the latter than the former. But, if a country is forced to "bite the bullet" to correct past mistakes and excesses, liquidation of excessive debt by payment of a small fraction in sound money may not be the worst way and might even be the best way if the new currency—or the new dollar or whatever it might be called—were made convertible into gold, when a durable rate could be established.

None of these disturbing developments is inevitable, but unless the American people and their leaders who are dependent on their votes have the will to put our house in order and accept the austerity that must be faced, events will indeed take over—and they are not likely to be pleasant.

Where the Monetarists Go Wrong

by Henry Hazlitt

In the last decade or two there has grown up in this country, principally under the leadership of Professor Milton Friedman, a school calling itself the Monetarists. The leaders sometimes sum up their doctrine in the phrase: "Money matters," and even sometimes in the phrase: "Money matters most."

They believe, broadly speaking, that the "level" of prices of commodities and services tends to vary directly and proportionately with the outstanding quantity of money and credit—that if the quantity of money (comprehensively defined) is increased 10 percent, the prices of commodities will increase 10 percent; that if the quantity of money is doubled, prices will double, and so on. (This of course is on the assumption that the quantity of goods remains unchanged. If this is increased also, the rise in prices due to a greater supply of money will be correspondingly less.)

This is called the Quantity Theory of Money. It is not new, but very old. It has been traced by some economic historians as far back as the French economist Jean Bodin in 1566, and by others to the Italian Davanzati in 1588. In its modern form it was most elaborately presented by the American Irving Fisher in *The Purchasing Power of Money* (1911) and in later books.

The monetarists have added some refinements to this theory, but principally they have devoted themselves to giving it detailed statistical support, and drawing much different conclusions than did Fisher himself regarding an appropriate monetary policy.

When Fisher began writing, the gold standard was still dominant in practice. He proposed to keep it, but with a radical modification. He would have varied its gold content according to the variations of an official price index, so that the dollar should represent, instead of a constant quantity of gold, a constant quantity of purchasing power.

Henry Hazlitt (1894–1993), noted economist, author, editor, reviewer, and columnist, was well known to readers of the *New York Times, Newsweek, The Freeman, Barron's, Human Events*, and many other publications. Best known of his books are *Economics in One Lesson, The Failure of the "New Economics," The Foundations of Morality*, and *What You Should Know About Inflation*. This article is reprinted from the August 1976 issue of *The Freeman*.

Milton Friedman rejects the gold standard altogether. He would substitute for it a law prescribing a precise quantitative issuance of irredeemable paper money:

> My choice at the moment would be a legislated rule instructing the monetary authority to achieve a specified rate of growth in the stock of money. For this purpose, I would define the stock of money as including currency outside commercial banks plus all deposits of commercial banks. I would specify that the Reserve System shall see to it that the total stock of money so defined rises month by month, and indeed, so far as possible, day by day, at an annual rate of X percent, where X is some number between 3 and 5. The precise definition of money adopted, or the precise rate of growth chosen, makes far less difference than the definite choice of a particular definition and a particular rate of growth.[1]

It is with considerable reluctance that I criticize the monetarists, because, though I consider their proposed monetary policy unfeasible, they are after all much more nearly right in their assumptions and prescriptions than the majority of present academic economists. The simplistic form of the quantity theory of money that they hold is not tenable; but they are overwhelmingly right in insisting on how much "money matters," and they are right in insisting that in most circumstances, and over the long run, it is the quantity of money that is most influential in determining the purchasing power of the monetary unit. Other things being equal, the more dollars that are issued, the smaller becomes the value of each individual dollar. So at the moment the monetarists are more effective opponents of further inflation than the great bulk of politicians and even putative economists who still fail to recognize this basic truth.

I must add that I also regret that I take issue on this important question with Milton Friedman, with most of whose great contributions to economics, and especially to the defense of the free market, I have long been in full and admiring agreement. I hope that no reader of this article will get the impression that I fail to appreciate the extent to which Dr. Friedman's lucidity, persuasiveness, and penetration have put us all in his debt.

Let us begin by examining what is wrong with "the" quantity theory of money—which might rather be called the strict or mechanical quantity theory of money. It rests on greatly oversimplified assumptions. As formulated by Davanzati in 1588, the total existing stock of money must always buy the total existing stock of goods—no more, no less. So if you double the stock of money, and the supply of goods remains the same, you must double the average level of prices. Each monetary unit must then buy only half as much as before. As formulated by its modern exponents, the assumptions underlying the strict quantity theory of money are not much advanced from this. As "money is only wanted to buy goods and services," they argue, this proportional relationship must hold.

But this is not what happens. The truth in the quantity theory is that changes in the quantity of money are a very important factor in determining the exchange-value of a given unit of money. This is merely to say that what is true of other goods is true of money also. The market value of money, like the market value of goods in general, is determined by supply and demand. But it is determined at all times by *subjective* valuations, and not by purely objective, quantitative, or mechanical relationships.

Three Stages of Inflation

In a typical inflation we may roughly distinguish three stages. In the first stage prices do not rise nearly as fast as the quantity of money is being increased. For one thing, if there has been some slack in the economy, purchases made with the new money may mainly stimulate increased production. (This is the point so emphasized and overemphasized by Keynes. It can happen, however, only in the early stages of an inflation, and only in special circumstances.)

Apart from this possible early stimulative effect of an inflation, most people at first do not realize that an inflation of the currency has taken place. Some prices have risen, but many people, comparing them with the prices to which they have become accustomed, assume that these new prices are too high, and will soon fall back to "normal." They hold off buying, and increase their cash holdings. As a result, prices do not at first rise as much as the quantity of money has been increased.

If the inflation is slow and has occasional stops, prices tend to catch up with the rate of increase in the money supply, and for a while there may be a result much like what the strict quantity theory of money would predict, in which prices tend to rise roughly in proportion to the increase in the money stock.

But if the inflation (meaning the increase in the quantity of money) continues, and particularly if it accelerates, people begin to fear that it is a deliberate governmental policy, that it will go on indefinitely, and that prices will continue to soar. So they hasten to spend their money while it still has some value—i.e., before prices rise still further. The result is that prices begin to rise far faster than the quantity of money has been increased, and finally far faster than it even can be increased.

So we have the paradoxical result that, in a hyperinflation, when the government is grinding out new currency units at an astronomical rate, prices rise so fast that the existing quantity of money is not sufficient for the volume of transactions, and we have mounting complaints of a "scarcity" of money.[2] In the final stage of the German inflation of 1923, for example, the entire stock of paper money, though with a stamped value billions of times higher, had a gold exchange-value of only one-sixtieth of what it had before the inflation started. Of course the paper mark finally became utterly valueless, as had French assignats in 1796 and the American Continental currency in 1781.

It is for this reason that all inflation must finally have a stop. But the point I am stressing here is that the strict quantity theory of money is not true (though it may appear to be true under certain circumstances and for limited periods). So far as quantity is concerned, it is the *expected future* quantity of money, rather than the immediately existing quantity, that determines the exchange value of the monetary unit.

Quality Affects Value

The value of money, however, is determined not merely by its quantity—even its expected future quantity—but also by its quality. Currency issued by a shaky government, for example, will not have as much value, other things being equal, as currency issued by a strong "legitimate" government of long standing.

In recent years we have witnessed much more familiar illustrations of the effect of qualitative deterioration in the monetary unit. Scores of nations have repeatedly announced "devaluations" of their currency. Prices have begun to rise in those countries the very next day, before there has been any chance to increase the quantity of money any further.

Still more striking is what has happened when nations on a gold standard have announced their abandonment of it. The United States went off the gold standard in March of 1933. By 1934, the average of wholesale prices had increased 14 percent over 1933, and by 1937, 31 percent. The U.S. formally abandoned gold convertibility again in August, 1971. Wholesale prices had actually fallen by 2 percent from

August of the year before; but by August of the year later they increased by 4.35 percent. With all gold discipline removed, wholesale prices rose more than 13 percent between 1972 and 1973, and more than 34 percent between 1972 and 1974.

One of the most striking illustrations of the importance of the *quality* of the currency occurred in the Philippines at the late stage of World War II. The forces under General Douglas MacArthur had effected a landing at Leyte in the last week of October 1944. From then on, they achieved an almost uninterrupted series of successes. A wild "inflation" broke out in the capital city of Manila. In November and December 1944, prices in Manila rose to dizzy heights. Why? There was no increase in the money stock. But the inhabitants knew that as soon as the American forces were completely successful their Japanese-issued pesos would be worthless. So they hastened to get rid of them for whatever real goods they could get.[3]

Quantity Theory of Money

What has helped to keep the strict mathematical quantity theory of money alive, in spite of experiences of the kind just cited, is the famous Irving Fisher equation: MV = PT. In this M stands for the quantity of money, V for its "velocity of circulation," P for "the average price level" of goods and services, and T for the "volume of trade," or the quantity of goods and services against which money is exchanged.

So when the quantity of money remains unchanged, for example, and prices start to soar (or any similar discrepancy occurs) the quantity theorists are not at all disconcerted. They are provided in advance with an easy alibi: the "velocity of circulation" of money must have changed enough to account for the apparent discrepancy. True, this requires them sometimes to assume some remarkable things. I pointed out a few pages back that in the final stage of the German inflation of 1919–1923 the entire stock of paper money had a gold value only one-sixtieth that of the far smaller nominal money stock before the inflation began. This would require us to assume that the average "velocity of circulation" had increased in the meanwhile sixty times.

This is not possible. The concept of the "velocity of circulation" of money, as held by the quantity theorists and embodied in the Fisherine equation MV = PT, is quite fallacious. Strictly speaking, money does not "circulate": it is exchanged against goods. When the turnover of money increases, the turnover of goods increases correspondingly.

(We have here an illustration of how the use of mathematical symbols may mislead an economist even in an elementary application. If MV = PT, and you double V then it seems to follow that 2 MV =2 PT, and that this can be read as meaning that doubling V can double P. But if we spell out the equation as M x V = P x T, it can be seen that M x 2V does *not* necessarily equal 2P x T, but more likely P x 2T. In fact, the equation MV = PT does not mean what Irving Fisher and his disciples thought it meant. They considered MV the money side of the equation and PT the "goods side." But as Benjamin M. Anderson, Jr., long ago pointed out in a shrewd analysis,[4] "Both sides of the equation are money sides.... The equation asserts merely that "what is *paid* is equal to what is *received*.")

Velocity of Circulation—Geographical Variations

There are no reliable statistics on the "velocity of circulation" of hand-to-hand currency.[5] But we do have figures on the annual rate of turnover of demand bank deposits. As bank deposits in the United States cover about eight-ninths of the media of payment, these figures are an important index.

What is most striking, when we examine these figures, is first of all the wide discrepancy that we find between the rate of turnover of demand deposits in the big cities, especially New York, and the rate that we find in 226 other reporting centers. In December, 1975, the average annual rate of turnover of demand deposits in these 226 small centers was 71.8. In six large cities outside of New York it was 118.7. When we come to New York City itself, the rate was 351.8. This does not mean that people in New York were furiously spending their money at nearly five times the rate of people in the small centers. (We must always remember that each individual can spend his dollar income only *once*.) The difference is accounted for mainly by two factors. The big corporations have their headquarters or keep their banking accounts in the big cities, and these accounts are much more active than those of individuals. And New York City especially, with its stock exchanges and commodity exchanges, is the great center of speculation in the United States.

Though the velocity of circulation of money (mainly in the form of bank deposits) increases with speculation, speculation itself does not indefinitely increase. In order for speculation to increase, willingness to part with commodities must increase just as fast as eagerness to buy them. It is rapidly changing ideas of commodity values—not only differences of opinion between buyer and seller but changing opinions on the part of individual speculators—that are necessary to increase the volume of speculation.

The value of a commodity, a stock, or a house does not change in any predictable relationship to the number of times it changes hands. Nor does the value of a dollar. When 100 shares of a stock are sold, their value is not thereby necessarily depressed, because the shares are also bought. Every sale implies a purchase, and every purchase a sale. When a man buys a commodity, he "sells" money; but the seller of the commodity "buys" money. There is no necessary connection whatever between changes in the "velocity of circulation" of money and changes in the "level" of commodity prices. "Velocity of money" is merely a *resultant* of a complex of other factors, and not itself a *cause* of any important change whatever.[6]

Price Levels and Indexing

Still another fallacy into which many quantity theorists (and not they alone) are apt to fall is the concept of a price "level." This is the partly unconscious assumption that when prices rise during an inflation they rise uniformly—so that when the official consumer price index has risen over a given period by, say, 10 percent, all prices in that period have risen just about 10 percent. This assumption is never made explicitly, otherwise it would be much easier to correct. But it is latent in the discussions of most journalists and politicians. It therefore leads them greatly to underestimate the harm done by inflation. For the greater part of that harm is precisely that different people's prices, wage-rates, and incomes go up so unevenly and at different rates. This not only means great windfalls for some and tragedies for others, but it distorts and disrupts economic relationships. It unbalances, reduces, and misdirects production. It leads to unemployment and to malemployment. And attempts to correct this through such schemes as "indexing" only tend to increase the harm.

I do not mean to suggest that all those who call themselves monetarists make this unconscious assumption that an inflation involves this uniform rise of prices. But we may distinguish two schools of monetarism. The first would prescribe a monthly or annual increase in the stock of money just sufficient, in their judgment, to keep prices stable. The second school (which the first might dismiss as mere inflationists) wants a continuous increase in the stock of money sufficient to raise prices steadily by a "small" amount—2 or 3 percent a year.

These are the advocates of a "creeping" inflation. The late Professor Sumner H. Slichter of Harvard was the most prominent of these. He thought that a planned price rise of 2 or 3 percent a year would be about right. He forgot that even if the government could hold an inflationary price rise to a rate of only 2 percent a year it would mean an erosion of the purchasing power of the dollar by about one-half in each generation.

And it would not produce the results that Slichter expected of it. For inflation is always a swindle. It cannot be candidly and openly planned. People everywhere will take compensatory actions. If a price rise of 2 percent a year is announced as the official goal, lenders will immediately add 2 percent to the interest rate they would otherwise have asked, union leaders will add 2 percent to the wage increase they would otherwise have demanded, and so around the circle. Not only will the "creeping" inflation begin to race, but its effect on production and employment will be disruptive rather than stimulative.

But our concern here is not with the advocates of creeping inflation (in the sense of creeping price rises, at no matter how low an annual rate) but with the monetarists strictly so-called—that is, with those who recommend instructing government monetary authorities to increase the monetary stock every year only enough to keep prices from falling. What increase do the monetarists think sufficient to accomplish their purpose?

Problems of Determining How Much Inflation Is Enough

Let us return to the prescriptions of the acknowledged leader of the school, Professor Milton Friedman. We have seen that, in 1962, in his *Capitalism and Freedom,* he recommended that the Federal Reserve authorities be instructed to increase the total stock of money (including "all deposits of commercial banks") at an annual rate of somewhere between 3 and 5 percent. But three years later, in a memorandum prepared for a consultant's meeting with the Board of Governors of the Federal Reserve Board on October 7, 1965, we find him recommending "as the new target a rate close to the top of the desirable range of 4 to 6 percent for M-2" (currency plus demand and time deposits).[7]

Still later in 1969, we find him scaling down this rate considerably, though with misgivings and vacillations:

"A policy fairly close to the optimum would probably be to hold the absolute quantity of money constant. . . . However, this policy, too, seems to me too drastic to be desirable in the near future although it might very well serve as a long-term objective."

He then discusses the relative advantages of a 1 percent and of a 2 percent rate, and then goes on:

> I do not want to gloss over the real contradiction between these two policies, between what for simplicity I shall call the 5 percent and the 2 percent rules. There are two reasons for this contradiction. One is that the 5 percent rule was constructed with an eye primarily to short-run considerations, whereas the 2 percent rule puts more emphasis on long-run considerations. The more basic reason is that I had not worked out in full the analysis presented in this paper when I came out for the 5 percent rule. I simply took it for granted, in line with a long tradition and a near-consensus in the profession, that a stable level of prices of final products was a desirable policy objective. Had I been fully aware then of the analysis of this paper, I suspect that I would have come out for the 2 percent rule. . . .
>
> Either a 5 percent rule or a 2 percent rule would be far superior to the monetary policy we have actually followed. The gain from shifting to the 5 percent rule would, I believe, dwarf the further gain from going to the 2 percent rule, even though that gain may well be substantial enough to be worth pursuing. Hence I shall continue to support the 5 percent as an intermediate objective greatly superior to the present practice.[8]

One hardly knows whether to twit Dr. Friedman for tergiversation or praise him for remarkable candor. But his hesitations, as I hope to show, really point to the inherent difficulties in the monetarists' proposals.

I made a distinction earlier between the monetarists strictly so-called and the "creeping inflationists." This distinction applies to the intent of their recommended policies rather than to the result. The *intent* of the monetarists is not to keep raising the price "level" but simply to keep it from falling, i.e., simply to keep it "stable." But it is impossible to know in advance precisely what uniform rate of money-supply increase would in fact do this. The monetarists are right in assuming that in a prospering economy, if the stock of money were not increased, there would probably be a mild long-run tendency for prices to decline. But they are wrong in assuming that this would necessarily threaten employment or production. For in a free and flexible economy prices would be falling because productivity was increasing, that is, because costs of production were falling. There would be no necessary reduction in real profit margins. The American economy has often been prosperous in the past over periods when prices were declining. Though money wage-rates may not increase in such periods, their purchasing power does increase. So there is no need to keep increasing the stock of money to prevent prices from declining. A fixed arbitrary annual increase in the money stock "to keep prices stable" could easily lead to a "creeping inflation" of prices.

A Political Football

But this brings us to what I consider the fatal flaw in the monetarist prescriptions. If the leader of the school cannot make up his own mind regarding what the most desirable rate of monetary increase should be, what does he expect to happen when the decision is put in the hands of politicians?

We do not need to allow our fancies to roam very far. We already know the answer from what has been happening in the United States since we left the gold standard 43 years ago—and from what has been happening, for that matter, in nearly every country in the world since the gold standard was abandoned. The decision regarding the national money supply has already been in the hands of the politicians everywhere. And this situation has led practically everywhere to continuous and usually accelerating inflation.

Dr. Friedman would take the decision out of the discretion of appointed monetary authorities and make it a "legislative rule." But what rate would a popularly-elected legislature set? We may be sure that it would pick a "safe" rate of monetary expansion—at least 6 percent a year to begin with—to make sure that there would be no depression or unemployment. But at the first feeble sign of unemployment or "recession"—brought about by excessive union wage demands or any other of a score of factors—politicians seeking election or re-election would demand that the legislative monetary-increase rule be raised to 8 percent, 10 percent, or whatever rate the political scramble for office might suggest.

The prescribed rate would become a political football. The tendency nearly always would be for the highest bidder to win. For the belief in inflation as the master solution of every economic problem is not new in this generation. Throughout recorded history it has always been latent. It did not need the Keynesian rationalization. Whenever there has been depression and unemployment it has always been popularly blamed on or identified with "not enough money." In 1776, in his *Wealth of Nations*, Adam Smith was pointing out that "No complaint is more common than that of a scarcity of money."

The fatal flaw in the monetarist prescription, in brief, is that it postulates that money should consist of irredeemable paper notes and that the final power of determining how many of these are issued should be placed in the hands of the government—that is, in the hands of the politicians in office. The assumption that these politicians could be trusted to act responsibly, particularly for any prolonged period, seems incredibly naive. The real problem today is the opposite of what the monetarists suggest. It is how to get the arbitrary power over the stock of money *out* of the hands of the government, *out* of the hands of the politicians.

The solution to that problem cannot be offered in a few lines. The present writer has attempted to deal with it in his article, "The Search for an Ideal Money."[9]

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1. *Capitalism and Freedom* (Chicago: University of Chicago Press, 1962), p. 54.

2. See, e.g., on the French assignats. Andrew Dickson White, *Fiat Money Inflation in France* (Irvington-on-Hudson, N.Y.: Foundation for Economic Education, 1959), p. 83 and *passim*, and on the German inflation of 1923, Constantino Bresciani-Turroni, *The Economics of Inflation* (London: George Allen & Unwin, 1931), pp. 80–81.

3. I have never seen a reference to this striking event in any textbook on money. See, e.g., *The New York Times* January 30, 1945.

4. *The Value of Money* (New York: Richard R. Smith, 1917 and 1936), p. 161.

5. Milton Friedman and Anna Jacobsen Schwartz in their *Monetary History of the United States: 1867–1960* (Princeton University Press, 1963), do offer annual estimates and tables of "velocity of money" based on worksheets of Simon Kuznets made for another study. But they define this velocity as "the ratio of money income to the stock of money." This hardly makes it a *transactions* velocity. Moreover, they appear to attach very little commodity-price-determining importance to it: "Velocity is a relatively stable magnitude that has declined secularly as real income has risen." (p. 34).

6. I have treated this subject at greater length in the essay, "Velocity of Circulation," in *Money, the Market, and the State: Economic Essays in Honor of James Muir Waller*, edited by N. A. Beadles and L. A. Drewry (Athens, Ga.: University of Georgia Press, 1968).

7. Reprinted in *Dollars and Deficits* (Englewood Cliffs, N. J.: Prentice-Hall, 1968), p. 152.

8. *The Optimum Quantity of Money* (Chicago: Aldine Publishers Co., 1969), pp. 46–48.

9. See pages 95–106 of this volume.

II. THE GOLD STANDARD

The Gold Standard: A Standard for Freedom

by Paul Stevens

At one time the case for the gold standard was practically self-evident—undisputed by most economists and appreciated by both laymen and professionals. Today, however, the case for gold is buried under decades of propaganda, misconceptions, and myths. It has been only recently that the case for the gold standard has begun to surface from under the Policy Makers' anti-gold debris. Consequently, gold is once again gaining the attention and interest it so rightly deserves.

Today's free-market advocates of the gold standard differ from past advocates. For example, free-market advocates do not exclude silver or other commodities from their concept of a gold standard. Indeed, they do not even insist that gold must be money. The case for the gold standard is actually the case for market-originated commodity money, and the case against government-regulated fiat money. It is simply an extension of the case for free markets which respect the rights of man, and the case against controlled markets which violate the rights of man.

To be concerned with the gold standard is to be concerned with a free economy, regulated by the values and choices of men, rather than a controlled economy in which the values and choices of men are regulated by government. This concern for man's freedom to express values and exercise choices is derived from the deeper concern for justice and for man's right to property. The man concerned with justice does not aim to force others to use gold as money. Rather, he insists that government has no right to prevent him and other men from using gold as money if they choose. The man concerned with property rights does not urge government to legislate pro-gold policies in order to arbitrarily increase the value, popularity, or status of gold. Rather, he insists that government stop inflating, since this arbitrarily decreases the value of his money claims to property.

Antagonists of the gold standard claim that it is impractical. But the gold standard is, in fact, the most practical monetary system yet conceived by man. However, the gold standard's primary virtue does

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Mr. Stevens, a free-lance writer specializing in the field of economics and monetary policy, wrote this article for the January 1975 issue of *The Freeman*.

not lie in its practicality: it lies in its *morality*. Those concerned about such things as freedom, justice, the preservation of property rights and purchasing power, would do well to consider the *moral* case for the gold standard, for, once understood, it is the individual's best defense against government confiscation of property through inflation.

The fact that prevents government from indulging in inflationary schemes under the gold standard can be best summed up in a phrase: *governments can't print gold*. But to understand the implications of this statement, and the virtues of having gold as money, it is first necessary to understand what money *is*—and what money is *not*.

What Money Is . . .

A man on a desert island has no need for money. He produces the goods he needs to survive, and consumes all he produces. Similarly, a primitive society has no need for money. The kinds of goods produced are extremely limited, and if individuals desire to exchange their goods with one another, they can do so through direct exchange, i.e., barter. But under a division of labor economy where men specialize in production and where there is a variety of goods produced, desired, and traded, there is a very definite need for money. For how else could Mr. Jones in Florida sell his oranges to men throughout the world and then buy Mr. Smith's best-selling novel, unless there existed some medium of exchange acceptable to all parties.

Money originates from men's desire for *indirect* exchange. And more, since indirect exchange usually occurs between strangers like Smith and Jones, money must be an object which is mutually valued. Thus, money is that commodity which serves as a medium of exchange by virtue of its high degree of marketability.

The task of discovering *which* commodity will be most valued by and most acceptable to men as a medium of exchange can only be accomplished through a *market* process; for it is only through the market that men's *values* and *choices* are properly reflected. The verdict of the market has reflected three general requirements for any lasting medium of exchange: that money should be generally acceptable to most men; that it should be practical to use; and that it should be relatively stable in value. If these requirements are satisfied, the result is a money of *trust*. Trust is the lifeblood of money, and money is the lifeblood of any economy based on the indirect exchange of goods and services. A money of trust serves to facilitate exchange among men, and in doing so, breeds a healthy and growing economy. But if men should ever begin to mistrust money, the market will immediately reflect this loss of confidence. Then money will begin to lose stability, lose its acceptability, and will soon become impractical to use in exchange.

Mistrusted money is the antithesis of the lifeblood of an economy. It's a kind of "bad blood" circulating between men throughout the economy, breeding confusion and suspicion. The fact that men's mistrust of money will result in monetary crises and collapse, underscores the need for a money that never contradicts men's values, a money that at all times properly reflects men's values, i.e., a money based on, and constantly exposed to, individual choices—which means a free-market-originated commodity money.

A Market Decision

When one considers the complex process that must take place before men can discover which commodity money constantly reflects their changing values and choices, one can understand why it is only through a free market process that money can properly evolve as a medium of trust. And one may also understand why no man, group of men, or government, has the right to dictate what money or its value should be. This decision must be a *market* decision if it is to be a *lasting* decision.

Throughout history, almost every conceivable commodity has been used as a medium of exchange. Through the years of economic development and through trial and error, those commodities least suited to serve as money were eliminated, while those commodities best suited survived as forms of money. After centuries of exchange between men, the commodity that emerged as the most valued, the most practical, the most trusted money among men, was gold.

What gives rise to men's trust in gold? First, men value gold as money because men value gold as a *commodity*. Gold at any time can be *converted* to its commodity role if its monetary role should ever be questioned. Second, since gold is relatively scarce and precious to men, it has stability of value. Therefore, it can be trusted to serve as a relatively stable medium of exchange. And since most individuals desire to save part of what they produce in some monetary form, gold's stability of value provides them with a reliable monetary method of accumulating and storing wealth.

What else gives rise to men's trust in gold? Gold is easily marketable, which means it is acceptable to men in exchanges of all kinds. Gold is also trusted because it is practical: it's durable, so it won't perish or rot; it's small in bulk, so it is easily transportable. It's a metal, which means it can be used in different forms, such as bars or coins; and, since gold does not evaporate, it will lose neither quantity nor quality if or when men should decide to melt their coins into bullion or melt their bullion for use in production.

There is one more thing that gives rise to men's trust in gold: the knowledge that gold cannot be counterfeited; the conviction that the money supply cannot be artificially and arbitrarily increased by those who would aim to confiscate wealth rather than produce it; the knowledge that money (the *claim* to production and effort) will itself represent production and effort. In short, men's trust in gold carries the conviction that the monetary system freely adopted by men is based, not on whim and decree, but on integrity and productivity.

These are some of the reasons why men have trusted gold as a medium of exchange through history—and why today's Policy Makers damn its existence.

. . . And What Money Is Not

Money is not paper. Paper notes evolve from the desire for a convenient substitute for commodity money. The paper notes that circulate as money today were once *money substitutes* (receipts for gold), defined by and convertible into a specific amount of gold. Paper notes did not and cannot become a money of trust without first representing a commodity of trust.

Consider the reaction of free men—men who, understanding and respecting the meaning of property rights, are suddenly and for the first time offered in place of gold, non-convertible paper notes. These notes would be meaningless to such men. No man who had just come from harvesting a field of wheat would even consider trading his wheat for scrap paper.

There are only two ways in which men will accept paper notes without commodity convertibility: if they are *forced* to do so, or if they are *conned* into doing so. Americans are now legally *forced* to accept government's non-convertible paper notes—but only because they have been conned into believing that commodity money is "old-fashioned" and "impractical" and that paper notes are indicative of a "modern and sophisticated economy."

Nothing could be further from the truth. Non-convertible paper "money" is *fiat money* that derives its value, *not* from its value as a commodity, *not* from its value as a useful medium of exchange according to the requirements of a medium of exchange, but from the *decree* of government. Fiat money is a throwback to the days of kings and the mentality of dictators. It is not a money evolved from the values and choices of free men in free markets, but a money created through the coercion of government.

Is commodity money old-fashioned and impractical, as today's Policy Makers contend it is? Consider the following facts: Over the last several decades, the exchange ratios (the prices) of various commodities have not varied much in value relative to each other. For example, the value of eggs to milk or milk to bread would be at approximately the same ratios today as they were years ago.

Why Prices Rise

But if it is true that the exchange ratios of commodities are relatively the same today as they were in the past, why then have prices (the exchange ratios of dollars to goods) soared over the years? The reason is that the value of the *paper* money, with which government forces everyone to deal, has fallen yearly relative to all commodities. Clearly, if a commodity (theoretically, almost *any* commodity) had been used as a medium of exchange over the past decades instead of government's fiat money, prices would have remained relatively stable. It is important to realize that it is not commodities that are *rising* in value, but fiat money that is *falling* in value.

Since 1933, when the U.S. severed the dollar-commodity relationship by abandoning what was left of the gold standard, the value of the dollar has depreciated by over two-thirds in relation to other commodities. This could never occur under a commodity standard—only under a government-imposed fiat standard. Had the U.S. returned to a dollar based on and convertible into gold instead of severing the dollar-gold relationship, the supply of dollars over the years would have been limited to, or checked by, the supply of gold. Therefore, the value of the dollar today would have been equal to the value of gold *in relation to other commodities.* Instead, the U.S. decided to print dollars whenever "needed" and to pretend that the dollar was "as good as, gold" by legally fixing its value. The pretense couldn't last, and today the dollar is worth approximately 25 percent of its value in terms of gold in 1933.

Paper notes that are not representative of and convertible into a commodity are not money and have never satisfied the requirements of money for long. They are notes of circulating debt which men are forced to accept, so that governments can continuously pursue their policies of inflation.

The Nature of Inflation

Inflation is the fraudulent increase in the supply of money substitutes and credit. It is a policy which allows government to artificially create and spend more money than it is able to collect in taxes or borrow from its citizens. Government is the *cause of* inflation—the *effect* is higher prices. Consider each dollar as a claim to some tangible good. If the claims are increased, the value of each claim goes down because there are more dollars seeking goods. This bids prices up.

But inflation is *not* simply rising prices. In fact, inflation may exist even when prices remain the same or *decrease.* How is this possible? If the production of goods and services increases more than the artificial increase in paper claims, prices will drop—but not by as much as they would have, had there been *no* artificial increase in paper claims. Thus, in *real* terms, the value of paper claims is effectively *reduced* even though in *relative* terms the value of these claims may increase.

Historically, and in relatively free market economies, there are only two ways in which a general across-the-board increase in prices can occur: through a dramatic increase in commodity money (such as new gold discoveries) or through a fraudulent increase of money substitutes by banks and governments. The former type of general price increase rarely occurs and is perfectly natural. The latter is both unnatural and immoral.

In the case of new gold production, those who have *produced* the new commodity money will have *earned* the right to exchange their product for the products of others. All other non-money producers may have to pay higher prices for goods, as the supply of gold increases, but the higher prices are compensated for by having more money to spend. Who receives the "new" money will depend on *individual productivity*—and this is as it should be, for it is the justice of the market that the acquisition and distribution of wealth is based upon productivity rather than decree.

But, given a fiat standard where government sanctions and sponsors an *artificial* increase in paper money or credit, the increase in purchasing power for some men can only be obtained at the expense of other men. Given a fiat standard, income distribution is the result of chance, caprice, or government favors and loans. When government doles out its fiat money, these notes dilute the value of all other outstanding money claims. Those who receive the fiat money first, benefit from spending their money before prices rise. But as the fiat money is spent, prices are higher for all other consumers. Thus, the difference between a *real* increase in the money supply (i.e., commodity money) and an *artificial* increase (i.e., in paper *claims)* is the difference between production and theft.

Clearly, inflation is a moral issue. However prices respond, it is immoral that some man, agency, or government is legally permitted to obtain wealth at the involuntary expense of other men. The major challenge in the sphere of monetary relations today is how to abolish the coercive power of government to control the supply and regulate the value of money, and how to return this function to the market where it properly belongs.

The Fiat Standard at Work

Under a fiat standard, government gains control of the banking system and thus, indirectly, of the nation's money supply. It can artificially and arbitrarily create money and furnish credit. Government paper notes are not based on or convertible into gold, or any other tangible commodity; man's production and labor are not the sole claim to other men's production and labor: the supply and value of money are determined by government.

Under the American version of the fiat standard, the banking system and the nation's money supply are controlled and regulated for the most part by a twelve-man Board of Governors which is empowered to make policy decisions for the majority of the nation's banks. Thus, America's banking system is not a free and private banking system—it is a quasi-governmental banking system, known as the Federal Reserve System.

It should be clear that the Federal Reserve System's power to create claims against individuals' property is immoral. But neither the Federal Reserve System nor the fiat standard is ever defended on moral grounds; they are defended on practical grounds. Once inspected, however, these grounds turn out to be about as solid as quicksand. The primary justification given for a fiat standard is that credit can be extended far more rapidly and extensively. This, it is claimed, is the fiat standard's major virtue. It is, in fact, a major vice.

The greatest economic threat under a fiat standard is that the Federal Reserve System will supply heavy doses of money and credit to the loan market in an attempt to reduce interest rates and "stimulate" the economy. This attempt, while temporarily stimulating economic activity, leads to *malinvestment,* as businessmen falsely anticipate greater profits. A "boom" results, but since the "boom" is artificially created, the prosperity is temporary and, for the most part, illusory. Government has not furnished more goods; it has not increased the nation's prosperity; it has simply increased the money supply—which leads men to believe they are richer. The fact is, however, they only have more paper claims to goods. This cannot enrich anyone; it can only lead to future inflation, i.e., a reduction of the value of real claims to wealth.

Illusion of Prosperity

Thus, increases of money and credit provide only an illusion of prosperity, for with increased money and credit come increased costs for producer goods and increased wage costs. Higher wages then lead to *over-consumption,* as consumers, too, are enticed by the illusion of prosperity. But over-consumption results in higher prices which reduce the consumer's standard of living. Since the "boom" was inflation-inspired, producers and consumers are not better off—they are worse off. Malinvestment and over-consumption are mistakes—errors in judgment—caused by government's attempt to con its citizens into believing that profit opportunities are better than they really are.

When the credit expansion that stimulated the "boom" ends, the mistakes that were made cannot be perpetuated. These mistakes must be liquidated: consumers buy less and begin paying off their unrealistic accumulation of debts. Producers liquidate inventories. Interest rates rise, and unemployment increases as the economy struggles to readjust. The severity of the readjustment depends on the degree and length of government's prior credit expansion and the policies implemented to cope with the adverse effects. Given continual injections of money and credit in the inane attempt to continue the "boom" and prevent a necessary recession, hyperinflation will result. Hyperinflation must lead to monetary chaos as well as economic disaster, i.e., to depression. A major depression is not a necessary result of the fiat standard, but inflation and the "boom-bust cycle" are.

The whole purpose of fiat money is to allow government to spend more money than it can raise in direct taxes from its citizens. As a result, the American fiat standard has worked more often as a means of redistributing wealth than a means of stimulating the economy. Government, instead of furnishing money to the loan market in the attempt to continuously reduce interest rates, has created money to finance the "welfare" state. When government's fiat money enters the economy in the form of checks for expenditures, rather than through the loan market, the sequence of events and the effects are a little different.

Men usually hold their money as savings, but as prices continue to rise over the years of government deficit spending, men realize that the pieces of paper they hold are continuously and progressively depreciating in value—that inflation is becoming a way of life. Once men begin to lose confidence in government's fiat money, it's only a matter of time before the years of simple inflation burst into hyperinflation and monetary collapse.

Thus, whether government tries to stimulate the economy or to finance programs that it cannot afford, the fiat standard is self-defeating and counter-productive. The consequences of America's fiat standard have been mild by historical standards: the Great Depression of the '30s, an endless series of booms and busts since then, and a depreciation of the dollar by about 75 percent. So much for the "practicality" of the fiat standard!

The Meaning of the Gold Standard

In a free society, no man, group of men, or government has the "right" to infringe upon the rights of others. This means that within a free society, the initiation of force is banned. All goals must be attained through persuasion and voluntary cooperation, and no goal may be achieved at the expense of any man—not for the "good" of another man, not for the "good" of the state, and not for the "good" of society. A system of voluntary exchange is a system of laissez-faire capitalism. Under capitalism, man's rights are supreme. They are defended by government—not violated by government.

A gold standard is an integral part of a free society; a fiat standard is an integral part of a controlled society. A gold standard cannot exist without the consent of individuals; a fiat standard cannot exist without the initiated force of government. A gold standard is based on voluntary exchange, the recognition of men's values, and respect for private property; a fiat standard is based on compulsory "exchange," the denial of men's values, and the insidious confiscation of private property.

Wealth is production, and gold is the equivalent of wealth produced. Because neither wealth nor gold can be created out of nothing, neither wealth nor gold are possible without men of intelligence, men of ability, and men of productivity. Fiat is force and is the equivalent of wealth confiscated. Both fiat and force are the tools of the envious and the cowardly. Where a gold standard is welcomed by the best of men, the fiat standard is welcomed by the worst of men. Where the gold standard demands the *earned,* the fiat standard grants the *unearned.* Where a gold standard evolves from individual choice, a fiat standard evolves from government edict. Where a gold standard necessitates only that men be left free to act, to choose, and to trade, a fiat standard invites government to control, to regulate, and to dictate men's choices, actions, and the terms of trade.

Gold limits the government's power to spend more money than it receives in taxes, and in doing so, gold limits the government's arbitrary power over the economy; gold checks artificial money and credit expansion; it prevents artificial "booms" which lead to very real "busts"; gold protects individuals from economically unsound government programs; and it protects citizens from the inflationary confiscation of private property. Not only is the gold standard the most practical monetary system yet discovered, it is a standard consistent with freedom—yet it is the gold standard that today's Policy Makers either ignore or denounce.

Private Coinage in America

by Brian Summers

America has never had a free market in money. From 1933 to 1975, Americans could not legally own gold. Since 1933, contracts payable in gold or indexed to the price of gold have been illegal, although the restored right to own gold may soon lead to new legal challenges. Since 1864, the private coining of money has been illegal. And since colonial days, we have had legal tender laws designed to force the acceptance of coins and bills minted by the government.

Despite the absence of a completely free market, there have been times when Americans have privately minted money, and buyers and sellers have willingly used this money. Let us survey the history of American private coinage, for this history lends support to the practicality of free market money, with private minters supplying the monetary needs of the market, and the government protecting people from fraud and coercion.

One of the first private coiners was John Higley, a blacksmith in Granby, Connecticut, who minted copper coins in 1737 and 1739. Higley let the market determine the value of his coins, on which he imprinted "I am good copper/Value me as you please." No one was forced to accept Higley's coins, in contrast with our federal government's policy of printing on its paper money, "This note is legal tender for all debts, public and private."

The eminent numismatist Edgar H. Adams attested to the quality of Higley's coins: "In fact, so pure was the metal coins seem to have been in pretty general use until 1792, the time of the opening of the United States mint."[1]

Both Silver and Gold

Silver was also coined by private minters. In 1783, I. Chalmers of Annapolis, Maryland, minted silver shillings, sixpences, and threepences that were described by Henry Chapman as "very creditable."[2] But the favorite metal of private minters was gold.

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Joseph Coffin reports on the first privately coined gold: "During this period of our history (1830–1861) many private gold coins were struck in various sections of the United States. The first of such gold coins was issued in 1830 by Templeton Reid, an assayer at the gold mines of Lumpkin County, Georgia, the same county in which the Dahlonega mint [a Federal mint] was located. The Templeton Reid coins were issued in three denominations ($2.50, $5, and $10) at Reid's private mint. The gold was of the best quality, and later many of the coins were melted because they were worth more as bullion than the face value of the coins."[3]

Templeton Reid successfully competed with the Dahlonega Federal mint. Another mintmaster who thrived in the face of Federal competition was Christopher Bechtler of Rutherfordton, North Carolina.

Bechtler, his sons, and nephew arrived in Rutherfordton in 1830, having emigrated from the Grand Duchy of Baden. From 1831 to 1847 they coined gold in three denominations ($1, $2.50, $5) despite competition from the nearby Federal mint established in 1837 in Charlotte.

Clarence Griffin reports on the public's acceptance of the Bechtler coins which, like all privately minted coins, were not legal tender:

> Bechtler coins were accepted and passed at face value in all of western North Carolina, South Carolina, western Tennessee, Kentucky and portions of Virginia. One of the country's oldest citizens once told the writer that he was 16 years old before he ever saw any other coin than the Bechtlers. The coins filled a long-felt need for specie and continued to circulate long after the discontinuance of the mint in 1847. At the outbreak of the War between the States the new Confederacy began issuing currency, but did not put out any specie. Bechtler coins, especially in this locality, were carefully hoarded, and many contracts and agreements of the sixties specified Bechtler gold coins as a consideration rather than the Confederate States currency or the scant supply of Federal specie.
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> Despite the fact that these coins bore no device emblematic of a national character, or any official guaranty of their purity, they were unhesitatingly accepted by all. In the proper sense of the word they were only "tokens" and when offered at the government mints were worth less than the face value, as the government deducted the seigniorage and assay fees for reminting. Yet these coins were *passed* over the counters of the stores, where they received the same consideration as if they were made by the United States Government. They

> were carried by traders into Kentucky and South Carolina, and many homeseekers going westward during the great immigration period of 1850–1870 carried their Bechtler coins with them. Many circulated more freely than did government specie, and it has not been so many years since the local banks accepted them at face value.
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> Today [1929] Bechtler coins sell at enormous prices. Numismatists quote them from $5 to $100 and more.[4]

Honesty the Best Policy

G. W. Featherstonhaugh, who visited Bechtler in 1837, gave the following account of his visit: "Christopher Bechtler's maxim was that honesty was the best policy and that maxim appeared to govern his conduct. I was never so pleased with observing transactions of business as those I saw at his house during the time I was there. Several country people came with rough gold to be left for coinage. He weighed it before them and entered it in his book, where there was marginal room for noting the subsequent assay. To others he delivered the coin he had struck. The most perfect confidence prevailed between them, and the transactions were conducted with quite as much simplicity as those at a country grist mill, where the miller deducts the toll for the grist he has manufactured."[5]

Christopher Bechtler coined over three million dollars in gold. But his operation was dwarfed by the private mints that sprang up after the discovery of gold in California in 1848. At least 15 private mints coined gold in California during 1849–1855. The bullion content of some of these coins was less than their face value, so these coins were rejected by the market and soon passed out of circulation. However, the coins of Moffat & Co., Kellogg & Co., and Wass, Molitor & Co. enjoyed the confidence of the community and were readily accepted.

The January 8, 1852, issue of the *San Francisco Herald* contains the following comments on the Wass, Molitor & Co. mint:

> The very serious inconveniences to which the people of California have been subjected through the want of a [Federal] mint, and the stream of unwieldy slugs that have issued from the United States Assay Office have imperatively called for an increase of small coin. The well known and highly respectable firm of Wass, Molitor & Co. have come forward in this emergency, and are now issuing a coin of the value of $5 to supply the necessities of trade.

The mechanical execution of the coin issued by these gentlemen certainly reflects the highest credit upon their skill. It is a beautiful specimen of art, far superior in finish to anything of the kind ever gotten up in California.

But the most important point to the public is its fineness and weight, as upon these two qualities combined must depend its value. In this particular it will be found highly satisfactory, and at once secure the confidence of the community. It has a uniform standard of .880, and contains no other alloy than that of silver, which is found naturally combined with gold. The weight of each of the $5 pieces, which are the only ones at present issued, is 131.9 grains.

The standard fineness of the United States Five Dollar piece is .900, weight 127 grains. It is therefore 20/1000 finer than Wass, Molitor & Co.'s pieces, but this is more than counterbalanced by the latter's being 4.9 grains heavier, so that the new Five Dollar gold piece is in reality worth five dollars and four cents, a sufficient excess to pay the expense of recoinage at the United States Mint without cost to the depositor.

The reason Messrs. Wass, Molitor & Co. have adopted the standard of .880 is because this is about the average fineness of California gold, and further because the cost of refining California gold to the United States standard is exceedingly heavy, and the necessary chemicals cannot be obtained in this country. But it will be remembered that the difference is more than made up by the increased weight of 4.9 grains, which every one can try for himself on a pair of scales. These coins will be redeemed on presentation in funds received at the Custom House and banks. The high reputation for honor and integrity enjoyed by Count Wass and his associates in this enterprise is an additional guaranty that every representation made by them will be strictly complied with. The public will be glad to have a coin in which they can feel confidence, and which can't depreciate in their hands. The leading bankers, too, sustain and encourage this issue, and will receive it on deposit.[6]

The End of an Era

One of the last private mints was Clark, Gruber & Co. Carl Watner writes: "Between 1860 and 1862 the firm of Clark, Gruber & Co. was engaged in the manufacture of their own coins from their mint in the city of Denver. Here again, the demand for a circulating medium was satisfied by private means before the government was able to act. The Clark, Gruber coins were of high quality and always either met or exceeded the gold bullion value of similar United States coins. In a period of less than two years this firm minted approximately three million dollars' worth of coin. Their mint promised to outdo the government's own production, and to get rid of them, the government bought them out in 1863 for $25,000."[7]

In 1864 the private coining of money was banned by an Act of Congress. Today the prohibition against private coinage, the doubtful legality of gold contracts, and legal tender laws assure the federal government a legal monopoly over money, and prevent buyers and sellers from freely choosing mutually acceptable media of exchange.

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1. Edgar H. Adams, "Higley Coppers 'Granby Coinage,'" *The Numismatist*, August 1908.
2. Henry Chapman, "The Colonial Coins Prior to July 4, 1776," *The Numismatist*, February 1948.
3. Joseph Coffin, *The Complete Book of Coin Collecting* (New York: Coward, McCann & Geoghegan, 1973), p. 108.
4. Clarence Griffin, "The Story of the Bechtler Gold Coinage," *The Numismatist*, September 1929.
5. *Ibid.*
6. Edgar H. Adams, *Private Gold Coinage of California* (Brooklyn, N.Y.: Edgar H. Adams, 1913), pp. 79–80.
7. Carl Watner, "California Gold: 1849–65," *Reason*, January 1976, pp. 27–28.

No Shortage of Gold

by Hans F. Sennholz

Many economists seem to agree on the virtues of the gold standard. It limits the power of governments or banks to create excessive amounts of paper currency and bank deposits, that is, to cause inflation. And it affords an international standard with stable patterns of exchange rates that encourage international trade and investments. But the same economists usually reject it without much hesitation because of its assumed disadvantages.

The gold standard, they say, does not allow sufficient flexibility in the supply of money. The quantity of newly mined gold is not closely related to the growing needs of the world economy. If it had not been for the use of paper money, a serious shortage of money would have developed and economic progress would have been impeded. The gold standard, they say, also makes it difficult for a single country to isolate its economy from depression or inflation in the rest of the world. It does not permit exchange rate changes and resists government controls over international trade and payments.

It is true, the gold standard makes it difficult to isolate one country from another. After all, the common currency that is gold would invite exchanges of goods and services and thus thwart an isolationist policy. For this reason, completely regimented economies cannot possibly tolerate the gold standard that springs from economic freedom and inherently resists regimentation. It is true, the gold standard also exposes all countries that adhere to it to imported inflations and depressions.

But as the chances of any gold inflation—and depression that would follow such an inflation—are extremely small, the danger of contagion is equally small. It is smaller by far than with the floating fiat standard that suffers frequent disruptions and uncertainties, or with the dollar-exchange standard that actually has inundated the world with inflation and credit expansion.

It must also be admitted that the gold standard is inconsistent with government controls over international trade and payment. But we

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should like to question the objection that the newly mined gold is not closely related to the growing needs of business and that a serious shortage of money would have developed without the issue of paper money. In fact, this popular objection to the gold standard is rooted in several ancient errors that live on in spite of the refutations by economists.

There is no shortage of gold today and there has been no such shortage in the past. Indeed, it is inconceivable that the needs of business will ever require more gold than is presently available. Gold has been an item of wealth and a medium of exchange in all of the great civilizations. Throughout history men have toiled for this enduring metal and used it in economic exchanges. It has been estimated that most of the gold won from the earth during the last 10,000 years, perhaps from the beginning of man, can still be accounted for in man's vaults today, and in ornaments, jewelry, and other artifacts throughout the world. No other possession of man has been so jealously guarded as gold. And yet, we are to believe that today we are suffering from a serious shortage of gold and therefore must be content with fiat money.

Economic policies are the product of economic ideas. This is true also in the sphere of monetary policies and the organization of the monetary system. The advocates of government paper and foes of gold are motivated by the age-old notion that the monetary system in scope and elasticity has to be tailored to the monetary needs of business. They believe that these needs exceed the available supply of gold, which deprives it of any monetary usefulness and thus makes it a relic of the distant past.

The Monetary Needs of Business

With most contemporary economists, the notion of the monetary requirements of business implies the need for an institution, organization, or authority that will determine and provide the requirements. It ultimately implies that the government must either establish such an institution or provide the required money itself. These writers, in fact, accept without further thought government control over the people's money. Today, all but a few economists readily accept the apparent axiom that it is the function of the government to issue money and regulate its value. Like the great classical economists, they blindly trust in the monetary integrity and trust-worthiness of government and the body politic. But while we can understand the faith of Hume, Thornton, and Ricardo, we are at a loss to explain the confidence of our contemporaries. We understand Ricardo when he proclaimed that "In a free society, with an enlightened legislature, the power of issuing paper money, under the requisite checks of convertibility at the will of the holder, might be safely lodged in the hands of commissioners . . . "[1] The English economists had reason to be proud of their political and economic achievements and confident in the world's future in liberty. However, it is more difficult to understand any such naive confidence today. After half a century of monetary depreciation and economic instability, still to accept the dogma that it is the proper function of government to issue money and regulate its value, reflects a high degree of insensibility to our monetary plight.

And yet, the world of contemporary American economics blindly accepts the dogma. It is true, we may witness heated debates between the Monetarists and Keynesians about the proper rate of currency expansion by government, or the proper monetary/fiscal mix of Federal policy. But when their squabbles occasionally subside they all agree on "the disadvantages" of the gold standard and the desirability of fiat currency. They vehemently deny the only alternative: monetary freedom and a genuine free market.

The money supply needs no regulation; it can be left to the free market in which individuals determine the demand for and supply of money. A person wants to keep a certain store of purchasing power, a margin of wealth in the form of money. It does not matter to him whether this wealth is represented by a few large units of money or by numerous smaller units with the same total purchasing power. And he is not interested in an increase in the number of units if such an increase constitutes no addition to his wealth. This is not to deny that people frequently complain about their "lack of money" or their "need for more money." What they mean, of course, is additional wealth, not merely more monetary units with smaller purchasing power. But this popular mode of expression probably has contributed to the spread of erroneous notions according to which monetary expansion is identical with additional wealth. Our present policies of inflation seem to draw public support from this primitive confusion.

More than 200 years ago John Law was victim of this confusion when he stated that "a larger quantity (of money) employs more people than a smaller one. And a limited quantity can employ only a proportionate number." It also made Benjamin Franklin denounce the "want of money in a country" as "discouraging laboring and handicraft from coming to settle in it." And it made Alexander Hamilton advocate currency expansion for the development of the "vast tracts of waste land." But only additional real capital in the shape of plants and equipment can employ additional people at unchanged wage rates, or develop new tracts of land. It is true, even without additional capital, a market economy readily adjusts to additions in the labor supply until every worker who seeks employment is fully employed. But in this process of adjustment wage rates must decline on account of the declining marginal productivity of labor. Monetary expansion tends to hide this wage reduction as it tends to support nominal wages, or even may raise them, while real wages decline.

The "full-employment" economists, such as Lord Keynes and his followers, recommend monetary expansion because of this very wage reduction. They correctly realize that institutional maladjustments may prevent a necessary readjustment and thus cause chronic unemployment. The labor unions may enforce wage rates that are higher than the market rates, which inevitably leads to unemployment. Or political expedience may call for the enactment of minimum wage legislation that causes mass unemployment. Under such conditions the full-employment economists recommend monetary expansion as a face-saving device for both the labor government and labor unions. But while it alleviates the unemployment, it causes a new set of ominous effects. It originates the economic boom that will be followed by another recession. It benefits the debtors at the expense of the creditors. And while it depreciates the currency, it causes maladjustment and capital consumption and destroys individual thrift and self-reliance.

In fact, the effects of currency depreciation, no matter how expedient such a policy may be, are worse than the restrictive effects of labor legislation and union policies. Furthermore, monetary expansion as a face-saving device sooner or later must come to an end. If not soon abandoned by a courageous administration, it will destroy the currency. If it is abandoned in time, the maladjustments and restrictive effects of labor legislation and union policies will then be fully visible.

No matter how ominous and ultimately disastrous this array of consequences of currency expansion may be, it is immensely popular with short-sighted and poorly-informed people. After all, currency expansion at first generates an economic boom; it benefits the large class of debtors; it causes a sensation of ease and affluence; it is a face-saving device for popular but harmful labor policies; and last but not least, it affords government and its army of politicians and bureaucrats more revenue and power than they would enjoy without inflation. But all these effects that may explain the popularity of currency expansion do not prove the necessity of expanding the stock of money for any objective reason. In fact, *an increase in the money supply confers* *no social benefits whatsoever.* It merely redistributes income and wealth, disrupts and misguides economic production and, as such, constitutes a powerful weapon of conflict within society.

In a free market economy, it is utterly irrelevant what the total stock of money should be. Any given quantity renders the full services and yields the maximum utility of a medium of exchange. No additional utility can be derived from additions to the quantity of money. When the stock is relatively large, the purchasing power of the individual units of money will be relatively small. And when the stock is small, the purchasing power of the individual units will be relatively large. No wealth can be created and no economic growth can be achieved by changing the quantity of the medium of exchange. It is so obvious, and yet so obscured by the specious reasoning of special interest spokesmen, that the printing of another ton of paper money does not create new wealth. It merely wastes valuable paper resources and generates the redistributive effects mentioned above.

Money is only a medium of exchange. To add additional media merely tends to reduce their exchange value, their purchasing power. Only the production of additional consumer goods and capital goods enhances the wealth and income of society. For this reason, some economists consider the mining of gold a sheer waste of capital and labor. Man is burrowing the ground in search of gold, they say, merely to hide it again in a vault underground. And since gold is a very expensive medium of exchange, why should it not be replaced with a cheaper medium, such as paper money?

If gold were to serve merely as medium of exchange, new mining would indeed be superfluous. But it is also a commodity that is used in countless different ways. Its mining, therefore, does enrich society in the form of ornaments, dental uses, industrial products, and the like. Gold mining is as useful as any other mining that serves to satisfy human wants.

The Law of Costs Applies to Money

Actually, the great expense of gold mining and processing assures the limitation of its quantity and therefore its value. Both gold and paper money are subject to the "law of costs," which explains why gold has remained so valuable over the millennia and why the value of paper money always falls to the level of costs of the paper. This law, which is so well-established in economic literature, states that *in the long run the market price of freely reproducible goods tends to equal the* *costs of production.* For if the market price should rise considerably above cost, production of the goods becomes profitable, which invites additional production. When more goods are produced and offered on the market, their price begins to fall in accordance with the law of demand and supply. Conversely, if the market price should fall below cost and inflict losses on manufacturers, production is restricted or abandoned. Thus, the supply in the market is decreased, which tends to raise the price again in conformity with the law of supply and demand. Of course, the law of costs does not conflict with the basic principle of value and price. Their determination originates in the consumers' subjective valuations of finished products.

The law of costs obviously is applicable to gold. When its exchange value rises, mining becomes more profitable, which will encourage the search for gold and invite mining of ore that heretofore was unprofitable because of low gold content or other high mining costs. When additional quantities of gold are offered on the market, its exchange value or purchasing power tends to decline in accordance with the law of supply and demand. Conversely, when its exchange value falls, the opposite effects tend to ensue, thus discouraging further mining.

That paper money is subject to the law of costs is vehemently denied by all who favor such money. After all, they retort, the profit motive does not apply to its production and management. Its exchange value may be kept far above its cost of manufacture through wise restraint and management by monetary authorities.

It must be admitted that the law of costs works slowly on money, more slowly indeed than on other goods. It may take several decades before the paper money exchange value falls to the level of manufacturing costs. After all, the fall is rather considerable, from the value of gold—or which the paper money first substitutes—to that of the printing paper. Few other commodities ever experience such a large discrepancy between market value and manufacturing costs when the law of costs begins to work. But this original discrepancy does not refute the applicability of the law; it merely offers an explanation for the length of time needed for the price-cost adjustment.

It must also be admitted that a certain measure of restraint prevents an immediate fall of the paper money value to the level of manufacturing costs. Popular opposition prevents the monetary authorities from multiplying the quantity of paper issue too rapidly, which would depreciate its value at intolerable rates and lead to an early disintegration of the exchange economy. In a democratic society these monetary authorities and their political employers would soon be removed from office and be replaced by others promising more restraint.

But no matter who manages the fiat money, the law of costs is working quietly and continuously. After all, the manufacturers do profit from a gradual expansion of the money supply. The profit motive is as applicable to money as it is to all other goods. The only difference between the manufacturer of fiat money and that of other goods is the monopolistic position of the former and the normally competitive limitations of the latter. Who would contend that the incomes and fortunes of central bankers and the jobs of many thousands of their employees do not provide a powerful motive for currency expansion? To stabilize the stock of money is to deny them position and power and thus income and wealth.

Political Motivation

The profit motive for fiat money expansion is even stronger with the administration in power and thousands of politicians seeking the votes of their electorates. Election to high political office usually assures great personal fortune, prestige, and power, and successful politicians quickly rise from rags to riches. But in order to be elected in a redistributive conflict society, commonly called the welfare society, the candidate for political office is tempted to promise his electorate any conceivable benefit. It is true, he may at first propose to tax the rich members of his society whose few votes may be ignored. But when their incomes and fortunes no longer yield the additional revenue needed for costly handouts, called social benefits, the welfare politician resorts to deficit spending. That is to say, he calls for currency expansion that facilitates the government expenditures that hopefully win the vote and support of his electorate and thus assure his election. When seen in this light, the profit motive is surely applicable to the manufacture of paper money.

Or, the politicians in power conduct full-employment policies through easy money and credit expansion. In search of the popular boom that would assure their re-election, they spend and inflate and thus set into operation the law of costs. Who would believe that such policies are not motivated by the personal gains that accrue to the politicians in power?

But this profit motive must be sharply distinguished from that in the competitive exchange economy. When encompassed by competition, the motive is a powerful driving force for the best possible service to the ultimate bosses, the consumers. It raises output and income and leads to capital formation and high standards of living. But in the case of the monopolistic manufacture of paper money by government authorities, the profit motive finds expression in currency expansion, which is inflation. In the end, when the law of costs has completely prevailed and the exchange value of money equals the cost of paper manufacture, not only the fiat money is destroyed but also the individual-enterprise private-property order. For inflation not only bears bitter economic fruits but also has evil social, political, and moral consequences.

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1. David Ricardo, *Principles of Political Economy and Taxation* in "The Works and Correspondence of David Ricardo," ed. by Piero Sraffa, Vol. I, Cambridge, 1951, p. 362.

Gold Is Legal, But . . .

by Robert G. Anderson

Today, as was true 42 years ago, the American people once again have freedom to own as much gold as they choose. Devotees of the free market have viewed this development with pleasure, for they have had little cause to rejoice during these many years of steady erosion of individual liberty. Socialistic governmental intervention has steadily expanded since the denial of our right to own gold.

The restoration of legal gold ownership by individuals is certainly a reversal of this ominous trend of government omnipotence. It has been heralded as a sign of change in the course of statism. Upon closer scrutiny, however, such optimism may be questioned, for there is a marked distinction between conditions then and now.

What has been restored, and what was lost 42 years ago, are not the same. Prior to April 5, 1933, gold was money. Individuals used gold daily as their medium of exchange for goods or services at the rate of $20.67 an ounce of gold. It is true that the payment was rarely made in gold bullion, but the gold certificates or gold coins in use represented bullion. Gold was legal tender, along with the coins and currency of the Treasury and Federal Reserve Banks. Upon demand, anyone could surrender his paper money and receive gold bullion.

The legalization of gold ownership has not restored it as our medium of exchange—money. The statist legal tender laws (in conjunction with Gresham's Law) continue to force the fiat paper money of government upon us. The use of gold as money is still forbidden. Any attempt to use or demand gold payment for goods or services remains illegal. The absolute governmental monopoly of fiat money continues to be protected by law against competition from gold.

Calling in the Gold

The evolution of this government monopoly of money began with a Proclamation of President Roosevelt on April 5, 1933; under enabling

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legislation passed a month earlier, the destruction of gold as money commenced:

> All persons are hereby required to deliver on or before May 1, 1933 . . . all gold coin, gold bullion, and gold certificates now owned by them or coming into their ownership on or before April 28, 1933 . . . Until otherwise ordered any person becoming the owner of any gold coin, gold bullion, or gold certificates after April 28, 1933, shall, within three days after receipt thereof, deliver the same . . . upon receipt of gold coin, gold bullion, or gold certificates delivered to it . . . The Federal Reserve Bank or member bank will pay therefor an equivalent amount of any other form of coin or currency coined or issued under the laws of the United States.

This order called for the surrender of private gold holdings. Individuals, many believing it was merely a temporary action arising out of the "national emergency" of the great depression, obediently exchanged their gold for paper money.

The surrender of gold coins for paper money is understandable, inasmuch as gold could no longer be used as a medium of exchange. Individuals needed money to transact their exchanges. Since the exchange value of money at the time was greater than the commodity value of the gold content in the coins, people generally did not resist exchanging their gold for the remaining medium of exchange—paper money.

But the government wanted to make sure of its money monopoly position. It wanted all the gold, and in furtherance of that end, President Roosevelt issued another Proclamation on August 28, 1933:

> After 30 days from the date of this order no person shall hold in his possession or retain any interest, legal or equitable, in any gold coin, gold bullion, or gold certificates situated in the United States and owned by any person subject to the jurisdiction of the United States, except under license therefor issued pursuant to this Executive order . . .

While nominal holdings of gold were exempted from these edicts, any subsequent use of or holding of gold was under the direct control of government. Gold ownership was now illegal except under Treasury license and scrutiny.

It only remained to establish penalties for any violation to these edicts. This came in short order as a part of the Gold Reserve Act, January 30, 1934:

> Any gold withheld, acquired, transported, melted or treated, imported, exported, or earmarked or held in custody, in violation of this Act . . . shall be forfeited to the United States . . . and in addition any person failing to comply with the provisions of this Act or of any such regulations or licenses, shall be subject to a penalty equal to twice the value of the gold in respect of which such failure occurred.

To all intent and purpose, the medium of exchange was now an irredeemable paper currency. Certain legal relationships prevailed between gold and money, but convertibility by United States citizens was ended. The only remaining convertibility was with foreign holders of our dollars. In time, even these provisions would disappear.

The Gold Reserve Act of 1934 transferred all the gold in the United States into the hands of the Treasury. The Federal Reserve Banks were issued "gold certificates" by the Treasury in exchange for their gold. It was cynically observed that "These are not certificates that you can get gold. These are certificates that gold has been taken away from you."[1]

Gold Repriced at $35

The abandonment of the gold exchange standard was now complete. With the bulk of the nation's gold stock in the possession of government, and its monopoly over our money supply established, it didn't take long for the government to exploit its position. The very day after the passage of this legislation, January 31, 1934, President Roosevelt reduced the gold content of the dollar by 40.94 percent. The new price of gold was established at $35 per ounce in place of the old price of $20.67 per ounce.

Overnight the face value of the gold held by the Treasury and Federal Reserve Banks increased by almost three billion dollars. This devaluation directly repudiated forty percent of the dollar claims to gold held by foreigners. The government wasted no time in getting started its engine of inflation. The American people were about to learn that only the discretion of the government money monopolists remained to limit the inflation of our money supply.

It is a matter of historical record that not much discretion ever existed. The money supply has increased more than seventeen-fold since our abandonment of the gold exchange standard. The magnitude of this monetary expansion has reduced the purchasing power of today's paper dollar to about one-quarter of its value in 1933.

During this era of continued inflation the government was severing any remaining legal ties to gold. The final tie was cut on August 15, 1971, when the "gold window" was closed to foreigners. After that date, not even foreign central banks could convert their dollar holdings to gold. The American dollar was nothing but irredeemable fiat money.

Still a Money Monopoly

The legalization of gold ownership today does not restore gold as a medium of exchange. As a matter of fact, the willingness of the state to once again permit gold ownership is precisely because the state no longer views gold as a threat to its money monopoly.

Gold can now be owned as a nonmonetary commodity. Any effort, however, by private citizens to reintroduce gold money as a medium of exchange will be promptly challenged by the government as illegal competition against its monopoly of paper money. Gold ownership was not legalized in order to restore a sound money, but instead, because government no longer considers gold important.

Overconfidence, however, even by a monopolist, can lead to a miscalculation. So, any relaxation of power by the State, any restoration of freedom to the citizenry, should be acclaimed with joy and fully exploited.

The restoration of the legal right to own gold is the action of an overconfident money monopolist. While the use of gold as a medium of exchange is still prohibited, the fact that we may own gold provides a means to protect our wealth from the ravages of inflation.

A Measure of Stability

If the State continues on its inflationary path, cash holdings in paper money will be reduced, or even eliminated in some cases. Holding gold will be more advantageous. The expansion of the quantity of the government's paper money, which erodes its purchasing power, cannot touch gold. On the contrary, the price of gold may be expected to rise in direct reflection of the declining purchasing power of the paper dollar.

This development will become more and more visible. The advantage of holding gold rather than paper money will become obvious to all. Conversion from gold to paper money, in order to complete an exchange, and then converting back to gold from paper will become commonplace. While the process introduces an additional complication in our exchanges, buyers and sellers in the market will readily discover that this additional "complication" is a small burden to pay in order to offset the inflationary impact of government money.

This trading practice is widespread in those countries throughout the world that permit private ownership of gold while still suffering from chronic inflation. With lengthy histories of paper inflation as their lesson, people in foreign lands hold gold, not paper, in their secret hiding places. Gold's immunity from government-generated inflation has made it a prized possession in these inflationary times.

Our exchange economy does not have to follow such dismal examples. Though not intended as such, the first step toward a return to sound money has been taken. As individuals begin to register their preference for gold over paper in the market, the next major step by our government must be considered: permitting gold as a medium of exchange.[2]

Leave It to the Market

Past intrusion by government into monetary affairs has only led to monetary destruction. While the law can guard money from fraud, it cannot create money. Money evolves from the market and the need for a means to facilitate our exchanges.

If individuals are to have their full freedom to make exchanges, they must also be free to determine the media in which their exchanges shall be made. Throughout history, gold has been the commodity chosen by free men to accomplish this end.

The legalization of gold ownership will allow the market to demonstrate that gold is the preferred media for making trades. Once again it will be seen that sound money can only originate within the market.

The final restoration of a sound money will require a major shift in political thinking. The futility of continued inflation must first be recognized. As the failure of "political money" becomes increasingly obvious to voters, government hopefully will abandon its monopoly power over the money system. In response to the public clamor for a sound money, gold will finally prevail.

The soundness of gold in contrast to the deterioration of paper money will be clear to all who care to see it. All that is required by government hereafter is the removal of legal barriers to free use of gold in trade. The competitive forces of the market will shortly re-establish it as the "market's money."

So, from the now restored right to own gold, we may hope eventually to reassert our right to use it as money. The welfare of all of us is dependent on such a result.

The survival of a free market is dependent on the preservation of a sound money. If sound money is to be restored and our freedom preserved, government must surrender its monopoly over money and allow gold to once again serve buyers and sellers in the market as our medium of exchange.

Gold is legal, but it is not yet money.

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1. B. M. Anderson, *Economics and the Public Welfare* (Princeton, N. J.: D. Van Nostrand Company, Inc., 1959), pp. 348–49.

2. See Hans F. Sennholz, "Return to the Gold Standard," *Inflation, or Gold Standard?* (Lansing, Mich.: Bramble Minibooks, 1973).

III. FROM GOLD TO PAPER

Remonetizing Gold, Again

by Randall R. Rader

Since 1933 when President F. D. Roosevelt prohibited private ownership of gold, United States money has been completely in government hands. Monetary instability has, consequently, been institutionalized. Inflation has followed wave of inflation. Just consider some figures: From 1967 to 1978, the consumer price index doubled. In 1979, the index rose by 14 percent—a pace that would double the CPI again in only 5 years. Yet the first months of 1980 have shown the CPI increasing at an annual rate of around 20 percent. These figures speak for themselves. Government has lost control of inflation. Anticipating two centuries ago that the federal government would not have the restraint to avoid the temptation to inflate, the Constitutional Convention carefully circumscribed the government's monetary authority.

"The congress shall have power to coin money, regulate the value thereof, and of foreign coin, and fix the standard of weights and measures." (Article I, Section 8.)

The framers of the Constitution gave Congress authority to "coin money," but specifically withheld authority to create money. By carefully choosing the verb "coin," they wisely designed to limit the government to stamping metal into money. The Articles of Confederation, from which was derived the idea to give the government power to "coin" metal, granted as well only the specific power to "strike coin." At the time of the Constitution's ratification, it was clearly understood that the Congress should only have authority to strike coin and regulate its alloy and value.

The *Federalist Papers*, Number 44, clarify:

> The right of coining money, which is here taken from the States, was left in their hands by the Confederation, as a concurrent right with that of Congress, under an exception in favor of the exclusive right of Congress to regulate the alloy and value. In this instance, also, the new provision is an im-

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Mr. Rader, a former Congressional legislative counsel, wrote this article for the September 1980 issue of *The Freeman*.

> provement on the old. Whilst the alloy and value depended on the general authority, a right of coinage in the particular States could have no other effect than to multiply expensive mints, and diversify the forms and weights of the circulating pieces.[1]

Fixing the Weight

The framers of the Constitution knew the dangers of irredeemable paper currency. They had experienced the uncertainty and disappointment of an unbacked currency during their struggle for independence. Therefore, they placed the coining authority in the same sentence with the authority to set weights and measures. They were only giving the central government the power to decide what weight of metal each coin would contain. This allowed Congress to mandate uniform denominations nationwide. Thus, as explained in *Federalist Paper* 44, Congress would provide for harmony and smooth commerce amongst the states. But Congress could no more debase its coinage than it could reduce its fixed standard of twelve inches to the foot down to seven inches. Just as it could "fix" a permanent standard of measurement, Congress could "coin" a permanent standard of money.

The Constitutional "coining" clause needs only one further explanation. The "power to regulate the value thereof" did not imply anything more than the right to add, if necessary, new standard coins. In the words of the Supreme Court, "This power of regulation is a power to determine the weight, purity, form, impression and denomination of the several coins, and their relation to each other, and the relations of foreign coins to the monetary unit of the United States."[2]

The framers in an earlier clause allowing Congress to "borrow money" expressly avoided stating the Congress could "regulate the value" of the money it borrowed. The framers were wary that borrowing would be the means of debasing the nation's money. Moreover, if they had meant to give Congress the right to debase the nation's coinage with the "regulate" language, they would have extended that regulating power to borrowed money as well. Perhaps the Constitution's view of money is best expressed in summary by this Supreme Court pronouncement:

> The power of coining money and regulating its value was delegated to the Congress by the Constitution for the very purpose, as assigned by the Framers of that instrument, of

> creating and preserving the uniformity and purity of such a standard of value.[3]

Thus, under the Constitution, the Congress launched the gold standard. The dollar was simply a name for a specified weight of gold, one-twentieth of a gold ounce. Because the rest of the world also used gold as money, the world enjoyed the economic blessing of a universal currency. One money worldwide facilitated freedom of commerce, travel, and investment across national borders. Without force or external governmental constraint, workers specialized and cooperated internationally. No wonder the nineteenth century saw unprecedented economic growth. Indeed, much of our current progress must be attributed to the accumulation of capital that occurred during the "golden" economic decades.

The result of leaving the gold standard in 1933 has been clear. The Consumer Price Index in 1933 was 38.8 (1967 dollar equals 100) on all items. In 1979, that index has soared to 217.4—nearly a sixfold increase. The index only failed to rise in three of the 46 years since the gold standard was abandoned.[4] The government has demonstrated its inability to maintain price stability. Once before, the United States left the gold standard only to learn that it must return. A review of that history reveals some instructive parallels with our current plight.

The Civil War Era

The Civil War demanded that the federal government immediately produce wealth it did not have. This led to a sad experience with fiat currency.

As the clouds of war began to gather (South Carolina seceded in December 1860), the Treasury—already weakened by three years of deficits—began to experience great difficulty in borrowing money. Into this tenuous atmosphere stepped the new Secretary of Treasury, Salmon P. Chase. Already the national debt stood at $75 million, of which $18 million had been incurred in the few months since the secession.[5]

Supposing that the impending war would be won in a few weeks (a common miscalculation), Secretary Chase decided to finance the conflict by issuing more debt. Chase did not anticipate how much he would have to borrow. Throughout 1861, the Treasury was incurring obligations at an alarming rate, faster than it could finance them. In a vain attempt to meet these obligations, the Treasury issued bonds, i.e., borrowed, so swiftly that gold was pouring out of the banks. Confidence that the banks could redeem in specie began to waver. The banks feared a run on their remaining specie reserves.

At this juncture, Chase made a grievous mistake which turned the state banks against him. Chase had been using the banks as temporary depositories for the proceeds of the loans. Many of the loans came from the banks themselves. The banks expected to hold the specie until the government needed it. But Chase required the specie to be transferred, without delay, to the Treasury. The banks thus saw the depletion of their gold reserves accelerate.

In July of 1861, the North lost the First Battle of Bull Run. The financial community realized that the war would not soon be over. In mid-December, Chase's financial report to the nation increased an earlier 1862 budget by $200 million. The federal government's borrowing would grow even more. Already banks saw their gold stocks disappearing daily. In New York City alone, the banks were losing $7 million of specie a week. Finally, on December 16th, the British demanded return of two Southern emissaries forcibly removed from the British steamer *Trent*. Great Britain seemed to be siding with the South. Panic spread in the financial community. On December 30th, the private banks suspended specie payments. The government suspended specie payments the next day.

Greenbacks

Chase still had to meet obligations that were approaching $2 million a day. The people were not prepared to absorb such enormous loans, and the banks could not invest all their funds in government loans. Accordingly, voluntary domestic loans were not coming in fast enough to fund the war effort. Nor could loans be obtained overseas due to an unfavorable balance of trade and uncertainty about the outcome of the war. The pressure on the government to meet its financial promises mounted.

Chase continued to issue notes, but now they were not redeemable. No one would accept them as payment. Seven weeks after suspension of specie payment, at Chase's request, Congress passed a law making the notes legal tender. The greenbacks were born. The first "temporary" issue was set at $150 million. In July 1862, another $150 million was allowed. Later, yet another $150 million was authorized. These were the infamous Legal Tender Acts. In essence, Congress decided to impose involuntary debt upon the nation.

In retrospect, Chase was later to admit that this was a great error.

He said to Congress in 1863 that it was not too much, and perhaps hardly enough, to say that every dollar raised by taxation for extraordinary purposes or reduction of debt is worth two in the increased value of national securities. He learned too late that a nation, like any individual, must live within its means, that current taxes must at least cover current expenses.

Overt Taxation Preferred to Hidden Tax of Inflation

Taxes are always undesirable because they deprive individuals of the capital and incentive to continue to produce, especially when they reach confiscatory rates. Nonetheless, overt taxation is preferable to the covert tax of inflation because it is more easily monitored. The representatives of the people in Congress must vote unambiguously to deprive their constituents of wealth when approving an overt tax. The covert tax of inflation also deprives the constituents of wealth, but the representatives escape the consequences. The constituents do not file an "inflation tax" return every year to acquaint them with the extent of their losses. Thus the representatives are tempted to perpetually inflate the currency to raise revenue which they can spend.

An economist Chase never encountered, John Maynard Keynes, offered a concise, though somewhat ironic, appraisal of inflation. He cautioned that inflation "engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose."[6] Chase apparently sensed, too late, the ultimate evil of inflation: it circumvents the citizen's ability to hold his government accountable.

Many representatives arose in Congress to criticize the Legal Tender Acts. Nonetheless they were approved by wide margins because of the temporary emergency. (Isn't every fatal poison administered as a serum to alleviate some "temporary emergency"?) Everyone, including President Lincoln, swore that the nation would soon mend its erroneous ways. In December 1862, Lincoln thus addressed the Congress:

> The suspension of specie payments by the banks, soon after the commencement of your last session, made large issues of United States notes unavoidable. In no other way could the payment of the troops, and the satisfaction of other just demands, be so economically or so well provided for.... A return to specie payments, however, at the earliest period compatible with due regard to all interests concerned, should ever

> be kept in view. Fluctuations in the value of currency are always injurious. Convertibility, prompt and certain convertibility into coin, is generally acknowledged to be the best and surest safeguard against them.[7]

The greenbacks began to depreciate in terms of specie almost as soon as they were issued. On the New York gold market (conversion to specie was allowed in this single location to facilitate international trade), gold could be purchased at a premium with greenbacks. In 1864, greenbacks depreciated to their all-time low: $1 of gold equal to $2.85 of paper or $1 of paper worth only 35¢ of gold.[8]

The Post-War Era

After the war, Federal expenditures dropped sharply. While the government was spending $37 per capita in 1865 to finance the war, spending was only $14 per capita the following year.[9] Due to tax revenues, the government already had a surplus in 1866.

In 1865, Congress voted (with only a single dissenter) to begin retiring the greenback debt. McCulloch, the new Secretary of Treasury, implemented that policy with revenue surpluses.

At that point, however, sentiment began to grow in favor of retaining the greenbacks as non-interest-bearing debt. The masses (primarily in the agrarian states) mistakenly believed that retiring greenbacks was depriving them of money. Some debtors, however, knowingly advocated inflation to escape the full consequences of their borrowing. They urged the government to use "cheap tender" to pay off its war debts. Greenbackism began to take hold.

The Democratic party took up the cause of greenbackism. Many of the leaders who had stood on the floor of the House and declared paper "money" unconstitutional now argued that gold-convertible bonds be paid in greenbacks. Only two years after all the fervor to retire the debt, a Republican Congress enacted a bill halting contraction of the debt. This measure was intended to allow the people to escape debt and cope with high prices. Instead, prices remained high; debt multiplied; depression spread. The greenbacks were in fact causing the problems they were supposed to cure. Throughout the next few years, Congress would occasionally consider a measure to replace the non-interest-bearing debt (greenbacks) with interest-bearing debt (bonds). These were defeated.

Supreme Court Rulings

The Supreme Court entered the debate over the integrity of our money in 1870. Chief Justice Chase issued in 1870 a finding that the Legal Tender Acts were unconstitutional as applied to pre-existing contracts. Speaking for the Court, he stated:

> For no one will question that the United States notes, which the act makes a legal tender in payment, are essentially unlike in nature, and, being irredeemable in coin, are necessarily unlike in value, to the lawful money intending by the parties to contracts for the payment of money made before its passage.[10]

This is the same Chase who as Secretary of the Treasury issued the paper nine years earlier. He pronounced this judgment upon his own action:

> And there is abundant evidence, that whatever benefit is possible from that compulsion to some individuals or to the government, is far more than outweighed by the losses of property, the derangement of business, the fluctuations of currency and the values, and the increase of prices to the people and the government, and the long train of evils which flow from the use of irredeemable paper money.[11]

This statement now echoes as a grim prophecy about the current age of inflation. He did not base his decision merely on the effects of inflation, however, but went on to substantiate his decision with reasoning based on the "coining" clause of the Constitution and the Fifth Amendment which prohibits the government from impairing private contracts or depriving citizens of property without due process of law. He concluded that his own action as Secretary of Treasury violated both the letter and the spirit of the nation's most sacred document.

No effort was made to conform to the 1870 decision. On the contrary, every effort was directed at changing the makeup of the Court to reverse the ruling. President Grant appointed two railroad lawyers to the bench who were sympathetic to the railroad's deep debt and desire to repay loans with inflated currency. The monumental *Hepburn v. Griswold* decision, which could have prevented the United States from ever suffering from wholesale inflation, was retried and fell, 5–4, the following year. The heart of the Court's reversing decision was an expediency argument:

> If it be held by this court that Congress has no constitutional power, under any circumstances, or in any emergency, to make treasury notes a legal tender for the payment of all debts, . . . the government is without those means of self-preservation which, all must admit, may, in certain contingencies, become indispensable even if they were not when the acts of Congress now called in question were enacted.[12]

Chief Justice Chase, now writing a bitter dissent to the majority decision, could only reiterate:

> We perceive no connection between the express power to coin money and the inference that the government may, in a contingency make its securities perform the functions of coined money, as a legal tender in the payment of debts.[13]

If one Supreme Court decision could be expunged to have the greatest altering effect on our current economic conditions, this would be the one. Inflation could have been pronounced dead and sealed in a tomb of law, instead it was reincarnated by this last Legal Tender Case.

The Legal Tender Cases did not quiet the constitutional debate, however. The Court had implied that the greenbacks were constitutional only because the war emergency warranted drastic action. The emergency was over and greenbackism persisted. Despite the doubts, Boutwell (another Treasury Secretary) began to issue more greenbacks.

Resumption

Specie coins continued to circulate throughout this period. The greenbacks were, of course, always worth less than the coins. In fact, the coin value of greenbacks varied with the amount of paper in circulation, the degree of uncertainty that the paper would ever be redeemed, and the strength of general consent to accept payment in paper. Early in 1873, the coin value of paper currency dipped significantly. Due to Gresham's Law, "bad money drives out good," coins were held out of circulation. Moreover, lenders hesitated to extend credit, fearing payment in depreciating currency. Traders were reluctant to accept greenbacks. At harvest time, these inflationary pressures caused a scarcity of money. This developed into panic in 1874.

The Treasury, of course, was asked to print more greenbacks. The nation's attention was focused on a bill to authorize more unbacked paper currency. It passed Congress and the debate shifted to the White House. The eastern establishment (primarily creditors) protested against this inflation bill and urged a veto. The agrarian debtors west of Ohio were arrayed in favor of the measure. The whole issue of greenbackism had reached a climax.

As long as the matter of the currency's integrity was only debated in the intellectual circles of Washington, D.C., no wave of popular fervor developed on either side of the question. This bill made the issue public. In the perspective of the bulk of the people, the nation's honor was at stake. Grant, sensing the public mood, vetoed the bill on April 22, 1874, reminding the nation that Congress had repeatedly passed resolutions promising to discharge the war debt and return to sound money:

> Among the evils growing out of the rebellion, and not yet referred to, is that of an irredeemable currency. It is an evil which I hope will receive your most earnest attention. It is a duty, and one of the highest duties, of Government to secure to the citizen a medium of exchange of fixed, unvarying value. This implies a return to a specie basis, and no substitute for it can be devised. It should be commenced now and reached at the earliest practicable moment consistent with a fair regard for the interests of the debtor class.... Fluctuation, however, in the paper value of the measure of all values (gold) is detrimental to the interests of trade. It makes the man of business an involuntary gambler, for in all sales where the future payment is to be made both parties speculate as to what will be the value of the currency to be paid and received.[14]

The issue, which had bubbled along beneath the nation's consciousness for years, was now in the open and decided. There was no turning back. Congress felt honor-bound to uphold its promises. A bill quickly passed to limit greenback distribution. Congressional elections in 1874 restored the Republicans to power in Congress and they immediately adopted the Resumption Act which effected specie payment by 1879. The conversion happened smoothly.

Results of 1879 Resumption

In 1861, when the U.S. abandoned the gold standard, the consumer price index rested at 27 (1967 dollar equals 100). By 1864, the index had soared to 47—almost a doubling. Prices remained high, between 36 and 46 on the index scale, until the Resumption Act was adopted in 1875. The value of the currency fluctuated wildly during this period. Indeed it lost one-tenth of its value in a single day. This decade provides some instructive lessons about the causes of our own age of inflation. The politicians of this period, in order to stay in power, were willing to sell the notion that more paper currency meant more wealth. Advocates of greenbackism thought they wanted more paper currency; they really needed more capital, a greater capacity to produce. Nonetheless, it took the nation a decade to learn that lesson.

The year 1879 brought the resumption of the redeemable currency. The consumer price index stabilized at 28 in that year. For more than three decades thereafter (World War I interrupted the price tranquility), the index never rose above 29 or dipped below 25. The index remained at 27 for a decade.[15] Never did it rise or fall more than a single point in a year. The gold standard worked throughout that entire period to keep prices remarkably stable.

The United States has been locked for years in a devastating cycle of inflation. Each flare-up of inflation is followed by recession. But the bottom figure for inflation each time through the cycle is higher than the last bottom. The launching platform for the inflation take-off is always higher. If the cycle continues, our inflation may go over 50 percent in the eighties. The current 20 percent rate is already intolerable. America returned to the gold standard in 1879. A century later, it needs to return again.

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Gold versus Fractional Reserves

by Henry Hazlitt

The present worldwide inflation has done, and will continue to do, immense harm. But it may eventually lead to one great achievement. It may make it possible to restore (or perhaps it would be more accurate to say to *create)* a full 100 percent gold standard.

That could come about in a simple manner. Our government has made it once more legal to hold gold, to trade in gold, and to make contracts in terms of gold. This makes it possible for private individuals to buy and sell in terms of gold, and therefore to restore gold as a medium of exchange. If our present inflation, as seems likely, continues and accelerates, and if the future purchasing power of the paper dollar becomes less and less predictable, it also seems probable that gold will be more and more widely used as a medium of exchange. If this happens, there will then arise a dual system of prices—prices expressed in paper dollars, and prices expressed in a weight of gold. And the latter may finally supplant the former. This will be all the more likely if private individuals or banks are legally allowed to mint gold coins and to issue gold certificates.

But even of the small number of monetary economists who favor a return to a gold standard, probably less than a handful accept the idea of such a 100 percent gold standard. They want a return, at best, to the so-called classical gold standard that is, the gold standard as it functioned from about the middle of the nineteenth century to 1914. This did work, one must admit, incomparably better than the present chaos of depreciating paper monies. But it had a grave weakness: it rested on only a fractional gold reserve. And this weakness eventually proved its undoing.

Not Enough Gold?

The advocates of the fractional gold standard, however, saw—and still see—this weakness as a strength. They contend that a pure gold standard was and is impossible; that there is just not enough gold in the world to provide such a currency. Moreover, a pure gold standard,

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they argue, would be unworkably rigid. On the other hand, a fractional reserve system, they say, is flexible; it can be adjusted to "the needs of business"; it provides an "elastic" currency.

We will come back to these alleged virtues later, and examine them in detail; but first I should like to call attention to the central weakness of a fractional reserve system: it embodies a long-term tendency to inflation.

Let us begin with a hypothetical illustration. Suppose we have a world in which the leading countries have been maintaining a 100 percent gold standard, that they begin to find this very confining, and that they decide to adopt a fractional gold standard requiring only a 50 percent gold reserve against bank deposits and bank notes.

The banks are now suddenly free to extend more credit. They can, in fact, extend twice as much credit as before. Previously, assuming they were lent up, they had to wait until one loan was paid off before they could extend another loan of similar size. Now they can keep extending more loans until the total is twice as great. The new credit plus competition causes them to lower their interest rates. The lower interest rates tempt more firms to borrow, because the lower costs of borrowing make more projects seem profitable than seemed profitable before. Credit increases, projects increase, and there is a "boom."

So reducing the gold reserve requirement from 100 percent to 50 percent, it appears, has been a great success. But has it? For other consequences have followed besides those just outlined. Production has been stimulated to some extent by lowering the reserve requirement; but production cannot be increased nearly as fast as credit can be. So as a result of increasing the credit supply most prices have practically doubled. Twice the credit does not "do twice the work" as before, because each monetary unit now does, so to speak, only half the work it did before. There has been no magic. The supposed gain from doubling the nominal amount of money has been an illusion.

And this illusion has been bought at a price. Lowering the required gold reserve to 50 percent has enabled the banks to double the volume of credit. But as they begin to approach even the new credit limit, available new credit becomes scarce. Some banks have to wait for old loans to be paid off before they can grant new ones. Interest rates rise. New projects have to be abandoned, as well as some uncompleted projects that have already been launched. A recession sets in, or even a financial panic.

And then, of course, the proposal is made that the simple way out is to reduce the gold-reserve requirement once again, so as to permit a still further creation of credit.

The Federal Reserve Act

Historically, this is exactly what has been happening. Space does not permit a detailed review of what has happened in one nation after another, starting, say, after the adoption in England of Sir Robert Peel's Bank Act of 1844. But we can point to a few sample changes in our own country, beginning with the Federal Reserve Act of 1913.

That act set up twelve Federal Reserve Banks, and made them the repositories for the cash reserves of the national banks. The first thing that was done was to reduce the reserve requirements of these commercial banks. Under the national banking system the banks had been classified according to the size of the city in which they were located. They were Central Reserve City Banks, Reserve City Banks, and Country Banks. These were required to keep reserves, respectively, of 25 percent of total net deposits (all in the bank's own vaults), 25 percent of total net deposits (at least half in the bank's own vaults), and 15 percent of total net deposits (two-fifths in the bank's own vaults).

The Federal Reserve Act classified deposits into two categories, demand and time, with separate reserve requirements for each. For demand deposits the act reduced the reserve requirements to 18 percent for Central Reserve City Banks, 15 percent for Reserve City Banks, and 12 percent for Country Banks. In each case at least one-third of the reserve was to be kept in the bank's own vaults. For time deposits the reserve was only 5 percent for all classes of banks.

In 1917, as an aid in floating government war loans, the reserve requirements were further relaxed, to 13, 10, and 7 percent respectively, with only a 3 percent reserve requirement for time deposits. Though the amendment also required that all reserve cash should thereafter be held on deposit with the Federal Reserve Banks, the amount of till or vault cash necessary to meet daily withdrawals was found to be small.

In addition to this lowering of the reserve requirements of the member banks, the Federal Reserve System provided for the building of a second inverted credit pyramid on top of the one that the member banks could build. For the Federal Reserve Banks themselves were authorized to issue note and deposit liabilities against their gold reserves, which were required to total only 35 percent against deposits.

As a result of such changes, if the average reserves held by the commercial banks against their deposits were taken as 10 percent, and the gold reserves held by the System against these reserves at 35 percent, the actual gold held against the commercial deposits of the System could be reduced to as low as 3.5 percent.

What actually did happen is that between 1914 and 1931, total net deposits of member banks increased from $7.5 billion to $32 billion, or more than 300 percent in less than two decades.[1]

These figures continued to grow. Gold reserve requirements were finally removed altogether. In August 1971, when the United States officially went off the gold standard, the money stock, as measured by combined demand and time deposits plus currency outside of banks, was $454.5 billion. The U.S. gold reserves were then valued at $10.2 billion. This meant that the money stock of the country had been multiplied more than sixty times over that of 1914, and the gold reserve against this money stock had fallen to only 2.24 percent. Put another way, there was then $44 of bank credit issued against every $1 of gold reserves.

Exhausting the Gold Reserve

The situation was actually more ominous than these figures suggest. For under the gold-exchange system of the International Monetary Fund, it was not merely the American dollar, but the total currencies of practically all the nations in the Fund, that were supposed to be ultimately convertible into the U.S. monetary gold stock. The miracle is not that this gold exchange system collapsed altogether in August of 1971, but that it did not do so much sooner.

In short, the fractional gold standard tends almost inevitably to become more and more attenuated, and while it does so it permits and encourages progressive inflation.

When the gold standard is abandoned completely and officially, inflation usually accelerates. This has been illustrated in the more than seven years since August, 1971. At the end of 1978, the money stock, counting both demand and time deposits, had risen to $871 billion—nearly double the figure at which it stood in August 1971.

But what happens as long as the fractional gold standard is being nominally maintained is that the milder rate of inflation is less noticed, and even many monetary economists are inclined to view it with complacency. This is partly because they have a reassuring theory of what is happening. The amount of currency and credit, they say, is responding to the "needs of business." The loans on which the deposits or Federal Reserve Notes are based represent "real goods." A manufacturer of widgets, for example, borrows a six-month loan from his bank to meet his payroll and other production costs, then when he sells his goods he pays off the loan with the proceeds, and the credit is cancelled. It is "self-liquidating." The money is therefore "sound"; it cannot be over-issued, because it increases and contracts with the volume of business activity.

What this theory overlooks is that while the individual loan may be self-liquidating, this is not what happens to the total volume of credit outstanding. Manufacturer Smith's loan has been repaid. But under the fractional reserve system, the bank, as a result of this repayment, now has "excess reserves," which it is entitled to re-lend. Of course if the bank is fully lent up, even under a fractional reserve system, it cannot extend credit further. But when a substantial number of banks are seen to be nearing this point, pressure comes from all sides—from the banks and their would-be borrowers, and from the government monetary authorities and the politicians who have appointed them—to lower the reserve requirements further. If nothing has gone wrong so far with the existing fractional reserve, indeed, there seems to be no harm in reducing the fraction further. It will permit a further expansion of credit, reduce interest rates, and prevent a threatened business recession.

In sum, to repeat, a fractional-reserve gold system, once accepted, must periodically bring about business and political pressure for a further reduction of the fractional reserve required.

The Harmful Consequences

We have now to examine the harm that the system does whether or not the pressure to reduce the reserve requirements is continuously successful.

Let us begin with a situation in, say, Ruritania, which has a fractional-reserve gold standard and a central bank, but in which business activity has not been fully satisfactory. The central bank then either lowers the discount rate, or creates more member-bank reserves by buying government securities, or it does both. As a result, business is encouraged to increase its borrowing and to launch on new enterprises, and the banks are now able to extend the new credit demanded.

As a consequence of the increased supply of money and credit, prices in Ruritania rise, and so do employment and money incomes. As a further result, Ruritanians buy more goods from abroad. As another result, Ruritania becomes a better place to sell to, and a poorer place to buy from. It therefore develops an adverse balance of trade or payments. If neighboring countries are also on a gold basis, and inflating less than Ruritania, the exchange rate for the rurita declines, and Ruritania is obliged to export more gold. This reduces its reserves and forces it to contract its currency and credit. More immediately, it obliges Ruritania to increase its interest rates to attract funds instead of losing them. But this rise in interest rates makes many projects unprofitable that previously looked profitable, shrinks the volume of credit, lowers demand and prices, and brings on a recession or a financial crisis.

If neighboring countries are also inflating, or expanding the volume of their money and credit at as fast a rate, a crisis in Ruritania may be postponed; but the crisis and the necessary readjustment are all the more violent when they finally occur.

The Cycle of Boom and Bust

The fractional-reserve gold standard, in short—especially when it exists, as it usually does, with a central bank, a government and a public opinion eager to keep expanding credit to start a "full employment" boom or to keep it going—brings about what is known as the business cycle, that periodic oscillation of boom and bust that socialists and Communists attribute, not to the monetary and credit system and central banking, but to some inherent tendency in the capitalist system itself.

I need describe here only in a general way the process by which credit expansion brings about the boom and the inevitable subsequent bust. The credit expansion does not raise all prices simultaneously and uniformly. Tempted by the deceptively low interest rates it initially brings about, the producers of capital goods borrow the money for new long-term projects. This leads to distortions in the economy. It leads to overexpansion in the production of capital goods, and to other malinvestments that are only recognized as such after the boom has been going on for a considerable time. When this malinvestment does become evident, the boom collapses. The whole economy and structure of production must undergo a painful readjustment accompanied by greatly increased unemployment.

This is the Austrian Theory of the trade cycle, which I need not expound here in all its complex detail because that has already been done fully and brilliantly by such writers as Mises, Hayek, Haberler, and Rothbard.

The World Adrift in Turbulent Seas of Paper Money

My chief concern in this article has been to show that in addition to being the principal institution responsible for bringing about the cycle of boom-and-bust that has plagued the civilized world since the early nineteenth century, the fractional-reserve standard, once its principle of "economizing the use of gold" has been fully accepted, itself encourages an inflation that has no logical stopping place until gold has been "phased out" altogether, and the world is adrift in the turbulent seas of paper money.

In emphasizing this weakness of a fractional-reserve standard, I do not intend to imply that I have solved the baffling problem of creating an ideal money assuming that that problem is even soluble. An opportunity now exists—for the first time in a couple of centuries—to introduce a 100 percent gold reserve standard. But if sufficient new gold supplies were not regularly available, such a standard could conceivably result over time in a troublesome fall in commodity prices. Moreover, unless there were rigid prohibitions against it, a private no less than a government money would soon tend to become a fractional-reserve standard. And if we allowed this, would we not soon be on the road once more to a constantly diminishing fraction, and at least a constant mild inflation?

I confess I do not have confident answers to these questions. But that does not invalidate my criticisms of a fractional-reserve standard. I should like to point out, incidentally, that expanding the money supply through a fractional-reserve standard—mainly for the purpose of holding down the exchange-value of the individual currency unit and thereby preventing a fall in prices—could also be accomplished under a full gold standard by constantly or periodically reducing the weight of gold into which the dollar (or other unit) was convertible. Such a proposal was once actually made by the economist Irving Fisher. I am unaware of any economist who accepts such a proposal today. But it is no different in principle from steadily expanding the money supply—under either a paper or a fractional-reserve gold standard—for the purpose of holding down the purchasing power of the monetary unit. Is this a power we would want to trust to the politicians?

As a result of what has already happened, I regret that I cannot join some of my fellow champions of the full gold standard in urging their respective national governments to return immediately to such a standard. I believe such a step at the moment to be both politically and economically impossible. Confidence in the monetary good faith of governments has been destroyed. If any one government were to attempt to return to gold convertibility, at even today's free market price for gold, it would probably be bailed out of its gold within a few weeks.

That is because holders of the currency would doubt not only that government's determination but its ability to maintain that conversion rate. People have seen their governments casually abandon the gold standard, and they are more aware of how slim and insecure the new gold-backing might be against the enormous volume of credit and paper money now outstanding. Gold convertibility of an individual currency could probably now be restored only after a few years of balanced budgets and refrainment from further currency expansion.

Meanwhile, if governments would permit private individuals or banks to mint gold coins and to issue gold certificates, a dual currency system could come into existence that could eventually permit a smooth transition back to a sound gold currency.

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1. See *Money and Man*, by Elgin Groseclose (University of Oklahoma Press), pp. 215–219.

Manning the Sea Walls

by Elgin Groseclose

The rising tide of foreign government defaults on their overseas, dollar-denominated debt threatens to break and overflow the sea walls of international banking and inundate the capitalistic world.

The recent Toronto convocation of international bankers for the annual meeting of the World Bank and International Monetary Fund considered the approaching flood, but their efforts were like those of a platoon of Dutch school boys recruited to stick their fingers in the leaking dykes. In desperation they shouted for more bags of the sand that was being washed away; that is, more international credit, more fiat money of the sort that was already being diluted into muddy liquid.

For the United States, with business bankruptcies soaring and the banking system tottering, confidence has begun to ebb in the power of the omnipotent Federal Reserve to control the flood. Although it mans the sluice gates of a mighty reservoir of credit, some see cracks in the great dam below which the economy sits like a present-day Johnstown. One journalistic commentator declares that the country faces its greatest economic crisis in fifty years.

The Great Debate

A popular cry is to denounce Reaganomics with its devotion to free market economics; more radical theorists accuse the capitalistic system and argue for authoritarian, communist, and socialist forms of government.

Advocates of more government intervention, however, face the dilemma that the crisis is severest in the Third World, most of which is governed by Marxist or socialistic principles under authoritarian regimes. Indeed, it is the collapse of Third World economies, despite a thirty-five-year drain of Western resources under various foreign aid

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programs, that has complicated the problems of the West; it is the defaults of Third World countries on loans from Western banks that now threaten the international banking structure.

Advocates of more government subsidies and intervention, however, ignore the fact that if Reaganomics has not borne the expected fruit, it is because of its failure to extend free market principles into the most important area of enterprise—the money system.

Despite dismantling of many government barriers to trade, money—which is the lifeblood of enterprise—remains under authoritarian controls by a bureaucracy as aloof, as unrestrained, as a Soviet Politbureau. This is the Open Market Committee of the Federal Reserve which congeals the wisdom of twelve mortal beings enjoying long tenure into directives as to the amount and direction of money flow; each Friday the markets of the world await with bated breath the effect of their deliberations.

Historical Review of System

The development of this autocratic power was gradual and often unperceived. For twenty-seven centuries, mankind regarded as axiomatic that the only valid means of payment is intrinsic money, that is, coinage. Rulers throughout history, however, have wherever possible circumvented this principle by degrading or counterfeiting the coinage. The most pervasive effort was in thirteenth-century China, when the Mongol emperors substituted paper notes for metallic coinage in circulation. The Venetian traveler Marco Polo admired the device which, he noted, gave the emperor enormous profits. Despite the inflation that followed, with the notes at a discount, the practice spread to Europe; but in the Middle East, efforts to introduce paper notes were resisted by sedition, and in India, silver remained the standard money of account until the British introduced paper in 1893. The British paid the price; within twenty years they nearly lost their colony but for a U.S. rescue operation. Iran had only metallic money until the 1930s when Reza Shah introduced central banking, à la the Federal Reserve; this monarch lost his throne before a decade had passed.

Rise of "Scientific" Economics

The framers of the United States Constitution rejected paper currency, but despite Constitutional doubts, paper currency was introduced as a war measure during the Civil War; specie payments were resumed in 1879.

Meantime, there had been growing up in the nineteenth century a school of thinkers employing the concepts of mathematics and physics; they obtained respect for their novel theories by designating them as "scientific." Karl Marx called his theory "scientific socialism." Their view was that man was a creature of physical wants and demands that could be measured statistically and programmed mathematically. The profession acquired status after World War II by the formation of an official Council of Economic Advisers, enjoying access to the head of state and more influential than the Secretary of the Treasury or the Secretary of State. Added prestige came in 1969 when a Nobel Prize in "economic science" was set up along with those in medicine and physics.

From this new profession came the philosophical framework for fractional reserve currency which came into being in 1913 with the Federal Reserve System. With fractional reserve currency, the Reserve banks were authorized to convert into cash the debt of member banks. In exchange for the member bank's paper the Reserve banks could issue legal tender notes up to 2+ times the amount of gold money held by the bank. The process was called discounting.

At first only short term commercial debt was generally convertible to cash, but such was the leverage given by this new mechanism, such was its power to create purchasing power by the stroke of a pen, that pressure for its expansion became irresistible. Government bonds became acceptable collateral—this helped finance World War I—the kinds of debt expanded; if not enough debt were offered for discount the Reserve, through the Open Market Committee, could go into the market and buy up debt either on the excuse of stabilizing the price level or of promoting employment. Eventually the requirement of a gold reserve was abandoned.

The Inflationary Flood and the Economic Consequences

The commercial banks, with this ever-ready fountain of liquidity, expanded their lending to the limits of their capital reserves. These dropped from around 25 percent of assets to currently less than 10 percent, with the 15 largest banks presently operating on margins of less than 5 percent.

Not finding productive use for this financial power, they have financed a rank and unhealthy growth of corporate conglomerates with an economic justification no one has yet been able to define. The system of fractional reserve currency became a world fashion like the current rage for blue jeans and lettered T-shirts that may be found on the Ginza and in Red Square. Countries, from Italian principalities governing only a mountain top to continental empires like China, engaged in the issue of currency through central bank emissions.

Despite the collapse of the system in 1933, when every bank in the country closed its doors, such is the fascination with fiat currency that ever-wider powers were conferred on the System. In 1980 Reserve banks were authorized to convert to cash practically any collateral they pleased. Under this authority, the Reserve has acquired some $2 billion of foreign government debt, and it is now being pressed to liquidate large chunks of the debt owed to United States banks by Poland, Mexico, and others. Only John Law, in his effort in 1729 to turn the soil of France into money, showed such effrontery.

Despite the evidence that the main cause of the current worldwide economic debauch is fractional reserve currency adopted everywhere, the Secretary of the Treasury continues to voice confidence in the System. The President tentatively suggests that it should be brought under Treasury supervision. This would be disastrous.

The correct course is to dismantle the Federal Reserve System.

True Function of Money

The function of a monetary system is not to manipulate the flow of credit and banking transactions to maintain a given, or even stable, price level; nor is the function to create employment. The money system should be managed neither in the interest of creditors nor of debtors; neither in the interest of producers nor consumers; neither in the interest of government nor of taxpayers. The function of government is to maintain the integrity of the standard; its function toward money is the same as toward the measure of length or of weight or of quantity. It is as corrupt to vary the standard of value and deferred payments as to change the length of the yard in the interest of cloth merchants, or the content of a bushel in the interest of wheat farmers.

The means of maintaining the standard is the definition of the dollar in terms of a given weight of silver or gold; since 1900, the sole metal of the standard has been gold; the dollar is still by law and statute defined in terms of gold. The regime under which the money system has been corrupted came to a climax in 1934 when the mint was closed to the free coinage of gold. The mechanism by which the circulation is always adequate to the needs of trade is that of free coinage. Under free coinage anyone can bring gold to the mint and have it coined only for the cost of mintage. Under this system the free market, rather than a bureaucracy, determines the amount of circulating media.

Restoration of Free Coinage

The system of free coinage was established in England in 1666; for the first time in history the government monopoly of money ceased; during the succeeding centuries, gold flowed to England, the circulation was always adequate, and England rose to be the principal commercial power of the world. The same system was adopted by the newly formed United States, and under this system the United States became the only rival of Great Britain as a commercial and industrial power. This is the system that should be re-established to restore stability in the United States. It is no more necessary for an international agreement to this end, as some argue, than for every country to agree on the length of a meter or the weight of a kilogram; the natural effect of integrity will compel them to do so.

IV. MONETARY REFORM

The Search for an Ideal Money

by Henry Hazlitt

For more than a century economists have toyed with the idea of designing or inventing an ideal money. So far no two of them seem to have precisely agreed on the detailed nature of such a money. But they do seem at the moment to agree on at least one negative point. I doubt that there is any economist today who would defend the international or American monetary system just as it is. No one openly defends the violent daily and hourly fluctuations in exchange rates, the steadily increasing unpredictability of future import, export, or domestic prices. Every newspaper reader fears that commodity prices will be higher next year and still higher the year after that. Even the man in the street, in brief, senses that the world is drifting toward monetary chaos.

But concerning the remedy, we find little agreement. Inflation is bad, some agree. Yes; but it isn't as bad as depression and unemployment; and at least it puts off those greater evils, so we must have just a little more inflation as long as these evils threaten us. Inflation is bad, others agree; but it has nothing to do with the monetary system. Rising prices are brought about by the greed and rapacity of sellers; they could promptly be stopped by price controls. Or, inflation is bad, still others concede; and yes, it is brought about by the increase in the quantity of money and credit. But this is not the fault of the monetary system itself, but of the blunders and misdeeds of the politicians or the bureaucrats in charge of it.

Even those who admit that there is something wrong with the monetary system itself cannot agree on the reforms needed in that system. Scores of such reforms have been proposed.

The reformers, however, tend to fall into two main groups. One of these would have nothing to do with a gold, a silver, or any other commodity standard, but would leave the issuance and control of the currency entirely in the hands of the State. The other group would return to some form of the gold standard.

Each of these two groups may again be divided into two schools. In what I shall call the statist or paper-money group, one school would

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leave everything to the day-to-day discretion of government monetary authorities, and the other would subject these authorities to strict quantitative controls. And in the gold group, likewise, one school would allow discretion, within vague but wide limits, to private bankers and government authorities, while the second would impose severe and definite limits on that discretion.

So we have, then, four main schools of monetary theorists. Nearly every currency proposal can be classified under one of them.

Paper Money—No Controls

Let us begin with School One, the paper-money statists, who would leave the power of controlling the nature, quantity and value of our money solely in the hands of the politicians in office or the bureaucrats they appoint. This is the worst imaginable monetary system, but it is the one that prevails nearly everywhere in the world today. It has brought about practically universal inflation, unprecedented uncertainty, and economic disruption.

None of this is accidental. It was built into the system deliberately adopted at a conference of 44 nations at Bretton Woods in 1944, under the guidance of Harry Dexter White of the U.S. and Lord Keynes of England. The ostensible purpose of that conference was to increase "international cooperation" and—believe it or not—to "stabilize" currencies and exchange rates.

The chief architects sincerely believed (though they did not as openly avow) that this end could best be achieved by phasing gold out of the monetary system. So they put the world, in effect, not on a gold but on a dollar standard. The value of every other currency was to be maintained by making it convertible into the American dollar at a fixed official exchange rate.

The system still had one tie to gold. The dollar itself was to be kept convertible into that metal at $35 an ounce. But this tie was weakened in two ways. Other countries could keep their currencies stabilized in terms of the dollar, not through the operations of a free foreign exchange market (as under the pre-World War I gold standard) but by government sales or purchases of dollars—in other words by government pegging operations. And dollars were no longer convertible into gold on demand by anybody who held them; they were convertible only by foreign central banks. The U.S. could even (off-the-record) use its great political and economic power—which in time it did—to indicate to any central bank with the effrontery to ask for gold that this was not considered a friendly act.

So the artificial stability that the Bretton Woods system was able to maintain for a few years was not the result of any real attempt by each country to keep its own currency sound—by refraining from excessive issuance of money and credit—but of government pegging operations and gentlemen's agreements not to upset the apple cart.

This arrangement proved, in the end, unwise, unsound, and unstable. The system was able to maintain the appearance of stability only by the stronger currencies constantly rushing to the rescue of the weaker. The U.S., say, would rush in and lend Britain millions of dollars, or buy millions of pounds. It would do the like for other currencies in crisis. But using the stronger currencies to support the weaker only weakened the stronger currencies. When the U.S. Treasury bought millions of pounds with dollars, it in effect got these dollars by printing them.

And so when the dollar itself, as the result of our own recklessness, began to turn bad, and when we went off the gold standard openly in August 1971, other nations were affected. Germany, for instance, under the terms of the Bretton Woods agreements, had to buy billions of dollars to keep the D-mark from going above its official parity. And where did Germany get the billions of marks necessary to buy the billions of dollars? Why, by printing them.

So the faster-inflating nations almost systematically exported their inflations to the slower-inflating nations. And this almost systematically brought the world toward its present inflationary chaos.

True, the nations with stronger currencies, even when they felt obliged by their Bretton Woods agreement to buy weaker currencies, did not *have* to increase their own money supply to buy them. Neither Germany nor any other nation that acquired dollars *had* to use the dollars as added central bank "reserves" against which they could issue still more of their own currency. They could have "sterilized" their reserves of dollars. Or they could have reduced their other government expenditures correspondingly when they felt obliged to buy dollars, or raised the amount by added taxation, instead of simply printing more D-marks or whatever. But these would have been very difficult decisions. They might have endangered the tenure of the governments that made them. What they chose seemed under the circumstances the path of least resistance.

What has to be made crystal clear, if we are to lay the foundations for any permanent sound monetary reform, is that the present worldwide inflationary chaos is not a mere accident. It is not something that has happened in spite of the wonderfully modern and enlightened International Monetary Fund system. It is something that has happened precisely *because* of that system. It is, in fact, its almost inevitable result.

Steady Breakdown

It was precisely the kind of "international cooperation" it set up that led to its final breakdown. The countries whose policies were chronically leading them into currency crises should have been obliged to pay the penalty. The faltering currencies should not have been rescued by the central banks of other countries. It was exactly because the soft-currency countries knew that an American or international safety net would be almost automatically spread out to save them that they chronically got themselves into more trouble.

As it was, the system kept breaking down anyway, but there was a sort of open conspiracy to ignore its fundamental unsoundness. In September 1949, the British pound was devalued by 30 percent, from $4.03 to $2.80. When this happened some 25 other countries devalued within a single week. In November 1967, the British pound was devalued once more, this time from $2.80 to $2.40. There have been in fact hundreds of devaluations of currencies in the International Monetary Fund since it opened for business in 1946. In its Monthly Bulletin the Fund has printed literally millions of statistics a year, but it has steadfastly refused, up to now, to publish one figure—the total number of these devaluations.

Enough of this. It should no longer be necessary to prove how bad the Bretton Woods system turned out to be. Few people, aside from the bureaucrats whose jobs are at stake, would seriously try to glue it together again. The system is dead. Unfortunately the corpse has not been buried.

The Monetarists

Let us turn to the next candidate—the proposals of the so-called monetarists. Two things may by said in favor of the monetarists. First, they do recognize the close connection between the quantity of money and the purchasing power of the monetary unit. And second, they do acknowledge the importance of imposing strict and explicit limits on the issuance of money. But there are serious weaknesses both in their factual assumptions and in their policy proposals.

It is true that there is a close relation between the outstanding supply of money and the buying power of the individual monetary unit. But it is not true that this relation is inversely proportional or in any other way fixed and dependable. Nor is it true that there is any fixed "lag" between an increase of a given percentage in the "growth" of the money supply and an increase of the same percentage in prices. The statistics on which this conclusion is based are at best inadequate. They do not cover enough currencies over long enough periods.

What happens during a typical inflation, for example, is that in its early stages commodity prices do not rise as fast as the supply of money is increased and in its later stages prices rise much faster than the supply of money is increased.

Monetarists will dismiss this whole comparison as unfair and irrelevant. They do not regard themselves as proposing inflation at all. To them inflation is *defined* not as an increase in the money supply, but only as a rise in prices. And their proposal, as they see it, is to increase the stock of money 3 to 5 percent a year *just to keep the price "level" from falling*. They propose an annual increase in the money stock merely to compensate for an expected annual increase of 3 percent or more in the "productivity" of the economy.

The monetarists' proposal rests on a false factual assumption. There is no automatic and dependable annual increase in "productivity" of 3 percent or any other fixed rate. The increase in productivity that has occurred in the U.S. in recent years is the result of saving, investment, and technical progress. None of these is automatic. In fact, in the last two years or so, the usual "productivity" measures have actually been declining.

Wholly apart from the formidable mathematical and statistical problems involved, which space does not permit me to go into, the maintenance of the price "level" is a dubious goal. It is based on the assumption that falling prices are somehow "deflationary," and that in any case they tend to bring about recession. This assumption is questionable. When the stock of money is not increased, falling prices are a normal result of increased production and economic progress. They need not bring recession, because the falling prices are themselves the result of falling production costs. Real profit margins are not reduced. Money wage-rates may not increase, but real wages will increase because the same money will buy more. Falling prices with continued or rising prosperity have occurred again and again in our history.

Abuses of Union Power

In our present world of powerful and aggressive labor unions, with legally built-in coercive powers, the monetarists do have a legitimate fear that such unions will not be satisfied with increased purchasing power for the same money wages. In that case, when such unions ask and get excessive wage-rates, they may bring on unemployment and recession. But this danger will exist under any monetary system whatever, as long as we retain our present one-sided labor laws and union ideology.

The central and fatal flaw of the monetarist proposal is its extreme political naivete. It puts the power of controlling the quantity, the quality, and the purchasing power of our money entirely in the hands of the State—that is, of the politicians and bureaucrats in office.

I am tempted to add that it leaves this power entirely to the *discretion,* the arbitrary caprice, of the temporary holders of office in the State. The monetarists would deny this. They would limit the discretion of the monetary managers, they contend, by a strict rule. The managers would be ordered to increase the stock of money by only 2, or 3, or 4, or 5 percent per year; and this figure would be written into the law, or into the Constitution.

It is a sign of the monetarists' own vacillation that they have never quite decided whether this figure should be a month-to-month bureaucratic goal, or embodied in a law, or nailed into the Constitution. Nor have they ever definitely decided whether the figure itself should be 2 or 3 or 4 or 5. They can apparently hold their ranks together only by remaining vague.

Continuous Political Pressure

It is obvious that once the premises of this system were adopted there would be continuous political pressure for inflation. Those who contended that an annual increase of 2 percent in the money stock would be enough would constantly have to combat the fears of their colleagues that this might be too low, and threaten to bring on recession. The 3 percenters, again, would have to fight a ceaseless rearguard action against the advocates of 4 percent, or these in turn against the champions of 5 percent. And so ad infinitum. Every time a recession seemed imminent, it would be blamed on the lowness of the existing rate of money increase. Agitation would be resumed to boost it.

None of this is a figment of my imagination. It is occurring today. On February 20, 1975, Henry Ford II, in presenting the disappointing annual report of his motor company, emphasized the need of measures to "assure strong recovery." Among these, he stipulated: "The Federal Reserve must raise the monetary growth rate to the range of 6 to 8 percent for a short period."

I cite this as only one among scores of examples. It was especially instructive because it came from a businessman and not from a politician.

A month later there was a far more striking illustration. On March 18, 1975, the Senate of the U.S. adopted unanimously, 86 to 0, a resolution urging the Federal Reserve Board to expand the money supply in a way "appropriate to facilitating prompt economic recovery." It also asked the board to consult with the House and Senate Banking Committee every six months on "objectives and plans" concerning the money supply. This was in effect an order to the Fed to continue inflating, and presumably to increase the rate of inflation. It also put the Fed on notice that whatever it may have previously supposed, it is not independent, but is subject to the directions of the politicians in office. The substance of this resolution was later adopted by the full Congress.

The monetarists' program would inevitably make the monetary system a political football. What else could we expect? Isn't it the height of naivete deliberately to put the power of determining the money supply in the hands of the State, and then expect existing officeholders not to use that power in the way they think is most likely to assure their own tenure of office?

The first requisite of a sound monetary system is that it put the least possible power over the quantity or quality of money in the hands of the politicians.

This brings us to gold. It is the outstanding merit of gold as the money standard that it makes the supply and the purchasing power of the monetary unit independent of government, of officeholders, of political parties, and of pressure groups. The great merit of gold is precisely that it is scarce; that its quantity is limited by nature; that it is costly to discover, to mine, and to process; and that it cannot be created by political fiat or caprice. It is precisely the merit of the gold standard, finally, that it puts a limit on credit expansion.

Fractional or Full Reserve?

But there are two major kinds of gold standard. One is the fractional-reserve system, and the other the pure gold or 100 percent reserve system.

The fractional-reserve system is the one that developed and prevailed in the Western world in the century from 1815 to 1914. It is what we now call the classical gold standard. It had the so-called advantage of elasticity. And it made possible—we might justly say it was responsible for—the business cycle, the recurrent round of prosperity and recession, of boom and bust.

With the fractional-reserve system what typically happened is that in a given country—let us say Ruritania—borrowers would be given credit by the banks, in the form of demand deposits, and they would launch upon various enterprises. The new money so created, perhaps after taking up any slack in business and employment, would increase Ruritanian prices. Ruritania would become a better place to sell to, and a poorer place to buy from. The balance of trade or payments would begin to turn against it. This would be reflected in a fall in the exchange rate of the Ruritanian currency until the "gold export point" was reached. Gold would then flow out to other countries. In order to stop it, interest rates in Ruritania would have to be raised. With a higher interest rate or a smaller gold base, the volume of currency would be contracted. This would often mean a deflation or a crisis followed by a slump.

In brief, the gold standard with a fractional-reserve system tended almost systematically to bring about the cycle of boom and slump.

Under such a system, there is constant political pressure to reduce interest rates or the reserve requirements so that credit expansion—i.e., inflation—may be encouraged or continued. It is supposed to be the great advantage of a fractional-reserve system that it allows credit expansion. But what is overlooked is that, no matter how low the required legal reserve is set, there must eventually come a point when the permissible legal credit expansion has been reached. There is then inevitable political pressure to reduce the percentage of required reserves still further.

This has been the history of the system in the United States. The effect—and partly the intention—of the Federal Reserve Act was enormously to increase the potential volume of credit expansion. The required reserves for member banks were reduced under the new Federal Reserve Act from a range of 15 to 25 percent for the previous national banks to 12 to 18 percent for the new Federal Reserve member banks. In 1917 the required reserves for member banks were reduced still further to a range of 7 to 13 percent.

Pyramiding Credit

But on top of the inverted pyramid of credit that the member banks were allowed to create, the newly established Federal Reserve Banks, which now held the reserves of the member banks, were permitted to erect a still further inverted credit pyramid of their own. The

Reserve Banks were required to carry only a 35 percent reserve against their deposits and a 40 percent gold reserve against their notes.

Later the Federal Reserve authorities became more strict in imposing reserve requirements on the member banks (they raised these sharply beginning in 1936, for example). But they continued to be very lenient in setting their own reserve requirements. Between June of 1945 and March of 1965 the reserve requirements were reduced from 35 and 40 percent to a flat 25 percent. And then they were dropped altogether.

So much for history. What of the future?

If the world, or at least this country, ever returns to its senses, and decides to re-establish a gold standard, the fractional-reserve system ought to be abandoned. If by some miracle the U.S. government were to make this decision tomorrow, it could not of course wipe out the already existing supply of fiduciary money and credit, or any substantial part of it, without bringing on a devastating and needless deflation. But the government would at least have to refrain from any further increase in the supply of such fiduciary currency. Assuming that the government were then able to fix upon a workable conversion rate of the dollar into gold—a rate that was sustainable and would not in itself lead to either inflation or deflation—the U.S. could then return to a sound currency and a sound gold basis.

But in the world as it has now become—sunk in hopeless confusion, inflationism, and demagogy—the likelihood of any such development in the foreseeable future is practically nil. The remedy I have suggested rests on the assumption that our government and other governments will become responsible, and suddenly begin doing what is in the long-run interest of the whole body of the citizens, instead of only in the short-run interest—or apparent interest—of special pressure groups. Today this is to expect a miracle.

But the outlook is not hopeless. I began by pointing out that for more than a century individual economists have tried to design an ideal money. Why have they not agreed? Why have their schemes come to nothing? They have failed, I think, because they have practically all begun with the same false assumption—the assumption that the creation and "management" of a monetary system is and ought to be the prerogative of the State.

This has become an almost universal superstition. It is tantamount to agreeing that a monetary system should be made the plaything of the politicians in power.

The proposals of the would-be monetary reformers have failed, in fact, for *two* main reasons. They have failed partly because they have misconceived the primary functions that a monetary system has to serve. Too many monetary reformers have assumed that the chief quality to be desired in a money is to be "neutral." And too many have assumed that this "neutrality" would be best achieved if they could create a money that would lead to a constant and unchanging "price level."

This was the goal of Irving Fisher in the 1920s, with his "compensated dollar." It is the goal of his present-day disciples, the "monetarists," and their proposal for a government-managed increase in the money supply of 3 to 5 percent a year to keep the "price level" stable.

I believe that this goal itself is a questionable one. But what is an even more serious and harmful error on their part is the method by which they propose to achieve this goal. They propose to achieve it by giving the power to the politicians in office to manipulate the currency according to the formula prescribed in advance by the monetarists.

Self-Serving Politicians

What such reformers fail to recognize is that once the politicians and their appointees are granted such powers, they are less likely to use them to pursue the objectives of the reformers than they are to pursue their own objectives. The politicians' own objectives will be those that seem best calculated to keep them in power. The particular policy they will assume is most likely to keep them in power is to keep increasing the issuance of money; because this will (1) increase "purchasing power" and so presumably increase the volume of trade and employment; (2) keep prices going up as fast as union pressure pushes up wages, so that continued employment will be possible; and (3) give subsidies and other handouts to special pressure groups without immediately raising taxes to pay for them. In other words, the best immediate policy for the politicians in power will always appear to them to be inflation.

In sum, the belief that the creation and management of a monetary system ought to be the prerogative of the State—i.e., of the politicians in power—is not only false but harmful. For the real solution is just the opposite. It is to get government, as far as possible, out of the monetary sphere. And the first step libertarians should insist on is to get our government and the courts not only to permit, but to enforce, voluntary private contracts providing for payment in gold or in terms of gold value.

A Movement Toward Gold

Let us see what would happen if this were done. As the rate of inflation increased, or became more uncertain, Americans would tend increasingly to make long-term contracts payable in gold. This is because sellers and lenders would become increasingly reluctant to make long-term contracts payable in paper dollars, or in irredeemable money—units of any other kind.

This would apply particularly to international contracts. The buyer or debtor would either have to keep a certain amount of gold in reserve, or make a forward contract to buy gold, or depend on buying gold in the open spot market with his paper money on the date that his contract fell due. In time, if inflation continued, even current transactions would increasingly be made in gold.

Thus there would grow up, side by side with fiat paper money, a *private* domestic and international gold standard. Each country that permitted this would then be on a dual monetary system, with a daily changing market relation between the two monies. And there would be a private gold system ready to take over completely on the very day that the government's paper money became absolutely worthless—as it did in Germany in November 1923, and in scores of other countries at various times.

A Private Gold Standard?

Could there be such a private gold standard? To ask such a question is to forget that history and prehistory have already answered it. Private gold coins, and private gold currencies, existed centuries before governments decided to take them over—to nationalize them, so to speak. The argument that the kings and governments put forward for doing this—and it was a plausible one—was that the existing private coins were not of uniform and easily recognizable size, weight, and imprint; that the fineness of their gold content, or whether they were gold at all, could not be easily tested; that the private coins were crude and easily counterfeited; and finally that the legal recourse of the receiver, if he found a coin to be underweight or debased, was uncertain and difficult. But, the kings went on to argue, if the coins were uniform, and bore the instantly recognizable stamp of the realm, and if the government itself stood ever ready to prosecute all clippers or counterfeiters, the people could depend on their money. Business transactions would become more efficient and certain, and enormously less time-consuming.

Still another specious argument for a government coinage applied especially to subsidiary coins. It was impossible, it was contended, or ridiculously inconvenient, to make gold coins small enough for use in the millions of necessary small transactions, like buying a quart of milk or a loaf of bread. What was needed was a subsidiary coinage, which represented halves, quarters, tenths, or hundredths of the standard unit. These coins, regardless of what they were made of, or what their intrinsic value might be, would be legally acceptable and convertible, at the rates stamped on them, into the standard gold coins.

It would be very difficult, I admit, to provide for this with a purely private currency, with everybody having the legal power to stamp out his own coins and guarantee their conversion by him into gold. A private coinage system might conceivably be able to solve this problem, but I confess I personally have been unable to think of any solution that would not be complicated, cumbersome, or undependable.

It is clear, in short, that a government-provided or a government-regulated coinage has some advantages. But these advantages are bought at a price. That price seemed comparatively low in the nineteenth century and until 1914; but today the price of government control of money has become excessive practically everywhere.

The basic problem that confronts us is not one that is confined to the monetary sphere. It is a problem of government. It is in fact *the* problem of government in every sphere. We need government to prevent or minimize internal and external violence and aggression and to keep the peace. But we are obliged to recognize that no group of men can be completely trusted with power. All power is liable to be abused, and the greater the power the greater the likelihood of abuse. For that reason, only minimum powers should be granted to government. But the tendency of government everywhere has been to use even minimum powers to increase its powers. And any government is certain to use great powers to usurp still greater powers. There is no doubt that the two great World Wars since 1914 brought on the present prevalence of the quasi-omnipotent State.

But the solution of the overall problem of government is beyond the province of this article. To decide what would be the best obtainable monetary system, if we could get it, would be a sufficiently formidable problem in itself. But a major part of the solution to this problem, to repeat once more, will be how to get the monetary system out of the hands of the politicians. Certainly as long as we retain our nearly omnipotent redistributive State, no sound currency will be possible.

Free Choice of Currencies

by Henry Hazlitt

In its issue of November 1975, *The Freeman* published an article of mine entitled "The Search for an Ideal Money." Let me summarize its main conclusions.

1. "The first requisite of a sound monetary system is that it put the least possible power over the quantity or quality of money in the hands of the politicians."

2. "It is the outstanding merit of gold as the monetary standard that it makes the supply and purchasing power of the monetary unit independent of government, of officeholders, of political parties, and of pressure groups. The great merit of gold is precisely that it is scarce . . . It cannot be created by political fiat or caprice. It is precisely the merit of the gold standard, finally, that it puts a limit on credit expansion."

3. But there are two major kinds of gold standard. One is the fractional-reserve system, and the other the pure gold or 100 percent reserve system. The fractional-reserve system "is what we now call the classical gold standard." It permitted excessive credit expansion followed by forced contraction, and so "tended almost systematically to bring about the cycle of boom and slump." The development of government-controlled central banks—in our own case of the Federal Reserve System—made the overexpansion of credit much worse.

4. "The fractional-reserve system ought to be abandoned. . . . The U.S. could then return to a sound currency and a sound gold basis."

5. But to expect this today, as long as governments are in control, "is to expect a miracle." The schemes of the currency reformers have failed "because they have practically all begun with the same false assumption—the assumption that the creation and 'management' of a monetary system is and ought to be the prerogative of the State. . . . The real solution is just the opposite. It is to get the government, as far as possible, out of the monetary sphere. And the first step libertarians should insist on is to get our government and the courts not only to permit, but to enforce, voluntary private contracts providing for payment in gold or in terms of gold value. . . . Thus there would grow up,

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side by side with fiat paper money, a private domestic and international gold standard . . . ready to take over completely on the very day that the government's paper money became absolutely worthless."

Hayek's Proposal

Since that article appeared, Professor F.A. Hayek, the Nobel laureate, has published two remarkable pamphlets embodying similar proposals, but carrying them in some important respects further.

The first of these is *Choice in Currency.*[1] I find this wholly admirable. Hayek begins by pointing out that the chief root of our recent monetary troubles is the scientific authority which the Keynesians seemed to give to the superstition that increasing the quantity of money can ensure prosperity and full employment. He then proceeds to point out the fallacies in this view. Inflation, however, he concedes, even before explicit Keynesianism, largely dominated monetary history until the emergence of the gold standard. The gold standard brought two centuries of stable prices and made possible the development of modern industrialism:

"It was the main function of the gold standard, of balanced budgets, of the necessity for deficit countries to contract their circulation, and of the limitation of the supply of 'international liquidity'," he points out, "to make it impossible for the monetary authorities to capitulate to the pressure for more money."

But under present world political conditions he does not believe that we can now remedy the situation by constructing some new international monetary order, whether a new international monetary authority or institution, or even an international agreement to adopt a particular mechanism or system of policy, such as the classical gold standard. I am fairly convinced that any attempt now to reinstate the gold standard by international agreement would break down within a short time and merely discredit the ideal of an international gold standard for even longer. Without the conviction of the public at large that certain immediately painful measures are occasionally necessary to preserve reasonable stability, we cannot hope that any authority which has the power to determine the quantity of money will long resist the pressure for, or the seduction of cheap money."

What Is the Remedy?

What, then, is the remedy? What is so dangerous and ought to be done away with, Dr. Hayek insists, is not the right of governments to issue money but their *exclusive* right to do so and their power to force people to use it and to accept it at a particular price. The legal tender laws should be repealed.

A great deal of confusion has existed about this. It is necessary, of course, for the government to decide what kind of money it will accept in payment of taxes, and it is necessary for the courts to be able to decide, in case of dispute, in what kind of money private debts should be paid. No doubt, in the absence of specification, courts would continue to decide that debts can be paid off in the official money of the country, no matter how much it may have depreciated. But if the debtor and creditor have expressly contracted for a payment to be made in gold, or in Swiss francs, or in D-marks, then the courts should hold that contract valid. The common law of enforcement of contracts should apply.

The immediate advantages of this should be obvious. A government would no longer be able to protect its money against competition. If it continued to inflate, its citizens would forsake its money for other currencies. Inflation would no longer pay.

There is, in a sense, nothing novel about Hayek's proposal. Toward the end of the German hyperinflation of 1920 to 1923, people refused to accept the old paper marks on any terms, and began to do business with each other in gold, dollars, Swiss francs, and even in a multitude of private currencies. But in any country in which the legal tender laws did not exist, inflation would never again go to such tragic lengths—if, indeed, it could be continued to any substantial extent at all.

If the present writer were to venture a prediction, it would be that when the gold standard is restored—as I believe it eventually will be—it is far more likely to be restored first, not in countries that have been suffering the least, but in those that have been suffering the worst inflation. It will first happen, not by deliberate governmental policy, but by breakdown and default. No matter what the nominal legal penalties, people will cease doing business in the national paper money. (They did so not only in Germany in 1923, but in the assignat period in France, and in Soviet Russia in 1923.)

Denationalization

I should like to turn now to the second Hayek pamphlet that I referred to a few pages back. This is called *Denationalization of Money*.[2]

It followed eight months after the pamphlet on *Choice in Currency*, and it continues the argument put forward in the latter. That argument is summarized in ten numbered points printed on the pamphlet's back cover. I quote the first five:

> 1. The government monopoly of money must be abolished to stop the recurring bouts of acute inflation and deflation that have become accentuated during the last 60 years.
> 2. Abolition is also the cure for the more deep-seated disease of the recurring waves of depression and unemployment attributed to "capitalism."
> 3. The monopoly of money by government has relieved it of the need to keep its expenditure within its revenue and has thus precipitated the spectacular increase in government expenditure over the last thirty years.
> 4. Abolition of the monopoly of money would make it increasingly impossible for governments to restrict the international movement of men, money and capital that safeguard the ability of dissidents to escape oppression.
> 5. These four defects—inflation, instability, undisciplined state expenditure, economic nationalization—have a common origin and a common cure: the replacement of the government monopoly of money by competition in currency supplied by private issuers who, to preserve public confidence, will limit the quantity of their paper issue and thus maintain its value. This is the "denationalization" of money.

Most libertarians can endorse the first four of these points unreservedly. About the fifth and those following I personally harbor grave doubts.

"Free" private currencies have been tried. In our early American history they were tried repeatedly in nearly all the existing states. Some of the states issued their own money, usually with disastrous results; and most of the private currencies that they licensed met with little better fate. Panics and financial collapses became a matter of course. To take one state at random, in Michigan, after 1836:

> Fraudulent overissues were frequent and in many cases not even recorded. Before long a million dollars in worthless bank notes were in circulation, a bewildering variety of issues each circulating at its own rate of discount with a confusion that required corps of bookkeepers to keep the accounts of a firm straight. Merchants kept couriers by whom they hurried off to the banks the notes they were compelled to take, in

> order to exchange them—if possible—for something which had more value. Misery and bankruptcy spread over the state. . . . The climax came in 1844 when, nearly all the "free banks" being in the hands of receivers, the state supreme court held that the general banking law had been passed in violation of the constitution and hence that even the receiverships had no legal existence![3]

Other states made other provisions and other reserve requirements for note issues by private banks, but the history of laxly controlled private note issue in all the states is depressingly similar. The interested reader can find a short but excellent account (pp. 180 to 193) in the book by Dr. Groseclose from which I have just quoted.

In the light of this history, I can only regard with astonishment the extraordinary optimism of Dr. Hayek regarding the outcome of unrestricted private note issue. He assures us that private competition in issuing money will lead us to a far sounder money than the classic gold standard was ever able to provide. The private issuers, he seems to assume, will in all cases be scrupulously honest, and will have in mind only their *long-run* self-interest; and therefore "money is the one thing competition would not make cheap, because its attractiveness rests on its preserving its 'dearness.'"

"Abstract Units," Not Convertible to Gold

Hayek does not seem to think that it is either necessary or desirable for the private issuers of currency to keep it convertible into gold. He suggests that their money could consist of "different abstract units" (p. 25). How a currency could consist of a merely "abstract" unit, and how a private issuer could get it launched and accepted at a "precisely defined" (p. 39) purchasing power, he does not explain.

If he were in charge of one of the major Swiss joint-stock banks, he tells us, he would issue a unit called, say, a "ducat." "And I would announce that I proposed from time to time to state the precise commodity equivalent in terms of which I intended to keep the value of the ducat constant, but that I reserved the right, after announcement, to alter the composition of the commodity standard as experience and the revealed preferences of the public suggested" (p. 39).

It is clear that Hayek has in mind that private issuers could and should adopt a "commodity reserve" or "market basket" standard. (He has advocated such a standard for a long time. For example, in *The Constitution of Liberty*, published in 1960, he tells us (p. 335): "A commodity reserve standard which has been worked out in some detail appears to me still the best plan for achieving all the advantages attributed to the gold standard without its defects." And he refers there to an essay advocating such a currency that he published as early as 1943.)

A Problem of Conversion

But Hayek is bafflingly vague concerning how a private issuer would maintain the value or purchasing power of such a currency. He says that "the issuing institution could achieve this result by regulating the quantity of its issue" (p. 43) and by keeping it "scarce" (p. 85). But quantity and scarcity mean nothing in this context except in relation to the liquid assets of the particular issuer and his demonstrated ability and readiness to keep his currency unit convertible on demand into the precise weight of the concrete commodity that his unit is supposed to be worth. He can make it convertible into a gram of gold or an ounce of silver or a pound of tobacco or a bushel of wheat. But there is no feasible way in which he could make it convertible into, say, a specified amount of each of the 400 or so commodities and services that enter into the official Consumer Price Index, not to speak of the 2,700 commodities in the official Wholesale Price Index. And no holder of his currency would in any case want to load himself down with these and give himself the problem of disposing of them.[4]

Others before Dr. Hayek have had a similar yearning for a commodity standard, but have been aware of this practical problem. The most prominent is Irving Fisher, who in the 1920s proposed his "compensated dollar." This is a dollar that would have been convertible into a constantly changing quantity of gold, to keep it fixed in value in relation to an average price of commodities as determined by an official index.

Fisher's compensated gold dollar would have solved the problem of the utter impracticability of any direct conversion of a currency unit into a trainload or shipload of assorted commodities, but it would have solved it at a prohibitive cost. As Benjamin M. Anderson[5] and others pointed out, it would have enabled international speculators to speculate with impunity against the dollar and the American gold reserve, and would have had other self-defeating and confidence-undermining effects.

What is strangest about the fascination that a commodity or "fixed-purchasing-power" standard has exercised over some otherwise brilliant minds is that such a standard is quite unnecessary. As Murray N. Rothbard has put it: "If creditors and debtors want to hedge against future changes in purchasing power, they can do so easily on the free market. When they make their contracts, they can agree that repayment will be made in a sum of money *adjusted* by some agreed-upon index number of changes in the value of money."[6]

This whole discussion of a private commodity-reserve currency may seem like a diversion which I could have avoided. I have made it chiefly because Dr. Hayek's deservedly great authority might otherwise lead some persons to advocate a false remedy and others to reject the whole idea of a private currency as chimerical.

But we can safely return to the recommendations of Hayek's earlier *Choice in Currency* pamphlet of 1976 and to my own suggestion of a private gold standard in 1975. Both are entirely valid.

Let us not reject the gold standard because governments once embraced it. After all, it was the end-product of centuries of experience. It was the survival of the fittest against the early competition of oxen, sheep, hides, wampum, tobacco, iron, copper, bronze, and finally of silver. It was the outcome of competition in the market place, as I am confident it would be again. It was only after its victory in private use that governments took it over, exploited it for their own purposes, diluted it, perverted it, and finally destroyed it.

Private Coinage; Notes Fully Redeemable

Let us see where this leads us: Governments should be deprived of their monopoly of the currency-issuing power. The private citizens of every country should be allowed, by mutual agreement, to do business with each other in the currency of any other country. In addition, they should be allowed to mint privately gold or silver coins and to do business with each other in such coins. (Each coin should bear the stamp, trademark or emblem of its coiner and specify its exact round weight—one gram, 10 grams, or whatever. It would be preferably referred to by that weight—a goldgram, say, and not bear any more abstract name like dollar or ducat.) Still further, private institutions should be allowed to issue notes payable in such metals. But these should be only gold or silver certificates, redeemable on demand in the respective quantities of the metals specified. The issuers should be required to hold at all times the full amount in metal of the notes they have issued, as a warehouse owner is required to hold at all times everything against which he has issued an outstanding warehouse receipt, on penalty of being prosecuted for fraud. And the courts should enforce all contracts made in good faith in such private currencies.

At first glance this proposal would seem to be much more restricted and hampering than the Hayek scheme. But it would, in fact—if it could be achieved—lead to an almost revolutionary monetary reform. The competition of foreign currencies and of private coins and certificates would bring almost immediate improvement in most national currencies. The governments would have to slow down or halt their inflations to get their own citizens to continue to use their government's money in preference to the most attractive foreign currencies, or to private gold or silver certificates.

But something far more important would happen. As the use of the private currencies expanded, a private gold standard would develop. And because of the restrictions placed on it, it would be a pure, a 100 percent, gold standard. The government fractional-reserve gold standard—which was the "classic" gold standard—was finally stretched and abused to the point where, in my opinion, it can never be restored by any single nation or even by a "world authority."

Worthy of Trust

But this, when one comes to think of it, will be ultimately a tremendous boon. For though people will probably again never trust a fractional-reserve gold standard, they will trust a full gold standard. And they will trust it the more if it is no longer in the exclusive custody of governments—consisting of vote-seeking politicians and vote-seeking officeholders—but also in private custody. The gold reserves will no longer be held solely in huge national piles—subject often to the overnight whim or ukase of a single man (Franklin D. Roosevelt or Richard Nixon). Gold coins will circulate, and be held by millions, and the gold reserves will be distributed among thousands of private vaults. The private certificate-issuers would not be allowed to treat—as governments have—this gold held in trust as if it had somehow become their own property. (In the U.S., that engine of inflation known as the Federal Reserve System would of course be abolished.)

Permitting private gold coinage and private gold-certificate issues will allow us to bring the world back to a pure gold standard. This has hitherto been considered an utterly hopeless project. As long as we were operating on a fractional-reserve gold standard, any attempt to return to a pure or 100 percent gold standard would have involved a devastating deflation, a ruinous fall of prices. But now that not only the United States, but every other nation, has abandoned a gold standard completely, the former problem no longer exists. The beginning of the new reform would bring a dual system of prices—prices in gold, and prices in the outstanding government paper money. In the transition period, prices would be stated in both currencies, until the government paper money either became worthless, or the issuing government itself returned to a gold standard and accepted its outstanding paper issues at a fixed conversion rate. (An example of this was the German acceptance of a trillion old paper marks for a new rentenmark—and finally gold mark—after 1923.)

Subsidiary Coinage

Government-issued money did supply a uniform subsidiary coinage. It is hard (though not impossible) to see how a private currency could solve this problem satisfactorily. Perhaps governments could be trusted to continue to mint a uniform subsidiary coinage and keep a 100 percent gold reserve at least against this.

But apart from such comparatively minor problems, I can see no great difficulties in the way of a private money. The main problem is not economic; it is political. It is how we can get governments voluntarily to repeal their legal tender laws and to surrender their monopoly of money issue. I confess I cannot see how this political problem is going to be solved. But it is the urgent and immediate goal to which every libertarian, and every citizen who can recognize the great jeopardy in which we all stand, should now direct his efforts.

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1. London: The Institute for Economic Affairs, 1976, 48 pages.
2. London: The Institute for Economic Affairs, 1976, 108 pages.
3. Elgin Groseclose, *Money and Man* (University of Oklahoma Press, fourth edition, 1976), p. 188.
4. In the 1943 essay by Hayek that I previously mentioned, "A Commodity Reserve Currency," included in his *Individualism and Economic Order* (University of Chicago Press, 1948), he endorses a scheme by Benjamin Graham involving only 24 different commodities. I need not discuss that plan in detail here, and will say only that I regard it as incredibly clumsy, complicated, costly, wasteful, unsettling, and altogether impracticable. It was in any case proposed as a government scheme, and would inevitably have become a political football.
5. See his *Economics and the Public Welfare* (New York: Van Nostrand, 1949), Ch. 51.
6. *What Has Government Done to Our Money?* (Santa Ana, Calif., Rampart College), p. 17.

In Search of a New Monetary Order

by Hans F. Sennholz

Ever since President Nixon suspended gold payments, on August 15, 1971, the question of realistic par values of the world's currencies has become a vexing international political issue. Governments and central banks are searching for new rules that permit "more flexible" currency fluctuations. Something beyond dollars and gold is needed, they believe, to provide a solid base for a new monetary order. Return to the old system spawned at Bretton Woods, N. H., in 1944, is out of the question. It was a gold and dollar standard, with the U.S. dollar payable in gold at $35 an ounce while other countries pegged their moneys to the dollar, holding them within a range of 1 per cent up or down from the parity registered with the 118-country International Monetary Fund.

Now, since the suspension of gold payments, the world has been waiting for monetary authorities to find a new monetary system. The process must necessarily be slow, as a political solution is sought to economic problems that were generated by various political considerations. After all, the depreciation of the U.S. dollar, which finally led to the gold payment suspension, was a political act by the monetary authorities of several Federal administrations. The decision to "float" the dollar rather than face the humiliation of a formal devaluation was also a political act. Similarly, the other governments are motivated politically in their attempts at monetary management. While most "experts" make the government, its powers and objectives, their point of departure for monetary deliberation, a few scholars continue to base their inquiries on the fundamental principles that flow from individual choice and action. In their judgment, the factors that affect the exchange relations between various national currencies rest on the economic principles that determine the purchasing power of each and every type of medium of exchange, whether it is a precious metal or government fiat money.

As they see it, the purchasing power of any monetary unit depends on the relation between the demand for and the quantity of money in individual cash holdings. The demand for money is purely

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individual, although a great many extraneous factors may influence this demand. There is, for instance, the expectation of future changes in the exchange value of money. An expected fall tends to reduce the demand for money and thus its purchasing power; an expected rise brings about the opposite. Also, the availability of goods affects the demand for money. In an expanding economy when more and better goods are offered on the market, the demand for money tends to rise; in a declining economy, where capital is consumed and the division of labor breaks down, the demand for money tends to decline.[1]

The Stock of Money

The supply of money is the stock of money available for exchange. During the age of the gold standard it consisted of gold bullion, gold coins and their various substitutes, such as bank notes, tokens, and demand deposits. In this age of government currency, it consists of fiat money and its substitutes, such as tokens and demand deposits. The substitutes may either be fully backed by money proper or else they are fiduciary, i.e., uncovered. Thus, an expansion or contraction of fiduciary media directly affects the total quantity of money available for exchange.

A change in the money relation through changes in either the demand for money or the stock of money affects changes in the purchasing power of money. As one factor of demand or supply cannot perfectly offset changes in the other factors, money can never be neutral. Now, if there are two or more media of exchange, such as gold or silver, or various fiat currencies, what determines the exchange ratio between the various media? Their purchasing powers! That is to say, exchange ratios correspond to the ratio of each one's purchasing power in terms of all other goods. Market forces tend to establish the parity between the purchasing powers and thus their exchange ratios. The equilibrium exchange rate is called the *purchasing power parity*.

Gold and Silver as Money

For more than 2,500 years the civilized world used gold and silver as money. These metals became valuable media of exchange because they were not only desirable for nonmonetary uses, but also suited so well for economic exchanges as they were durable, portable, and divisible. Silver was generally used for small transactions and gold in all larger exchanges. And throughout the ages their exchange ratios were determined by their purchasing power parities. If one ounce of gold bought a horse that also could be bought for 10 ounces of silver, the parity between gold and silver was 1:10. If for any reason the exchange rate differed from this parity, arbitrage would soon restore the exchange ratio to its purchasing power parity. If, in our example, the exchange ratio should be 11:1 and the purchasing power 10:1 it would be very profitable to exchange gold for silver and then buy commodities. But such money exchanges would soon drive the ratio back to its parity.

In all countries where gold was the standard money, the exchange ratios between gold coins of different weight and fineness were determined simply by this difference. If one coin weighed one ounce and another coin of equal fineness only one-third of an ounce, the exchange ratio obviously was 1:3. Under the gold-coin standard, commonly called the orthodox or classical gold standard, gold coins were the standard money. National currencies represented a certain quantity of gold of a certain fineness. The U.S. dollar, for example, consisted of 25.8 grains of gold, nine-tenths fine, before the 1934 devaluation, and 15 5/21 grains thereafter, or in troy ounces 1/20.67 and 1/35 respectively. The U.S. $20 gold coin (Double Eagle) contained 30.09312 grams of fine gold, the $10 coin (Eagle) 15.04656 grams, and the $5 coin (Half Eagle) 7.52328 grams. The British Sovereign contained 7.322 grams, the Mexican 50 Peso coin 37.5 grams, the French 20 Francs coin, also called Napoleon, 5.8 grams, and the Swiss 20 Francs coin 5.8 grams.[2] Exchange ratios between the various currency units consisting of gold thus were determined by their relative measures of gold.

International Acceptability

The world had an international currency while on the classical gold standard. It evolved without international treaties, conventions or institutions. No one had to make the gold standard work as an international system. When the leading countries had adopted gold as their standard money the world had an international currency without problems of convertibility or even parity. The fact that the coins bore different names and had different weights hardly mattered. As long as they consisted of gold, the national stamp or brand did not negate their function as an international medium of exchange.

The purchasing power of gold tended to be the same the world over. Once it was mined, it rendered exchange services throughout the world market, moving back and forth and thereby equalizing its purchasing power except for the costs of transport. It is true, the composition of this purchasing power differed from place to place. A gram of gold would buy more labor in Mexico than in the U.S. But as long as some goods were traded, gold, like any other economic good, would move to seek its highest purchasing power and thereby equalize its value throughout the world market. As all coins and bullion were traded in terms of weight of gold, there were no "exchange rates" such as those between gold and silver, or various fiat monies.

The Exchange-Rate Dilemma

The departure from the gold-coin standard, set the stage for the present exchange-rate dilemma. At first, governments began to restrict the actual circulation of gold. They gradually established the *gold-bullion standard* in which government or its central bank was managing the country's bullion supply. Gold coins were withdrawn from individual cash holdings and national currency was no longer redeemable in gold coins, but only in large, expensive gold bars. This standard then gave way to the *gold-exchange standard* in which the gold reserves were replaced by trusted foreign currency that was redeemable in gold bullion at a given rate. The world's monetary gold was held by a few central banks, such as the Bank of England and the Federal Reserve System, that served as the reserve banks of the world.[3] But after World War II, the Bank of England which was holding the gold reserves for more than 60 countries, commonly called the pound sterling area, gradually lost its eminent position. It began to hold most of its reserves in U.S. dollar claims to gold, which made the Federal Reserve System the ultimate reserve bank of the world; thus the gold-exchange standard became a *de facto gold and dollar standard*. Finally, during the accelerating inflation and credit expansion of the 1960s in the U.S., the dollar gradually fell from its respected position. Several monetary crises which triggered world-wide demands for dollar redemption greatly depleted the American stock of gold, and created precarious payment situations.

Altogether, in less than four years, we experienced seven currency crises that foretold the end of the international monetary system. In November, 1967, Great Britain devalued the pound and a number of other countries immediately followed suit. In March of 1968, under the pressure of massive pound sterling liquidation, the nine-nation gold pool was abandoned and the two-tier system adopted. The third crisis occurred in France in May, 1969, when political riots, followed by rapid currency expansion, greatly weakened the franc which was later devalued. The fourth crisis erupted in September, 1969, when massive dollar conversions to West German marks forced the German central bank to "float" the mark and then revalue it upward by 9.3 per cent. The fifth crisis occurred in March and early April, 1971, when a new flight from the dollar threatened to inundate several European central banks. In a concerted effort, the U.S. Treasury and the Export-Import Bank endeavored to "sop up" the dollar flood. The sixth crisis began in May, 1971, when a new flow of dollars into German marks, Swiss francs, and several other currencies caused the mark to float anew, the Swiss franc to be revalued upward by 7.07 per cent, and several other currencies to be allowed to float or be revalued. The seventh and last crisis was of such massive proportions that President Nixon was forced to announce the collapse of the old monetary order.

Why the Breakdown of International Monetary Relations?

What had caused this gradual deterioration of international monetary relations? An understanding of the causes may provide an answer to the dilemma, prevent further deterioration, and hopefully find a cure to all its somber consequences.

The popular explanation usually runs as follows: The rapid worsening of the U.S. international balance-of-payment deficit was the proverbial straw that broke the system's back. From a small surplus of $2.7 billion in 1969, achieved mainly through various government manipulations that amounted to window dressing, the 1970 payments deficit soared to an all-time record deficit of some $10.7 billion, on official settlement basis, i.e., official settlements between governments only. Then, in May, 1971, the U.S. Commerce Department announced that the first quarter 1971 deficit had grown to a record $5.4 billion.[4] And finally, private sources estimated that in 1971, up through mid-August, some $22 billion more dollars flowed out of the country than came in.

These new payment deficits were added to the accumulated unpaid deficits of the U.S. for many years. U.S. dollars and short-term claims to dollars in foreign hands amounted to $43 billion at the end of 1970. After deducting U.S. short-term claims on foreigners our *net* obligations exceeded $32 billion, plus the current deficits mentioned above. And while the U.S. gold stock stood at $11 billion, the lowest level since World War II, it became obvious that the U.S. could not meet its foreign obligations in gold.[5]

Dr. Arthur F. Burns, Chairman of the Federal Reserve Board, probably reflected the official position of the U.S. government when, on May 20, 1971, he blamed foreign governments for the precarious situation. He urged them to release their restraints on imports and American investments, and to help us with our foreign military operating expenses. Raising our interest rates, he asserted, was not the right way to improve the ailing dollar. He advocated more U.S. borrowing from the Eurodollar market through Treasury certificates and, in order to become more competitive in world markets, an "incomes policy" that would restrain the cost-push momentum of American labor.[6] Less than three months later President Nixon announced a 90-day price and wage freeze, to be followed by some government control thereafter, and a 10 percent surtax on imports to stem the flood of cheap foreign goods.

"National Balance of Payment"

Academic theories basically concurred with Dr. Burns' explanation although some offered different solutions, such as a crawling peg, a wider bank, flexible exchange rates, or the creation of new reserve assets, such as Special Drawing Rights by the International Monetary Fund.[7] But no matter what solution they proffer, their point of departure is the collectivist concept of the "national" balance of payment. Without any reference to individual actions and balances, they build ambiguous structures that ignore the causes. Balance of payments of a country is that very small segment of the combined balances of millions of individuals, the segment that is based on personal exchanges across national boundaries. As an individual may choose to increase or decrease his cash holdings, so may the millions of residents of a given country. But when they increase their holdings, that is called "favorable" in balance of payments terminology. And when they choose to reduce their cash holdings, that is called "unfavorable." The fact is that drains of gold are not mysterious forces that must be managed by wise governments, but are the result of deliberate choices by people eager to reduce their cash holdings.

Wherever governments resort to inflation, people tend to reduce their cash holdings through purchases of goods and services. When domestic prices begin to rise while foreign prices continue to be stable or rise at lower rates, individuals like to buy more foreign goods at bargain prices. They ship some of their money abroad in exchange for cheaper foreign products or property. Thus, an outflow of foreign exchange and gold sets in. It is the inevitable result of a rate of domestic inflation that exceeds that of the rest of the world and sets into operation "Gresham's Law."

During the 1960s, the decade of the "Great Society," and again during 1970 and 1971, money and credit were created at unprecedented rates prompted by record-breaking government deficits. Private demand deposits, bank credit at commercial banks, and Federal Reserve credit, which is fueling the credit expansion, often rose at rates of 10 per cent or more a year. Therefore, in spite of countless promises and reassurances by the President and his advisers, the U.S. dollar suffered inevitable depreciation at home and abroad. And the August 15, 1971, default of payment was the result of this depreciation.

Blaming the Creditor

Refusal to make gold payments by the United States, the richest and most powerful country on earth, casts serious doubt on future monetary cooperation. The immediate prospect for worldwide monetary reform is not too bright. The U.S., as the defaulting debtor, is taking the position that it is up to the countries with huge surpluses in their international payments to adjust their currencies upward against the dollar. It is Washington's basic premise that the U.S. was unfairly treated in international commerce and that it is time for correction. Convinced of the indispensability of the U.S. dollar as a world reserve currency, the U.S. is defiantly waiting for the others to act.

Bad debtors, when called upon to make payment, often make such charges against their creditors. It is shocking, however, that the U.S. government should prove to be such a poor debtor. Even its basic assumption, the indispensability of the dollar, no longer goes unchallenged. Sterling balances look more attractive today than dollar holdings. In fact, the holdings of Deutsche marks by central banks and treasuries probably exceed $3 billion. Foreign airlines and shippers have ceased to accept U.S. currency. And Eurodollar bonds are all but unsaleable in European capital markets, while mark, guilder, and Swiss franc securities remain in demand. The foreign position generally rejects the Washington charge of unfair treatment. If the U.S. had adopted appropriate domestic policies, foreign officials argue, it would not have accrued its huge international payments deficits. Therefore, they want the U.S. to share the burden of realignment. They are seeking a devaluation of the dollar along with realignment of their currencies. And above all, no one is suggesting that the U.S. dollar continue to serve as an international reserve currency.

After all, managed currencies are the products of political manipulations by parties and pressure groups, and all are destined to be destroyed gradually by weak administrations yielding to popular pressures for government largess and economic redistribution. No such currency can serve for long as the international reserve currency to which all others can repair. The U.S. dollar is no exception.

In the chaotic conditions of late 1971, the world may still have the following options:

(1) It may continue on its present road of fiat money and inflation, government manipulation of exchange rates, trade restrictions, and exchange controls. The goal is "national autonomy" in monetary and fiscal policies, an essential objective for all forms of central economic planning. On this road we are bound to suffer not only more inflation and depreciation, but also a gradual disintegration of the world economy and its division of labor. Our ultimate destination is a world-wide depression.

(2) Or the world may choose to turn off this road of self-destruction and seek stability in sound money. The very monetary authorities that have created the chaos and are now sitting in judgment over the international monetary order must relinquish their rights and powers over the people's money. This road leads to the various forms of gold standard, from the gold-exchange to the gold-bullion, and finally the gold-coin standard. For gold is the only international money the quantity of which is limited by high costs of mining and the value of which is independent of political aspirations and policies. Only the gold standard can afford monetary stability and peaceful international cooperation.

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1. Ludwig von Mises, *The Theory of Money and Credit* (Irvington-on-Hudson, N. Y.: The Foundation for Economic Education, Inc., 1971), p. 97 et seq.

2. Cf. Franz Pick, *Currency Yearbook* (New York: Pick Publishing Corp., 1970), pp. 13–15.

3. Cf. Leland B. Yeager, *International Monetary Relations* (New York: Harper & Row, Publishers, 1966), p. 251 *et seq*.

4. *Federal Reserve Bulletin*, Sept., 1971, p. A75.

5. *Ibid*., p. 94.

6. *The Commercial and Financial Chronicle*, June 9, 1971, p. 16.

7. Cf. William Fellner "On Limited Exchange Rate Flexibility," Chapter 5 of *Maintaining and Restoring Balance in International Payments*, Princeton University Press, 1966; George N. Halm, "The Bank Proposal: The Limit of Permissible Exchange Rate Variations," *Princeton Special Papers in International Economics*, No. 6; John H. Williamson: "The Crawling Peg," *Princeton Essays in International Finance*, No. 50; Francis Cassell, *International Adjustment and the Dollar*, 9th District Economic Information Series, Federal Reserve Bank of Minneapolis, June, 1970; Walter S. Salant, "International Reserves and Payments Adjustment," *Banca Nazionale del Lavoro, Quarterly Review*, Sept., 1969; Thomas D. Willet and Francesco Forte, "Interest Rate Policy and External Balance," *Quarterly Journal of Economics*, May, 1969; Friedrich A. Lutz, "Money Rates of Interest, Real Rates of Interest, and Capital Movements," Chapter 11 of *Maintaining and Restoring Balance in*

International Payments, Princeton University Press, 1966; Milton Gilbert, "The Gold-Dollar System: Conditions of Equilibrium and the Price of Gold," *Princeton Essays in International Finance,* No. 70.

In Search of Monetary Stability

by Hans F. Sennholz

Economic life is a process of perpetual change. Man continually chooses between alternatives, attaching everchanging values to economic goods. Therefore, the exchange ratios of his goods are forever adjusting. Nothing is fixed and, therefore, nothing can be measured. The economist searching for stability and measurement is like the music lover who would like to measure his preference for Beethoven's "Eroica" over Verdi's "Aida."

Money is no yardstick of prices. It is subject to man's valuations and actions in the same way as are all other economic goods. Its subjective as well as objective exchange values continually fluctuate and in turn affect the exchange ratios of other goods at different times and to different extents. There is no true stability of money, whether it is fiat or commodity money. There is no fixed point or relationship in economic exchange.

And yet, despite this inherent market place instability of economic value and purchasing power, the precious metals have served man well throughout the ages. Because of their natural qualities and their relative scarcity, both gold and silver were dependable media of exchange. They were marketable goods that gradually gained universal acceptance and employment in exchanges. They even could be used to serve as tools of economic calculation inasmuch as their quantities changed very slowly over time. This kept changes in their purchasing power at rates that could be disregarded in business accounting and bookkeeping. In this sense we may speak of an *accounting stability* that permits acting man to compare the countless objects of his economic concern.

The Clamor for Stability

Throughout the long history of money a clamor for this stability always arose when governments engaged in coin debasements and paper money inflation. Certainly the Romans yearned for monetary stability when their emperors resorted to every conceivable device of

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monetary depreciation. Medieval man longed for stability when his prince clipped, reduced or debased the coins and defrauded him through such devices. And throughout the 17th and 18th centuries, the early Americans sought monetary stability when the colonial governments issued legal tender "bills of credit," regulated the exchange ratios between British and Spanish coins, and imposed wage and price controls. Americans were dreaming of monetary stability during the Revolution when the Continental Congress emitted vast quantities of "Continental Dollars" until they became utterly worthless.

Man's hope for this monetary stability is his quest for government to abstain from monetary depreciation. This is the only permissible meaning of our search for stability, which is as old as inflation itself. In our century, it again has gained in intensity and urgency as governments the world over are waging devastating wars and engaging in massive redistribution of economic income and wealth. The savings and investments of millions of people are at stake. In the United States alone, the volume of long-term loan capital is estimated at more than 3 trillion dollars. Obviously, such a magnitude of credit lends economic, social, and political importance to the quest for monetary stability.

Our high rates of productivity, wages, and standards of living are built on an effective capital market. In the U.S., some $40,000 have been invested per worker, which make him highly productive and yield wage rates that are the highest in the world. More than one-half of this capital investment comes from lenders, such as bond holders, banks, and other institutional investors. Obviously, their direct stake in this marvelous apparatus of production depends on the stability of their dollar claims. They comprise what is commonly called "the middle classes" who do not own the facilities of production. They do not directly own the stores and factories, farms and livestock, but merely provide the loan capital that helps to build and improve them.

The savers and investors are not alone in their great concern for monetary stability. Anyone whose income depends on his labor productivity must be vitally interested in the efficient functioning of the capital market that supplies him with tools and equipment. The economic well-being of every manual laborer directly depends on capital investments, as does that of office workers, business executives, physicians, dentists and teachers. In fact, everyone has a stake in monetary stability and economic productivity. Even government itself which likes to issue ever more money in order to facilitate deficit spending, depends on the purchasing power of money. After all, money is the only economic good at the disposal of government, permitting it to acquire other goods and services and redistribute real income and wealth. When money ceases to function as a medium of exchange, government ceases to function in any form.

Accounting Stability

The hope for monetary stability, as we define it, is man's quest for government to abstain from montary depreciation. The only stable money, in the long run, is the money of the market: it is nonpolitical money. Real stability comes with the removal of government control over money.

Of course, one must recognize that the prospects for a dismantling of the monopolistic power which government now is wielding over money, or even for a total removal of government from the monetary scene, are rather slim. Public opinion, as of now, does not permit a reduction of government power. But it may change in the future as the government issues of fiat money continue to depreciate, breeding countless economic and social evils. Be that as it may, the monetary theorist is bound by nether public opinion nor the trend in policy. His thoughts and deliberations are free to seek truth and pursue his ideals, even the dismantling of government power over money. To remove government from all monetary affairs is to deny all government prerogatives in monetary matters. Government must have no special rights and privileges in the market place for money. In particular, the following government powers to which our generation has grown accustomed must be rescinded:

1. *The legal tender laws* that dictate what legal money shall be. There is no need for government to specify the kinds of money in which contracts may be written, or for government in any way to limit the freedom of contract. Surely, no degree of convenience that may come from a single currency system can outweigh the dangers of a monopolistic system that permits government, through legal tender legislation, to force its depreciating money on its people. Legal tender is the very device that prevents an easy escape by inflation victims into other monies and permits inflation to rage on until it becomes a fatal social disorder. It permits the massive transfer of income and wealth from hapless creditors to puzzled debtors, generating vast amounts of inflation losses and gains. In fact, legal tender legislation establishes the monopoly par excellence that permits the money monopolist to reap incalculable gains through the gradual depreciation of his product.

2. *The central banking system* that subjects financial institutions to a central authority and redirects their resources toward fiscal uses and economic policies. The central bank is the monetary arm of govern-

ment that facilitates the financing of budgetary deficits through monetary expansion. It serves as a crutch to commercial banks, which it enables to expand credit to the limit of their reserves. And when their reserves are exhausted it provides new excess reserves in ever larger quantities. In short, the central bank removes all checks on inflation and coordinates the inflation effort. It must be summarily abolished if the freedom of the money market is to be restored and monetary stability attained.

3. *The compulsory monopoly of the mint* that permits government to determine what coins shall be used in exchange. The rationale of the mint monopoly as given by governments throughout the ages is the convenience of a uniform coinage system. But no matter how popular this convenience may be, it affords government important sources of revenue: "seigniorage," which is the monopolistic charge for minting coins; and debasement, which secretly or openly dilutes or reduces the weight of the coin. As the mint monopoly was the first step toward government control over money, its removal is essential for the restoration of monetary freedom.

Few economists, if any, are advocating a stabilization of money through such comprehensive reforms. In the ideological climate of today, any deliberation along such lines, while it may be sagacious economic theory, is out of step with political reality. Therefore, most economists limit their deliberations to the search for monetary stability as it existed a few decades ago. Their inquiries are encompassed by political or historical considerations and colored by the hope of being "practical" and "effective."

We need not here enter a discussion of who is more practical and effective: he who uncompromisingly seeks to draw his conclusions and reveals irrefutable truths, or he who permits his deliberations to be colored by that which is more popular. In fact, most economists seek to be realistic and, therefore, advocate a *limited reform* that would restore monetary stability of their national systems as they existed in the recent past. American economists who are hoping and working for such a stability would like to restore the quality and integrity of the U.S. dollar.

Balancing the U.S. Government Budget

To stabilize the U.S. dollar, i.e., to safeguard its present purchasing power, obviously requires the immediate cessation of the inflation process. The monetary authorities must cease and desist from expanding the quantity of money in any form. But before this expansion can be halted the federal government must learn to live within its means and abstain from making further demands on the central banking system.

To the federal government, inflation is a convenient device for raising revenue. It easily covers budget deficits which otherwise would deplete the loan market, raise interest rates, and depress the economy. It turns deficit spending. which normally causes economic depressions, into spending sprees that generate the popular, and yet so pernicious, economic booms. Inflation boosts government revenue as it raises everyone's tax rates and thus absorbs an increasing share of individual income. It repudiates government debt as it reduces the purchasing power of all debt. In this respect it is a silent tax on all creditors and money holders. With a Federal debt of some $700 billion, an inflation rate of 10 percent reduces the value of the debt by $70 billion, which is taken from the owners of Treasury obligations and transferred to government as the debtor for more spending in the future.

In today's atmosphere of government welfare and economic redistribution, to balance the budget and thus refrain from its inflationary financing is no easy political task. An estimated 81.3 million Americans, or 38 per cent of the total population, are now enjoying redistribution dollars from government. (Retirement and Disability 28.6 million, survivor benefits 8.9 million, supplemental income 6.6 million, unemployment compensation 6.0 million, active military duty and dependents 3.5 million, civil servants and their dependents 27.7 million.) While the trend continues to favor ever more programs with more redistribution beneficiaries, it is difficult to envision a modification of the transfer process. And yet, the task is urgent; the great budgetary pressures exerted by the popular quest for economic transfer must be alleviated and the budget balanced. Without such a balance, the inflation will rage on.

"Rights" to Benefits

We cannot expect many beneficiaries readily to vote for a reduction, much less a removal of their benefits. Under the influence of the prevailing social and economic ideology they are convinced that they are morally entitled to their favors. They noisily oppose any modification affecting their innate "rights" to other people's income and wealth. In fact, their redistributive aspirations often induce their political representatives in Congress to authorize and appropriate even more money than the President is requesting. Such programs as Social

Security, Medicare, anti-poverty, housing, aid to education, environmental improvement, and pay increases for civil servants are so popular that few politicians dare oppose them.

And yet, the situation is not hopeless as long as only 38 percent of the population are transfer beneficiaries and 62 percent the primary victims. It is true, many victims do not realize that they are victimized by the redistribution process. With low personal incomes, their tax liabilities may be insignificant. And without money in the bank or in a pension fund, the inflation may be of no concern to them. But they do not realize, unfortunately, that the price of every product or service they buy has been boosted greatly by the taxes imposed on the producer. It is the consumers who ultimately pay the corporation taxes and other levies on business. And consumers suffer diminutions of income and wealth when inflation raises their income tax rates and boosts goods prices faster than incomes.

Other victims may be unconcerned because they themselves derive some clearly visible benefits from the political transfer process while their losses are hidden in a maze of taxes and prices. The parents of children in government schools or universities are counting their transfer blessings that hopefully exceed the transfer losses. This is why millions of middle class victims continue to favor the growing role of government as a transfer agency. They mistakenly conclude from the visible benefits they receive that their benefits exceed the losses, and therefore are led to approve the basic principles and objectives of the whole transfer system.

To reverse the trend and reduce the role of government in our lives, and thus alleviate the government deficit and inflation pressures, is a giant educational task. The social and economic ideas that gave birth to the transfer system must be discredited and replaced with the old values of individual independence and self-reliance. The social philosophy of individual freedom and unhampered private property must again be our guiding light.

Facing the Depression

Any stabilization program must make preparations for the inevitable depression. After all, the present system embodies at least two powerful depressive forces which a monetary stabilization would unleash. This is why the acid test of every stabilization attempt is the depression that soon appears in its trail.

A powerful depressive force is the very burden of government. Without monetary expansion that helps to finance the transfer programs, the high costs of government on all its levels would soon depress economic activity. A sixty-five billion dollar deficit like that suffered in fiscal year 1976, would simply crush the capital market and precipitate a devastating depression. But even if the government budgets were balanced, the combined load of federal, state and local governments, which is estimated to exceed 40 percent of national income, could not be carried by the "private sector." As a result of monetary stabilization, there would no longer be any inflation victims helping to finance government spending and public debt; government would have to rely exclusively on taxpayers and lenders. But this massive shift of burden from money holders and inflation victims to the latter would have the same depressive effects as a new deficit that consumes loan capital and invites additional taxation. This is why any attempt at monetary stabilization must be accompanied by reductions in government spending.

If our money were stable, business would soon be threatened by the scissor effects of stable prices and rising costs. When business taxes are raised, business must curtail its operations. When powerful labor unions raise business costs through higher wages or lower labor productivity. While goods prices are stable, business may suffer economic stagnation and losses. Therefore, any attempt at monetary stabilization must be accompanied by a reduction in business taxes, which in turn must be preceded by a reduction in government spending. Without this spending cut, a mere reduction in taxation that leads to budget deficits and a shift of the costs of government to the loan market, would bring no relief to business.

Withdrawal Pains

Another powerful depressive force, at the time of monetary stabilization, is the economic distortion and maladjustment which previous inflation and credit expansion are leaving behind. After many years of inflation the economy is *so* badly disarranged that a return to normalcy would be marred by painful withdrawal symptoms. When monetary authorities expand the quantity of money and credit, they cause interest rates at first to fall. Business is then tempted to embark upon new expansion and modernization projects, taking advantage of the lower interest costs.

But the feverish activity that follows is falsely induced by newly-created money and credit, unsupported by genuine savings. The feverish bidding for land, labor, and capital goods raises their prices. That is, business costs soar, and now render many projects unprofitable.

Many may have to be abandoned or written down as business failures—unless new money and credit are made available to support the malinvestments. During many years of inflation, countless economic undertakings were spawned by easy money considerations and sustained by even more inflation. This is why any attempt at monetary stabilization would reveal a shocking extent of disarrangement and maladjustment and should prepare to cope with the ensuing depression.

The monetary reformer faces a choice between two possibilities. He may rely completely on the flexibility and ingenuity of business to achieve new profitability through cost-cutting readjustment. He may do so with confidence in the individual enterprise system and in the knowledge that throughout the U.S. economic history, prior to the radical interventionism of the Great Depression, American business always rebounded quickly from occasional stagnations and depressions. Or, the reformer may want to give business recovery a boost through tax reductions. Of course, such a reduction must again be accompanied by cuts in government spending lest its burden merely be shifted to the loan market. In any case, during the trying weeks and months of the stabilization crisis, it is essential for the success of any stabilization program to resist arduously and successfully any temptation and public pressure to return to deficit spending and easy money.

Restoring the Labor Market

The inevitable stabilization depression must be expected to be especially painful because the U.S. labor market, after more than fifty years of government intervention, has lost its viability and flexibility to cope with necessary labor adjustments. Even without the special strains of a stabilization depression, the U.S. unemployment rate presently stands at 7.8 percent. A policy of monetary stabilization that would deny government the right to launch new deficit spending and easy money policies would soon encounter intolerable multiples of this unemployment rate—unless the labor market is restored to cope with the expected increase in unemployment. Without a labor market vitalization, any attempt at monetary stabilization is bound to run aground on unbearable rates of unemployment.

To vitalize the labor market is to rescind the government interventions of half a century. According to the late Roscoe Pound, one of the most eminent legal philosophers of our time, the labor leaders and labor unions are enjoying legal privileges and immunities which only kings and princes enjoyed during the Middle Ages. In the 1930s the

U.S. Congress granted labor unions and their members the legal right "to commit wrongs to person and property, to interfere with the use of highways, to break contracts, to deprive individuals of the means of earning a livelihood, to control the activities of the individual workers and their local organizations by national organizations centrally and arbitrarily administered beyond the reach of state laws—things which no one else can do with impunity."

Two statutes, the Norris-LaGuardia Act of 1932 and the Wagner Act of 1935 radically changed the nature of labor relations.

The Norris-LaGuardia Act drastically limited the jurisdiction of the Federal courts in labor disputes and especially prohibited the courts from enjoining coercive labor union activities. Before the Act, the Federal courts had been enjoining violent, intimidatory, coercive activities of the unions, although peaceful strikes were sanctioned. The Norris-LaGuardia Act made practically all union conduct untouchable by the courts.

The National Labor Relations Act (Wagner Act) placed one-sided emphasis upon "unfair practices" by employers and eliminated all possibilities of direct access to the Federal courts. It made it an "unfair practice" for an employer to interfere with, restrain, or coerce employees in the exercise of their rights to form a union and to participate in union activities. It forbade employers to interfere with the formation and administration of any labor organization. But above all, the Wagner Act took all labor cases out of the courts of law and transferred them to the new National Labor Relations Board. This Board is a quasi-judicial administrative tribunal whose members are appointed by the President. They have often been accused of corrupting the law that is already biased in favor of the unions.

Minimum Wage Laws

Federal labor laws have been setting minimum wage rates ever since 1933. The present rate is $2.30 an hour, to which we must add the legal fringe benefits amounting to approximately twenty-five to thirty-five percent, so that the minimum costs of employment of every American worker, even the least productive, may exceed $3 per hour. It is estimated that at least 3 million idle Americans owe their unemployment to this labor law. Teenagers and uneducated, unskilled minority workers are its primary victims. In a stabilization crisis, the minimum wage law may deny employment to several additional millions.

The Davis-Bacon Act as amended in 1961 authorizes the Secretary of Labor to set minimum wages in construction that is financed, subsidized, insured, or underwritten by Federal agencies. The Secretary usually sets a minimum that coincides with the going labor union pay scale. In most trades the pay for construction apprentices, for instance, stands at $7.50 per hour, which readily explains why there are no young people at work on construction sites.

The system of unemployment compensation in its present form is a powerful force for unemployment. It provides for compensation up to $125 per week for 65 weeks, in addition to some family allowances. It is supplemented by a generous food stamp program, and, in many cases, by various employer and union benefits. Altogether, the system paralyzes the market for unskilled labor through offering benefits for unemployment that may approach or even equal the pay for actual work performed. It leaves a tiny margin of financial incentive which for millions of workers does not offset the disutility of labor. In short, to many people, a week's leisure may be worth more than the small income increment that may be earned from a week's work.

All such handicaps to productivity need to be removed, or at least reduced, when the national currency is stabilized. Surely, it is very simple to halt inflation by ordering the central bank to cease and desist from any further money creation. But it is extremely painful, after many years of government intervention, to suffer the withdrawal symptoms. They point up not only the economic difficulties of any stabilization policy, but also its ideological and educational complications. In fact, they raise the ultimate reform question: are the people prepared to suffer the withdrawal pains that will be all the more excruciating the more they obstruct and restrict the labor market? In the pains of a stabilization crisis, will the people succumb, once again, to the temptations of easy money and deficit spending? Or will they see it through, all the way, to stable money?

A Market Choice of Money

by Ellis W. Lamborn

The most powerful individual in any organization is the person who controls the purse. The person controlling the keys to the vault where the cash is kept really has more power than many people who in an organizational sense should be in a position to order, or refuse to order, disbursement of funds.

In any attempt to control the federal government and the activities of the government we must first discover who is the keeper of the purse. Which branch, which person or which agency is actually in control. It does little good to look at an organizational chart—it will only confuse the issue. However, if we examine the actions of the federal government it soon becomes apparent that it is not the president, nor is it the Congress that is really in control, although both of these frequently announce that they are in charge. The real control is a semi-public agency known as the Federal Reserve System. Any person in control of the Federal Reserve really controls the system.

Governments have been successful in hiding the cost of many new programs because they have a monopoly in the creation and control of money. Because of this monopoly the government does not have to support new programs and other activities by taxation or the closing down of old programs. These new programs can be financed by the proper control of the money system. Nearly everyone thinks that this important activity must be run by and supervised by the government. It was thought to be so important that it was even written into the original United States Constitution, and it has remained there.

The Article is written " . . . shall have the power to coin money and regulate the value thereof." It has been fairly easy for the government to discharge the responsibility to coin money, but this regulation of the "value thereof" is a bit more difficult.

Tied to Gold

Some want the money supply tied to some particular metal, the most popular of which has been gold and/or silver. The argument in

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its simple form is that the value of the money supply will be controlled automatically, and there seems to be a profound trust in anything that is automatic. But although it is automatic there is no assurance that the money supply will behave in such a way as to give us anything like a stable price level or full employment or any of many other things which we desire.

Under the gold or some metal standard whether or not your price level remains stable will depend on three factors: (1) the supply of goods, (2) the supply of money (gold), and (3) the price of the money—usually referred to as the price at which the government will buy and sell gold. Under conditions where the supply of goods and the supply of gold remain constant or change at the same rate, the price level will remain relatively stable. However, that would be a rather unique situation and has happened only a few times in history.

The factors that control the supply of goods in a general sense are not the same factors that control the supply of one particular good such as gold (and it won't help much if the standard money is to be one, two or even three commodities). Witness what happened to the general price level following the discovery of gold in California in 1849, or the period 1872–1896.

But the gold standard people have one ace in the hole. If things get too far out of balance they can always change the price of gold. However, this presents two problems:

(1) If the price is not changed quickly enough, we may have either deflation or inflation.

(2) This gives some government agency the power to control the money supply and thus control the price level and the change in the price level.

So it should be apparent, if we adopt or revert to the classical gold standard and then let it alone to operate in its automatic way, we will be subject to long periods of inflation or deflation and not stable prices at all. Whether we have inflation or deflation will depend upon the increase in supply of goods and services relative to the increase in the supply of money. Even this assumes we know something about money velocity (the number of times a unit of money is used in a given period of time).

The other alternative, of course, is changing the price of the money, and that supposes that some individual (or group of individuals in some government agency) is able to determine when and by how much the price of money should be changed. It is likely that the price of the metal that is used as money might be changed to help finance new programs in situations where it seems undesirable to increase taxes or to eliminate older programs. If a metal is selected as our money standard, the price of the metal should at least be allowed to change as market conditions change on a worldwide basis, which means that the price of money should be determined by supply and demand conditions on a worldwide market. Indeed, this might well be the second best solution to our money problem.

Some individuals who can see the need for some changes in the supply of money over time but sense the inherent weakness of the classical gold standard are willing to settle for a constant increase in the money supply. These people point out that the productive capacity of the country will no doubt increase over time, so some increase in the money supply is needed (the alternative being, of course, long term deflation). If the money increases at about the same rate as the production of goods and services the result will be stable prices. This, of course, assumes that the velocity of money does not change to any significant degree. This rather simple solution to a complex problem overlooks at least three rather basic problems:

(1) It is difficult to increase the money supply at some preannounced rate. Although we may want the money supply to increase at four percent or five percent or some other magic figure, it is necessary to control the actions of the commercial banks as well as the saving institutions to achieve this desired result.

(2) Short time fluctuations in the growth rate of either the money supply or of goods and services may cause serious periods of inflation or deflation. These periods of inflation and deflation will of course come to an end if we are willing to wait and do not give in to the third defect of the system.

(3) If the government or some agency of the government has the power to set the rate of increase in the money supply, they also have the power to alter the rate of increase, and the rate of increase can be changed to provide for inflation. That is the most serious defect of the system.

The Federal Reserve

We, in the United States, have tried to avoid the pitfalls of either the gold standard or fixed increase in the money supply. We have turned the control and operation of our monetary system over to a semi-public agency known as the Federal Reserve System. The Fed, as it has come to be called, is a rather large bureau and has become self-supporting, gaining its revenue from the services it sells to commercial banks and the interest on the government securities which it "owns." The Federal Reserve also performs many services for the Federal Government, such as acting as its agent in the selling of bonds. However, the primary and most important function of the Federal Reserve is to control the monetary system. The Fed has been in existence since 1913 and is one of the most respected of all government agencies. However, when the Fed is measured against the yardstick of what it is supposed to be doing, the record is not only unimpressive—it looks like complete failure.

The best time to judge an institution is when it is working under stress, but when the Fed is placed under stress it fails to perform as we thought it would. This has been the case in every period of economic stress since 1913.

For example, during wars the government needs and uses large sums of money. The government really has only two ways to obtain the needed funds: taxation or borrowing. In my opinion, taxation is the preferred method, but they have chosen in every war and "police action" to borrow large sums. This borrowing action has been handled by the Federal Reserve, and in order to get the large sums needed the money supply has been expanded at too rapid a rate, and the result has been higher prices.

The alternative to money expansion was for the Fed to bid the resources away from the private sector by raising the interest rate paid on government securities, but in the short run situation we in the United States seem to prefer inflation over high interest rates. Following World War II when the Federal Reserve complained about carrying this burden for the United States Treasury, the result was the "accord" signed in 1951 which officially relieved the Federal Reserve of this burden which they never really had in the first place. The Fed sometimes keeps the money supply expansion at too low a rate causing unemployment. However, the most usual error has been to expand the money supply at too fast a pace so that prices have risen. This has been especially true since 1950. The inflation rate has recently been above a figure that was completely unacceptable in 1955.

The Great Depression

The worst recession, or depression, that this country experienced was in 1929–33. At the time, few people understood what happened or the reasons for what happened. But after the smoke cleared it seemed apparent that the Federal Reserve was too busy getting the gold standard restored in England during the 1920s, which was a questionable objective for the United States Federal Reserve System. Then, when it appeared that we were to have a slight or minor recession, the Fed responded by actually forcing a reduction in the money supply. At the bottom of the depression the officials made the statement which by now has almost become a classic: "We could have stopped the recession except that we didn't have enough power." The Congress responded by giving them more power, and the Federal Reserve then used their new weapons to cause the recession of 1937–38. This recession was more severe but more short-lived than the recession of 1929–33. The short duration of the recession was due to the upcoming war in Europe and the fact that the Fed was shifting over to their new position of continuous inflation to help the Federal government finance the war effort.

There have been times when the Federal Reserve has done the right thing at the right time. But the more important question is, have their good decisions outweighed their bad decisions?

It is true that there were recessions before the creation of the Federal Reserve in 1913. It is also true that there were periods of inflation before 1913. The important question is, has the Federal Reserve been stabilizing or destabilizing? It seems to me that the Fed has been destabilizing. Monetary authorities that are not government connected are coming to this same conclusion.

The problem is that although many are able to agree that the Federal Reserve System has worked less than perfectly, most want to keep the government involved in the monetary system in some fashion and try to correct the defects. However, it appears that the Federal Reserve has worked so poorly that any attempt to patch the system, which in most people's minds means giving it more power, will not solve the problem. Everyone makes mistakes. Usually when a person makes mistakes he affects his own future and the future of people with whom he deals. When a government decision is a mistake it affects the people that deal with that agency. Everyone is affected by the monetary system, so this is one government agency that influences the lives of everyone.

The solution, then, is to repeal the act (actually it will be several acts) that created and expanded the Federal Reserve System, and then amend the Constitution of the United States so that the Federal Government no longer has the power or the responsibility "to coin money and regulate the value thereof." This is drastic action, but drastic action is needed.

Mistakes Inevitable

Any government unit will make mistakes, but there are additional hazards with an agency that controls the money supply. Any government unit that wants to run continuous deficits over a period of time can do so only with the cooperation and aid of the people in control of the monetary system. Money is too important to the operation of the economy to trust the operation of the monetary system to government. It must be left in the hands of the people. The new system that will arise will handle our needs in better fashion, but of course the system will not be perfect.

The result of getting the government out of the money business will be chaos for awhile at least. After all, people for generations have been accustomed to the government controlling the monetary system. The point is that patching up the Federal Reserve, the gold standard, or any automatic monetary rule is not going to solve the problem. The problem is the government itself. A matter as important as money cannot be left to central government action.

Without government control there will be increased uncertainty, especially in the short run. After we have developed a new system the uncertainty will be at a minimum and the costs of operating the system will be no greater than the present costs—they might even be less. Remember that though the Federal Reserve operates without using money obtained from the Federal Treasury, they collect both for services rendered to commercial banks and interest on the securities that they own.

Cost of operating the new system will not be of major consideration. The cornerstone of the system will be that anyone who wants to can get into the production and sale of money. There is, of course, the problem of getting customers. This may be referred to as acceptability, but in the marketplace it is known as producing a product that consumers like.

Hopefully, under such a system the person or corporation that issued money would be interested in maintaining acceptability for that money. Some money would be worth more than others, and exchange rates would be established in the marketplace among the various monies offered. Some of these monies would become completely worthless. In time (and this period would be years, not days, weeks or months) it is rather safe to assume that there would be only a few issuers of currency.

Advantages of a Market Monetary System

The important point is that under this system there would be no inflation. Individual issuers of currency would be interested in maintaining the value of their currency, or else it would not be used. There would, of course, be some fly-by-night operations. Some people would be taken in by worthless currency. These costs and the cost of operating the system would be less than the cost of operating the present Federal Reserve System, especially when inflation is assessed as one of the costs of the present system. The issuers of the currency would keep the system in operation, not because they are particularly public spirited, but because it would be in their own best interests.

Individual banks and/or other institutions would be free to make loans, collect interest and perform other monetary transactions. They would even be free to insure their deposits if they thought it was in their own best interest to do so. Some are apt to point to the Federal Deposit Insurance Corporation as a well-run government agency. Needless to say, its record is somewhat better than the record of the Federal Reserve, but then the FDIC has been operating as an insurance agent during a period of almost continuing inflation. Under these conditions there can be some bad debt, but one must wonder if the FDIC would be able to survive a situation such as existed in 1929–33. It would be better to have several insurers of deposits, and there is no reason why these could not be international in scope.

In summary, then, the thesis is that the government should take itself by Constitutional amendment out of the money business and turn it over to private interests. It is not that the private interests will operate the system in a perfect manner, because they will not. But the private sector can and would operate the system better than the government has during the period since 1913.

One Currency for the World?

by Henry Hazlitt

"Needed: A Common World Currency."

So asserts the title of an article in the May 1978 issue of *PHP*. *PHP* is a monthly magazine published in Tokyo, by a dominantly Japanese editorial staff. It is in English, however, and aimed at a worldwide audience. The title initials stand for "Peace, Happiness and Prosperity." The author of the article is Konosuke Matsushita, founder of the international electric and home appliance company, Matsushita Electric.

The hope that Mr. Matsushita expresses is one that has been voiced by reformers for more than a century. His arguments for it are persuasive. He refers to the wild fluctuations in international exchange rates in the last few years. He points out that at the beginning of 1977 it took 290 yen to buy a dollar, but by the end of the year only 240. He reminds his readers that in December 1971 The Group of Ten countries met in Washington to set up a new international currency system, known as the "Smithsonian" agreement, hailed at the time as "the most important monetary agreement in history"—and that it broke down in a year or so.

After that the world entered a "floating currency" era. But this means that every day the exchange rate of every national currency fluctuates in terms of every other. It means that no one can foresee what any given currency will be worth in terms of any other a year from now, or even tomorrow. And so it means that every man engaged in import or export trade, or in any international business whatever, is forced to some extent to become a gambler. Deploring all this, Mr. Matsushita concludes:

> We need to integrate the wide variety of currencies we have now. In other words, I suggest we agree on the use of one currency that will be common in all the countries of the world.... I am fully aware of the numerous problems that would be involved, such as national pride, differences in eco-

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> nomic level and so on. However, if we want to continue our community life on this planet, we're going to have to integrate our currencies at the earliest possible date....
>
> I suggest the United Nations or the International Monetary Fund take up the problem, seek to overcome the difficulties which lie in the way by eliciting the cooperation, effort and wisdom of every country, and therefore achieve an integration of the world's currencies for the peace, happiness and prosperity of the world.

I find Mr. Matsushita's article encouraging in one respect but disheartening in others. It is encouraging as a sign that leading international businessmen are beginning to call for an end to the present intolerable chaos in the foreign exchange market, and are willing to set aside national prejudices to achieve a return to order. But it is disheartening as a sign that these businessmen—probably the majority of them—still do not understand the basic causes or suspect the basic cure for the world currency chaos.

Balance of Payments

Mr. Matsushita seems to think that the basic cause of the changes in the yen-dollar and other exchange rates was changes in the "balance of payments" between individual nations. He does not seem to realize that these wide fluctuations in the balance of payments were themselves in large part the result of different rates of inflation within the respective countries, and consequent shifts in the relationships between internal and external prices. His article nowhere mentions the enormous increase in the paper-money issuance of individual countries. And it nowhere mentions gold.

The truth is that the world once did have a common currency, in everything but name. It had such a currency roughly from the last third of the nineteenth century to 1914. It was known as the gold standard.

The majority of leading currencies were tied together not because they were tied to each other but because each of them was tied to gold. Each was directly convertible on demand into a specified weight of gold. The British pound was worth $4.86 because it was convertible into 4.86 times the weight of gold that the dollar was. The French franc was worth approximately 19.3 cents for similar reason.

True, as an international system this had a few shortcomings. It would have been far simpler and made calculation easier if each national currency had been made convertible into precisely the same weight of gold, or at least into a round relationship to other currencies—if, for example, the British pound had been convertible into exactly five times the weight of gold as the dollar, the dollar into exactly five times the weight of gold as the franc, and so on.

Fractional Reserve Gold Standard

A more serious shortcoming, however, is that the various national currencies were not on a full gold standard but only on what is known as a fractional reserve system. That is, the gold reserve they were obliged to keep was not equal to the full amount of their outstanding paper currency, but only to a fraction of it. And as time went on, and individual countries experienced no excessive runs on their gold supply, they yielded to the temptation to increase their credit and currency issues more and more. Their gold reserves, in consequence, tended to become a constantly smaller and more hazardous fraction of their credit and currency issue.

The fractional-reserve gold standard, moreover, even while it was preserved, suffered from a chronic defect. In good times, one country after another was tempted to expand its volume of money and credit. But when one country expanded faster than its neighbors, its internal prices increased relative to theirs. It became a better place to sell to and a poorer place to buy from. Its balance of trade (or payments) became "unfavorable." Its currency went to a discount on the foreign exchange market; and if that discount passed "the gold point," the country began to lose gold. To stop the outflow, it had to raise its interest rates and contract its issuance of credit and currency. It was this that caused the recurring business cycles, the alternation of boom and bust, that were considered by its critics to be inherent in capitalism itself.

Even the fractional gold standard was abandoned in Europe in 1914. The belligerents feared to lose their precious gold reserves, and in any case they wanted to be free to expand their currency and credit.

Gold-Exchange Standard

When the war was over the world went back, not to the old gold standard, but to a "gold-exchange" standard. This was something quite different. The gold-exchange standard meant that the majority of countries, instead of keeping their currencies directly convertible into gold, kept them convertible only into some "key currency" for example, the British pound or the American dollar—which was supposed to be directly convertible into gold.

As formalized at Bretton Woods in 1944, the gold-exchange standard became still more attenuated. The other participating countries agreed only to keep their currencies pegged to the American dollar; the dollar alone was convertible into gold. But even then, dollars were not, as formerly, convertible by anybody who held them, but only by foreign central banks.

The effect of this relaxation of discipline, combined with the growth of the Keynesian ideology, was increasing and almost universal inflation. The American monetary managers, under successive Administrations, did not seem to have the slightest realization of the weight of responsibility they had assumed in agreeing to make the dollar the anchor currency for the world. They continued to inflate until, when other countries finally became more importunate in their demand for actual gold, President Nixon officially suspended gold payments on August 15, 1971.

A profound irony in Mr. Matsushita's proposals is that he wants to turn over the problem of curing the world's currency ills to the International Monetary Fund. But the International Monetary Fund is the problem. It was set up at Bretton Woods, chiefly under the leadership of Lord Keynes of England and Harry Dexter White of the United States, to make inflation and devaluation easier, smoother, and respectable. Instead of letting each country suffer the full consequences of its own inflation, the IMF used the stronger currencies to support the weaker. The long-run effect was only to weaken the stronger currencies. One of the Bretton Woods' objectives from the beginning was to "phase gold out of the system." One of the first steps in any real currency reform would be to dismantle the IMF.

Mr. Matsushita forgets that the meeting that drafted the Smithsonian agreement, to which he refers, came only three months after the United States suspended gold payments; that the Smithsonian agreement was thought necessary because of this suspension; and that it broke down so soon because gold convertibility was not restored. There is simply no substitute for gold convertibility.

No international organization can wave a magic wand, or draft a magic formula, that will bring a sound world currency. Each nation must bear full responsibility for its own currency. It can make it sound only by making it convertible into gold. And it can make and keep it convertible only by strictly and constantly limiting the quantity of that currency.

Because of the dismal recent record of practically all countries in swindling their own citizens, the return to an honest convertible currency may now be difficult and remote. Individual nations can begin by strictly limiting any further expansion of their credit and currency issue. Meanwhile they can grant the right to their own citizens to coin gold privately and even to issue gold certificates against their coins.

When governments are ready themselves to return to a gold standard, it would be well if this time they kept a 100 percent gold reserve behind their paper currency and so removed the expansionary temptations of a fractional-reserve system. And it would be an excellent thing, also, if their new currency unit were fixed as a definite round weight of gold, say a gram, and were called simply a goldgram—instead of a dollar, franc, mark, peso or what not—and if at least the leading countries could agree on the same gold weight for their unit. Then the world would really have, for all practical purposes, the "single" and common currency that Mr. Matsushita would so much like to see.

Toward Radical Monetary Reform

by Lawrence W. Reed

In the late nineteenth century and early twentieth, the issue which occupied center stage of economic controversy was "the money question." From the time of the Civil War greenbacks through William Jennings Bryan's "Cross of Gold" speech of 1896 until the establishment of the Federal Reserve System in 1913, politicians, academics, editors, and business people squared off in heated debate over the proper monetary policy for the nation.

After the dramatic events of the Great Depression and the creation of the post-war monetary system, the issue became relatively dormant as attention turned to other things. But recently, "the money question" has emerged in full force once again. Its resurrection has come, not coincidentally, as an aftershock of a financial earthquake of staggering proportions.

What has happened is that the monetary chickens have come home to roost. Decades of government-managed money have produced a frightening flirtation with runaway prices. The American dollar has lost at least 80 percent of its 1940 value. The bond market has suffered fantastic losses. The devastation of dollar-denominated assets—savings, life insurance, pension funds, and the like—in *real* terms is tremendous. Faith and confidence in the future purchasing power of the dollar are everywhere in question.

We have been witness to nothing less than the historic *demonetization* of fiat money. The damage this process has wrought may yet assign government paper to the status of "barbarous relic" which Keynes once mistakenly ascribed to gold. Who can honestly survey the wreckage and pronounce of the monetary authorities, "This is a job well done"?

It is in this unfortunate set of circumstances that proposals for "monetary reform" are proliferating. It is not the objective of this essay to propose yet another or to endorse any particular one already advanced. Rather, the objective is to illuminate the intellectual path which any meaningful reform must take. The author leaves it to others

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to chart the specifics.

To begin with, monetary reformers must come to grips with something fundamental to the origin and history of money. They must rediscover what the Austrian economist Carl Menger told us in his pathbreaking *Principles of Economics* in 1871: "Money is not an invention of the state. It is not the product of a legislative act. Even the sanction of political authority is not necessary for its existence."

Of Natural Origin

The origin of money was entirely natural. It sprang from the awkwardness of barter and the desire for a marketable commodity to facilitate exchange. The first time man traded a good for something which he intended to use not for consumption himself but rather as a *means* to acquire what he really wanted, a medium of exchange—money—was born.

It was a revolutionary invention—the economic counterpart to the wheel—and it made possible trade and a division of labor inconceivable in a barter economy. It was truly an invention of the marketplace, of economizing individuals seeking to improve their well-being.

All sorts of commodities have served as media of exchange at one time or another. Cattle, cowry shells, furs and skins, wampum beads, tobacco, whale's teeth, cigarettes, and even rats are examples. Primitive though these monies may seem, they had the qualities of familiarity and acceptability which made them marketable and hence, candidates for money.

In most markets of the world, the precious metals emerged as the primary money commodities. Durability, divisibility, high value in small quantities, and relative stability in purchasing power over time were characteristics which no other commodities could match. As early as 650 B.C., coins of gold and silver became almost singularly synonymous with the term "money" in the trading world.

Paper arrived later on the monetary scene as a "money substitute." It took the form of promissory notes which pledged real money in payment for goods. Issued by early banks, for instance, they were redeemable or convertible on demand into the precious metals they represented.

Inflation Involves Government Control over Money

Governments, afflicted with an insatiable appetite for revenue, have generated history's inflations by first assuming control over money. Then gold coins became only partially gold or without gold at all. Paper notes, stripped of their "backing," became "fiat"—their value tied to the whims of the inflating authority. Monetary history records no instance of a people voluntarily choosing in the marketplace to use unbacked fiat paper as their money!

The problem with so much of monetary economics today is that it does not fully comprehend the inescapable conclusion that money is a market phenomenon—that it originated in the market, that it evolved in the market, and that the market laws of supply and demand apply to money just as they do to any other commodity traded in the market. I submit that no monetary reform is likely to succeed if it treats money as the invention and exclusive domain of a political monopoly. *The essential task of true monetary reform, then, is to find a way to divorce money from politics and make it as much a product of the market as possible.*

In this vein, the many proposals which call for minor alterations of the government's monetary function sound a little like rearranging the deck chairs on the *Titanic.* Simply putting a different crew in charge of the ship or experimenting with the compass are not radical enough. In this case, the market may be just the lifeboat we should be looking for.

The objection may be raised, "Without a central authority, how will anyone know what the supply of money should be?" Well, does anyone know what the supply of green beans should be? How many quarts of milk should be produced? How many size 36 undershorts there ought to be? How is it that the market is able to provide these things without central planners and in just the right amounts?

The answer, of course, is the market's mechanism of price. When costs are low and price is high, the signal to producers is, "Make more!" Producers know they should not pile up any more when costs exceed price. Why shouldn't money respond similarly?

When gold was money, this mechanism certainly did work reasonably well. As long as it was profitable to mine gold, producers did. "Too much gold" on the market caused the value of gold to fall and the cost of mining to rise—a double whammy that prevented producers from engaging in a continuous inflation. The supply of money, therefore, had something to do with the real market demand for money.

With today's fiat money, the mechanism is short-circuited. Double digit price inflation is the market's way of signaling that there's too much of the green stuff around, but the signal never directly strikes the producer. There's no chance that he will go broke in the process of creating more than the market demands. For the inflator of fiat money, the incentives are perverse: he grows bigger the more he does the very thing he shouldn't be doing!

It is no sure bet that the debate over monetary reform will deal fundamentally with this question of political versus market money. We have lived for so long with the former and its ruinous consequences that suggesting the radical alternative may be tantamount to the impossible task of teaching blind people what it would be like to see.

Once it was believed that witches, warlocks, and demons were the causes of such calamities as bad weather. Elaborate contrivances were devised to drive them away. When men learned that it wasn't so, they looked for more natural, scientific explanations. Perhaps it is time to relegate to superstition the idea that government should manage money and get on to the task at hand—putting money back in the marketplace where it belongs.

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