HUMAN ACTION

by Ludwig von Mises, 4th edition (1996)

PART FOUR

CATALLACTICS OR ECONOMICS OF THE MARKET SOCIETY

XVII. INDIRECT EXCHANGE && 12-19

12. The Limitation on the Issuance of Fiduciary Media

People deal with money-substitutes as if they were money because they are fully confident that it will be possible to exchange them at any time without delay and without cost against money. We may call those who share in this confidence and are therefore ready to deal with money-substitutes as if they were money, the *clients* of the issuing banker, bank, or authority. It does not matter whether or not this issuing establishment is operated according to the patterns of conduct customary in the banking business. Token coins issued by a country's treasury are money-substitutes too, although the treasury as a rule does not enter the amount issued into its accounts as a liability and does not consider this amount a part of the national debt. It is no less immaterial whether or not the owner of a money-substitute has an actionable claim to redemption. What counts is whether the money-substitute can really be exchanged against money without delay and cost.[1]

Issuing money-certificates is an expensive venture. The banknotes must be printed, the coins minted; a complicated accounting system for the deposits must be organized; the reserves must be kept in safety; then there is the risk of being cheated by counterfeit banknotes and checks. against all these expenses stands only the slight chance that some of the banknotes issued may be destroyed and the still slighter chance that some depositors may forget their deposits. Issuing money-certificates is a ruinous business if not connected with issuing fiduciary media. In the

[1] It is furthermore immaterial whether or not the laws assign to the money-substitutes legal tender quality. If these things are really dealt with by people as money-substitutes and are therefore money-substitutes and equal in purchasing power to the respective amount of money, the only effect of the legal tender quality is to prevent malicious people from resorting to chicanery for the mere sake of annoying their fellow men. If, however, the things concerned are not money-substitutes and are traded at a discount below their face value, the assignment of legal tender quality is tantamount to an authoritarian price ceiling, the fixing of a maximum price for gold and foreign exchange and of a minimum price for the things which are no longer money-substitutes but either credit money or fiat money. Then the effects appear which Gresham's Law describes.

early history of banking there were banks whose only operation consisted in issuing money-certificates. But these banks were indemnified by their clients for the costs incurred. at any rate, catallactics is not interested in the purely technical problems of banks not issuing fiduciary media. The only interest that catallactics takes in money-certificates is the connection between issuing them and the issuing of fiduciary media.

While the quantity of money-certificates is catallactically unimportant, an increase or decrease in the quantity of fiduciary media affects the determination of money's purchasing power in the same way as do changes in the quantity of money. Hence the question of whether there are or are not limits to the increase in the quantity of fiduciary media has fundamental importance.

If the clientele of the bank includes all members of the market economy, the limit to the issue of fiduciary media is the same as that drawn to the increase in the quantity of money. A bank which is, in an isolated country or in the whole world, the only institution issuing fiduciary media and the clientele of which comprises all individuals and firms, is bound to comply in its conduct of affairs with two rules:

First: It must avoid any action which could make the clients--i.e., the public--suspicious. As soon as the clients begin to lose confidence, they will ask for the redemption of the banknotes and withdraw their deposits. How far the bank can go on increasing its issues of fiduciary media without arousing distrust, depends on psychological factors.

Second: It must not increase the amount of fiduciary media at such a rate and with such speed that the clients get the conviction that the rise in prices will continue endlessly at an accelerated pace. For if the public believes that this is the case, they will reduce their cash holdings, flee into "real" values, and bring about the crack-up boom. It is impossible to imagine the approach of this catastrophe without assuming that its first manifestation consists in the evanescence of confidence. The public will certainly prefer exchanging the fiduciary media against money to fleeing into real values, i.e. to the indiscriminate buying of various commodities. Then the bank must go bankrupt. If the government interferes by freeing the bank from the obligation of redeeming its banknotes and of paying back the deposits in compliance with the terms of the contract, the fiduciary media become either credit money or fiat money. The suspension of specie payments entirely changes the state of affairs. There is no longer any question of fiduciary media, of money-certificates, and of money-substitutes. The government enters the scene with its government-made legal tender laws. The bank loses its independent existence; it becomes a tool of government policies, a subordinate office of the treasury.

The catallactically most important problems of the issuance of fiduciary media on the part of a single bank, or of banks acting in concert, the clientele of which comprehends all individuals, are not those of the limitations drawn to the amount of their issuance. We will deal with them in Chapter XX, devoted to the relations between the quantity of money and the rate of interest.

At this point of our investigations we have to scrutinize the problem of the coexistence of a multiplicity of independent banks. Independence means that every bank in issuing fiduciary media follows its own course and does not act in concert with other banks. Co-existence means that every bank has a clientele which does not include all members of the market system. For the sake of simplicity we will assume that no individual or firm is a client of more than one bank. It would not affect the result of our demonstration if we were to assume that there are also people who are clients of more than one bank and people who are not clients of any bank.

The question to be raised is not whether or not there are limits to the issuance of fiduciary media on the part of such independently coexisting banks. As there are even limits to the issuance of fiduciary media on the part of a unique bank the clientele of which comprises all people, it is obvious that there are such limits for a multiplicity of independently coexisting banks too. What we want to show is that for such a multiplicity of independently coexisting banks the limits are narrower than those drawn for a single bank with an unlimited clientele.

We assume that within a market system several independent banks have been established in the past. While previously only money was in use, these banks have introduced the use of money-substitutes a part of which are fiduciary media. Each bank has a clientele and has issued a certain quantity of fiduciary media which are dept as money-substitutes in the cash holdings of various clients. The total quantity of the fiduciary media as issued by the banks and absorbed by the cash holdings of their clients has altered the structure of prices and the monetary unit's purchasing power. But these effects have already been consummated and at present the market is no longer stirred by any movements generated from this past credit expansion.

But now, we assume further, one bank alone embarks upon an additional issue of fiduciary media while the other banks do not follow suit. The clients of the expanding bank--whether its old clients or new ones acquired on account of the expansion--receive additional credits, they expand their business activities, they appear on the market with an additional demand for goods and services, they bid up prices. Those people who are not clients of the expanding bank are not in a position to afford these higher prices; they are forced to restrict their purchases. Thus there prevails on the market a shifting of goods from the nonclients to the clients of the expanding bank. The clients buy more from the nonclients than they sell to them; they have more to pay to the nonclients than they receive from them. But money-substitutes issued by the expanding bank are not suitable for payments to nonclients, as these people do not assign to them the character of money-substitutes. In order to settle the payments due to nonclients, the clients must first exchange the money-substitutes issued by their own--viz., the expanding bank--against money. The expanding bank must redeem its banknotes and pay out its deposits. Its reserve--we suppose that only a part of the money-substitutes it had issued had the character of fiduciary media--dwindles. The instant approaches in which the bank will--after the exhaustion of its money reserve--no longer be in a position to redeem the money-substitutes still current. In order to avoid insolvency it must as soon as possible return to a policy of strengthening its money reserve. It must abandon its expansionist methods.

This reaction of the market to a credit expansion on the part of a bank with a limited clientele has been brilliantly described by the Currency School. The special case dealt with by the Currency School referred to the coincidence of credit expansion on the part of one country's privileged central bank or of all banks of one country and of a nonexpansionist policy on the part of the banks of other countries. Our demonstration covers the more general case of the coexistence of a multiplicity of banks with different clientele as well as the most general case of the existence of one bank with a limited clientele in a system in which the rest of the people do not patronize any bank and do not consider any claims as money-substitutes. It does not matter, of course, whether one assumes that the clients of a bank live neatly separated from those of the other banks in a definite district or country or whether they live side by side with those of the other banks. These are merely differences in the data not affecting the catallactic problems involved.

A bank can never issue more money-substitutes than its clients can keep in their cash holdings. The individual client can never keep a larger portion of his total cash holding in money-substitutes than that corresponding to the proportion which his turnover with other clients of his bank bears to his total turnover. For considerations of convenience he will, as a rule, remain far below this maximum proportion. Thus a limit is drawn to the issue of fiduciary media. We may admit that everybody is ready to accept in his current transactions indiscriminately banknotes issued by any bank and checks drawn upon any bank. But he deposits without delay with his own bank not only the checks but also the banknotes of banks of which he is not himself a client. In the further course his bank settles its accounts with the bank engaged. Thus the process described above comes into motion.

A lot of nonsense has been written about a perverse predilection of the public for banknotes issued buy dubious banks. The truth is that, except for small groups of businessmen who were able to distinguish between good and bad banks, banknotes were always looked upon with distrust. It was the special charters which the governments granted to privileged banks that slowly made these suspicions disappear. The often advanced argument that small banknotes come into the hands of poor and ignorant people who cannot distinguish between good and bad notes cannot be taken seriously. The poorer the recipient of a banknote is nd the less familiar he is with bank affairs, the more quickly will he spend the note and the more quickly will it return, by way of retail and wholesale trade, to the issuing bank or to people conversant with banking conditions.

It is very easy for a bank to increase the number of people who are ready to accept loans granted by credit expansion and paid out in an amount of money-substitutes. But it is very difficult for any bank to enlarge its clientele, that is, the number of people who are ready to consider these claims as money-substitutes and to keep them as such in their cash holdings. To enlarge this clientele is a troublesome and slow process, as is the acquisition of any kind of good will. On the other hand, a bank can lose its clientele very quickly. If it wants to preserve it, it must never permit any doubt about its ability and readiness to discharge all its liabilities in due compliance with the terms of the contract. A reserve must be kept large enough to redeem all banknotes which a holder may submit for redemption. Therefore no bank can content itself with issuing fiduciary media only; it must keep a reserve against the total amount of money-substitutes issued and thus combine issuing fiduciary media and money-certificates.

It was a serious blunder to believe that the reserve's task is to provide the means for the redemption of those banknotes the holders of which have lost confidence in the bank. The confidence which a bank and the money-substitutes it has issued enjoy is indivisible. It is either present with all its clients or it vanishes entirely. If some of the clients lose confidence, the rest of them lose it too. No bank issuing fiduciary media and granting circulation credit can fulfill the obligations which it has taken over in issuing money-substitutes if all clients are losing confidence and want to have their banknotes redeemed and their deposits paid back. This is an essential feature or weakness of the business of issuing fiduciary media and granting circulation credit. No system of reserve policy and no reserve requirements as enforced by the laws can remedy it. All that a reserve can do is to make it possible for the bank to withdraw from the market an excessive amount of fiduciary media issued. If the bank has issued more banknotes than its clients can use in doing business with other clients, it must redeem such an excess.

The laws which compelled the banks to keep a reserve in a definite ration of the total amount of deposits and of banknotes issued were effective in so far as they restricted the increase in the amount of fiduciary media and of circulation credit. They were futile as far as they aimed at safeguarding, in the event of a loss of confidence, the prompt redemption of the banknotes and the prompt payment on deposits.

The Banking School failed entirely in dealing with these problems. It was confused by a spurious idea according to which the requirements of business rigidly limit the maximum amount of convertible banknotes that a bank can issue. They did not see that the demand of the public for credit is a magnitude dependent on the banks' readiness to lend, and that banks which do not bother about their own solvency are in a position to expand circulation credit by lowering the rate of interest below the market rate. It is not true that the maximum amount which a bank can lend if it limits its lending to discounting short-term bills of exchange resulting from the sale and purchase of raw materials and half-manufactured goods, is a quantity uniquely determined by the state of business and independent of the bank's policies. This quantity expands or shrinks with the lowering or raising of the rate of discount. Lowering the rate of interest is tantamount to increasing the quantity of what is mistakenly considered as the fair and normal requirements of business.

The Currency School gave a quite correct explanation of the recurring crises as they upset English business conditions in the 'thirties and 'forties of the nineteenth century. There was credit expansion on the part of the Bank of England and the other British banks and bankers, while there was no credit expansion, or at least not to the same degree, in the countries with which Great Britain traded. The external drain occurred as the necessary consequence of this state of affairs. Everything that the Banking School advanced in order to refute this theory was vain. Unfortunately, the Currency School erred in two respects. It never realized that the remedy it suggested, namely strict legal limitation of the amount of banknotes issued beyond the specie reserve, was not the only one. It never gave a thought to the idea of free banking. The second fault of the Currency School was that it failed to recognize that deposits subject to check are money-substitutes and, as far as their amount exceeds the reserve kept, fiduciary media, and consequently no less a vehicle of credit expansion than are banknotes. It was the only merit of the Banking School that it recognized that what is called deposit currency is a money-substitute no less than banknotes. But except for this point, all the doctrines of the Banking School were spurious. It was guided by contradictory ideas concerning money's neutrality; it tried to refute the quantity theory of money by referring to a *deus ex machina*, the much talked about hoards, and it misconstrued entirely the problems of the rate of interest.

It must be emphasized that the problem of legal restrictions upon the issuance of fiduciary media could emerge only because governments had granted special privileges to one or several banks and had thus prevented the free evolution of banking. If the governments had never interfered for the benefit of special banks, if they had never released some banks from the obligation, incumbent upon all individuals and firms in the market economy, to settle their liabilities in full compliance with the terms of the contract, no bank problem would have come into being. The limits which are drawn to credit expansion would have worked effectively. Considerations of its own solvency would have forced every bank to cautious restraint in issuing fiduciary media. Those banks which would not have observed these indispensable rules would have gone bankrupt, and the public, warned through damage, would have become doubly suspicious and reserved.

The attitudes of the European governments with regard to banking were from the beginning insincere and mendacious. The pretended solicitude for the nation's welfare, for the public in general, and for the poor ignorant masses in particular was a mere blind. The governments wanted inflation and credit expansion, they wanted booms and easy money. Those Americans who twice succeeded in doing away with a central bank were aware of the dangers of such institutions; it was only too bad that they failed to see that the evils they fought were present in every kind of government interference with banking. Today even the most bigoted etatists cannot deny that all the alleged evils of free banking count little when compared with the disastrous effects of the tremendous inflations which the privileged and government-controlled banks have brought about.

It is a fable that governments interfered with banking in order to restrict the issue of fiduciary media and to prevent credit expansion. The idea that guided governments was, on the contrary, the lust for inflation and credit expansion. They privileged banks because they wanted to widen the limits that the unhampered market draws to credit expansion or because they were eager to open to the treasury a source of revenue. For the most part both of these considerations motivated the authorities. They were convinced that the fiduciary media are an efficient means of lowering the rate of interest, and asked the banks to expand credit for the benefit of both business and the treasury. Only when the undesired effects of credit expansion became visible, were laws enacted to restrict the issue of banknotes--and sometimes also of deposits--not covered by specie. The establishment of free banking was never seriously considered precisely because it would have been too efficient in restricting credit expansion. For rulers, writers, and the public were unanimous in the belief that business has a fair claim to a "normal" and "necessary" amount of circulation credit and that this amount could not be attained under free banking.[2]

Many governments never looked upon the issuance of fiduciary media from a point of view other than that of fiscal concerns. In their eyes the foremost task of the banks was to lend money to the treasury. The money-substitutes were a favorably considered as pacemakers for government-issued paper money. The convertible banknote was merely a first step on the way to the nonredeemable banknote. With the progress of statolatry and the policy of interventionism these ideas have become general and are no longer questioned by anybody. No government is willing today to give any thought to the program of free banking because no government wants to renounce what it considers a handy source of revenue. What is called today financial war preparedness is merely the ability to procure by means of privileged and government-controlled banks all the money a warring nation may need. Radical inflationism, although not admitted explicitly, is an essential feature of the economic ideology of our age.

[2] The notion of "normal" credit expansion is absurd. Issuance of additional fiduciary media, no matter what its quantity may be, always sets in motion those changes in the price structure the description of which is the task of the theory of the trade cycle. Of course, if the additional amount issued is not large, neither are the inevitable effects of the expansion.

But even at the time liberalism enjoyed its highest prestige and governments were more eager to preserve peace and well-being than to foment war, death, destruction, and misery, people were biased in dealing with the problems of banking. Outside of the Anglo-Saxon countries public opinion was convinced that it is one of the main tasks of good government to lower the rate of interest and that credit expansion is the appropriate means for the attainment of this end.

Great Britain was free from these errors when in 1844 it reformed its bank laws. But the two shortcomings of the Currency School vitiated this famous act. On one hand, the system of government interference with banking was preserved. On the other hand, limits were placed only on the issuance of banknotes not covered by specie. The fiduciary media were suppressed only in the shape of banknotes. They could thrive as deposit currency.

In carrying the idea implied in the Currency Theory to its full logical conclusion, one could suggest that all banks be forced by law to keep against the total amount of money-substitutes (banknotes plus demand deposits) a 100 per cent money reserve. This is the core of Professor Irving Fisher's 100 per cent plan. But Professor Fisher combined his plan with his proposals concerning the adoption of an index-number standard. It has been pointed out already why such a scheme is illusory and tantamount to open approval of the government's power to manipulate purchasing power according to the appetites of powerful pressure groups. But even if the 100 percent reserve plan were to be adopted on the basis of the unadulterated gold standard, it would not entirely remove the drawbacks inherent in every kind of government interference with banking. What is needed to prevent any further credit expansion is to place the banking business under the general rules of commercial and civil laws compelling every individual and firm to fulfill all obligations in full compliance with the terms of the contract. If banks are preserved as privileged establishments subject to special legislative provisions, the tool remains that governments can use for fiscal purposes. Then every restriction imposed upon the issuance of fiduciary media depends upon the government's and the parliament's good intentions. They may limit the issuance for periods which are called normal. The restriction will be withdrawn whenever a government deems that an emergency justifies resorting to extraordinary measures. If an administration and the party backing it want to increase expenditure without jeopardizing their popularity through the imposition of higher taxes, they will always be ready to call their impasse an emergency. Recourse to the printing press and to the obsequiousness of bank managers willing to oblige the authorities regulating their conduct of affairs is the foremost means of governments eager to spend money for purposes for which the taxpayers are not ready to pay higher taxes.

Free banking is the only method available for the prevention of the dangers inherent in credit expansion. It would, it is true, not hinder a slow credit expansion, kept within very narrow limits, on the part of cautious banks which provide the public with all information required about their financial status. But under free banking it would have been impossible for credit expansion with all its inevitable consequences to have developed into a regular--one is tempted to say normal--feature of the economic system. Only free banking would have rendered the market economy secure against crises and depressions.

Looking backward upon the history of the last two centuries, one cannot help realizing that the blunders committed by liberalism in handling the problems of banking were a deadly blow to the market economy. There was no reason whatever to abandon the principle of free enterprise in the field of banking. The majority of liberal politicians simply surrendered to the popular hostility against money-lending and interest taking. They failed to realize that the rate of interest is a market phenomenon which cannot be manipulated *ad libitum* by the authorities or by any other agency. They adopted the superstition that lowering the rate of interest is beneficial and that credit expansion is the right means of attaining such cheap money. Nothing harmed the cause of liberalism more than the almost regular return of feverish booms and of the dramatic breakdown of bull markets followed by lingering slumps. Public opinion has become convinced that such happenings are inevitable in the unhampered market economy. People did not conceive that what they lamented was the necessary outcome of policies directed toward a lowering of the rate of interest by means of credit expansion. They stubbornly kept to these policies and tried in vain to fight their undesired consequences by more and more government interference.

Observations on the Discussions Concerning Free Banking

The Banking School taught that an overissuance of banknotes is impossible if the bank limits its business to the granting of short-term loans.[3] When the loan is paid back at maturity, the banknotes return to the bank and thus disappear from the market. However, this happens only if the bank restricts the amount of credits granted. (But even then it would not undo the effects of its previous credit expansion. It would merely add

[3] See above, pp. 437-438.

to it the effects of a later credit contraction.) The regular course of affairs is that the bank replaces the bills expired and paid back by discounting new bills of exchange. Then to the amount of banknotes withdrawn from the market by the repayment of the earlier loan there corresponds an amount of newly issued banknotes.

The concatenation which sets a limit to credit expansion under a system of free banking works in a different way. It has no reference whatever to the process which this so-called Principle of Fullarton has in mind. It is brought about by the fact that credit expansion in itself does not expand a bank's clientele, viz., the number of people who assign to the demand-claims against this bank the character of money-substitutes. Since the overissuance of fiduciary media on the part of one bank, as has been shown above, increases the amount to be paid by the expanding bank's clients to other people, it increases concomitantly the demand for the redemption of its money-substitutes. It thus forces the expanding bank back to a restraint.

This fact was never questioned with regard to demand deposits subject to check. It is obvious that an expanding bank would very soon find itself in a difficult position in clearing with the other banks. However, people sometimes maintained that things are different as far as banknotes are concerned.

In dealing with the problems of money-substitutes, catallactics maintains that the claims in question are dealt with by a number of people like money, that they are, like money, given away and received in transactions and dept in cash holdings. Everything that catallactics asserts with regard to money-substitutes presupposes this state of affairs. But it would be preposterous to believe that every banknote issued by any bank really becomes a money-substitute. What makes a banknote a money-substitute is the special kind of good will of the issuing bank. The slightest doubt concerning the bank's ability or willingness to redeem every banknote without any delay at any time and with no expense to the bearer impairs this special good will and deprives the banknotes of their character as a money-substitute. We may assume that everybody not only is prepared to get such questionable banknotes as a loan but also prefers to receive them as payment instead of waiting longer. But if any doubts exist concerning their prime character, people will hurry to get rid of them as soon as possible. They will keep in their cash holdings money and such money-substitutes as they consider perfectly safe and will dispose of the suspect banknotes. These banknotes will be traded at a discount, and this fact will carry them back to the issuing bank which alone is bound to redeem them at their full face value.

The issue can still better be clarified by reviewing banking conditions in continental Europe. Here the commercial banks were free from any limitation concerning the amount of deposits subject to check. They would have been in a position to grant circulation credit and thus expand credit by adopting the methods applied by the banks of the Anglo-Saxon countries. However, the public was not ready to treat such bank deposits as money-substitutes. As a rule a man who received a check cashed it immediately and thereby withdrew the amount from the bank. It was impossible for a commercial bank to lend, except for negligible sums, by crediting the debtor's account. As soon as the debtor wrote out a check, a withdrawal of the amount concerned from the bank resulted. Only big business treated deposits as money-substitutes. Although the Central Banks in most of these countries were not submitted to any legal restrictions with regard to their deposit business, they were prevented from using it as a vehicle of large-scale credit expansion because the clientele for deposit currency was too small. Banknotes were practically the sole instrument of circulation credit and credit expansion.

In the 'eighties of the nineteenth century the Austrian Government embarked upon a project of popularizing checkbook money by establishing a checking account department with the Post Office Savings Service. It succeeded to some degree. Balances with this department of the Post Office were treated as money-substitutes by a clientele which was broader than that of the checking account department of the country's Central Bank of Issue. The system was later preserved by the new states which in 1918 succeeded the Habsburg Empire. It has also been adopted by many other European nations, for instance Germany. It is important to realize that this kind of deposit currency was a purely governmental venture and that the circulation credit that the system granted was exclusively lent to the governments. It is characteristic that the name of the Austrian Post Office Savings Institution, and likewise of most of its foreign replicas, was not Savings *Bank*, but Savings *Office (Amt)*. Apart from these demand deposits with the government post system in most of the non-Anglo-Saxon countries, banknotes--and, to a small extent, also deposits with the Government-controlled Central Bank of Issue--are the main vehicles of circulation credit. In speaking of credit expansion with regard to these countries, one refers almost entirely to banknotes.

In the United States many employers pay salaries and even wages by writing out checks. As far as the payees immediately cash the checks received and withdraw the whole amount from the bank, the method means merely that the onerous burden of manipulating coins and banknotes is shifted from the employer's cashier to the bank's cashier. It has no catallactic implications. If all citizens were to deal in this way with checks received, the deposits would not be money-substitutes and could not be used as instruments of circulation credit. It is solely the fact that a considerable part of the public looks upon deposits as money-substitutes that makes them what is popularly called checkbook money or deposit currency.

It is a mistake to associate with the notion of free banking the image of a state of affairs under which everybody is free to issue banknotes and to cheat the public *ad libitum*. People often refer to the dictum of an anonymous american quoted by Tooke: "Free trade in banking is free trade in swindling." However, freedom in the issuance of banknotes would have narrowed down the use of banknotes considerably if it had not entirely suppressed it. It was this idea which Cernuschi advanced in the hearings of the French Banking Inquiry of October 24, 1865: "I believe that what is called freedom of banking would result in a total suppression of banknotes in France. I want to give everybody the right to issue banknotes so that nobody should take any banknotes any longer."[4]

People may uphold the opinion that banknotes are more handy than coins and that considerations of convenience recommend their use. As far as this is the case, the public would be prepared to pay a premium for the avoidance of the inconveniences involved in carrying a heavy weight of coins in their pockets. Thus in earlier days banknotes issued by banks of unquestionable solvency stood at a slight premium as against metallic currency. Thus travelers' checks are rather popular although the bank issuing them charges a commission for their issuance. But all this has no reference whatever to the problem in question. It does not provide a justification for the policies urging the public to resort to the use of banknotes. Governments did not foster the use of banknotes in order to avoid inconvenience to ladies shopping. Their idea was to lower the rate of interest and to open a source of cheap credit to their treasuries. In their eyes the increase in the quantity of fiduciary media was a means of promoting welfare.

Banknotes are not indispensable. All the economic achievements of capitalism would have been accomplished if they had never existed. Besides, deposit currency can do all the things banknotes do. And government interference with the deposits of commercial banks cannot be

[4] Cf. Cernuschi, *Contre le billet de banque* (Paris, 1866), p. 55.

justified by the hypocritical pretext that poor ignorant wage earners and farmers must be protected against wicked bankers.

But, some people may ask, what about a cartel of the commercial banks? Could not the banks collude for the sake of a boundless expansion of their issuance of fiduciary media? The objection is preposterous. As long as the public is not, by government interference, deprived of the right of withdrawing its deposits, no bank can risk its own good will by collusion with banks whose good will is not so high as its own. One must not forget that every bank issuing fiduciary media is in a rather precarious position. Its most valuable asset is its reputation. It must go bankrupt as soon as doubts arise concerning its perfect trustworthiness and solvency. It would be suicidal for a bank of good standing to link its name with that of other banks with a poorer good will. Under free banking a cartel of the banks would destroy the country's whole banking system. It would not serve the interests of any bank.

For the most part the banks of good repute are blamed for their conservatism and their reluctance to expand credit. In the eyes of people not deserving of credit such restraint appears as a vice. But it is the first and supreme rule for the conduct of banking operations under free banking.

It is extremely difficult for our contemporaries to conceive of the conditions of free banking because they take government interference with banking for granted and as necessary. However, one must remember that this government interference was based on the erroneous assumption that credit expansion is a proper means of lowering the rate of interest permanently and without harm to anybody but the callous capitalists. The governments interfered precisely because they knew that free banking keeps credit expansion within narrow limits.

Economists may be right in asserting that the present state of banking makes government interference with banking problems advisable. But this present state of banking is not the outcome of the operation of the unhampered market economy. It is a product of the various governments' attempts to bring about the conditions required for large-scale credit expansion. If the governments had never interfered, the use of banknotes and of deposit currency would be limited to those strata of the population who know very well how to distinguish between solvent and insolvent banks. No large-scale credit expansion would have been possible. The governments alone are responsible for the spread of the superstitious awe with which the common man looks upon every bit of paper upon which the treasury or agencies which it controls have printed the magical words *legal tender*.

Government interference with the present state of banking affairs could be justified if its aim were to liquidate the unsatisfactory conditions by preventing or at least seriously restricting any further credit expansion. In fact, the chief objective of present-day government interference is to intensify further credit expansion. This policy is doomed to failure. Sooner or later it must result in a catastrophe.

13. The Size and Composition of Cash Holdings

The total amount of money and money-substitutes is kept by individuals and firms in their cash holdings. The share of each is determined by marginal utility. Each is eager to keep a certain portion of his total wealth in cash. He gets rid of an excess of cash by increased purchases and remedies a deficiency of cash by increased sales. The popular terminology confusing the demand for money for cash holding and the demand for wealth and vendible goods must not delude an economist.

What is valid with regard to individuals and firms is no less true with regard to every sum of the cash holdings of a number of individuals and firms. The point of view from which we treat a number of such individuals and firms as a totality and sum up their cash holdings is immaterial. The cash holdings of a city, a province, or a country is the sum of the cash holdings of all its residents.

Let us assume that the market economy uses only one kind of money and that money-substitutes are either unknown or used in the whole area by everybody without any difference. There are, for example, gold money and redeemable banknotes, issued by a world bank and treated by everybody as money-substitutes. On these assumptions measures hindering the exchange of commodities and services do not affect the state of monetary affairs and the size of cash holdings. Tariffs, embargoes, and migration barriers affect the tendencies toward an equalization of prices, wages, and interest rates. They do not react directly upon cash holdings.

If a government aims at increasing the amount of cash kept by its subjects, it must order them to deposit a certain amount with an office and to leave it there untouched. The necessity of procuring this amount would force everybody to sell more and to buy less; domestic prices would drop; exports would be increased and imports reduced; a quantity of cash would be imported. But if the government were simply to obstruct the importation of goods and the exportation of money, it would fail to attain its goal. If imports drop, other things being equal, exports drop concomitantly.

The role money plays in international trade is not different from that which it plays in domestic trade. Money is no less a medium of exchange in foreign trade than it is in domestic trade. Both in domestic trade and in international trade purchases and sales result in a more than passing change in the cash holdings of individuals and firms only if people are purposely intent upon increasing or restricting the size of their cash holdings. A surplus of money flows into a country only when its residents are more eager to increase their cash holdings than are the foreigners. An outflow of money occurs only if the residents are more eager to reduce their cash holdings than are the foreigners. A transfer of money from one country into another country which is not compensated by a transfer in the opposite direction is never the unintended result of international trade transactions. It is always the outcome of intended changes in the cash holdings of the residents. Just as wheat is exported only if a country's residents want to export a surplus of wheat, so money is exported only if the residents want to export a sum of money which they consider as a surplus.

If a country turns to the employment of money-substitutes which are not employed abroad, such a surplus emerges. The appearance of these money-substitutes is tantamount to an increase in the country's supply of money in the broader sense, i.e., supply of money plus fiduciary media; it brings about a surplus in the supply of money in the broader sense. The residents are eager to get rid of their share in the surplus by increasing their purchases either of domestic or of foreign goods. In the first case exports drop and in the second case imports increase. In both cases the surplus of money goes abroad. As, according to our assumption, money-substitutes cannot be exported, only money proper flows out. The result is that within the domestic supply of money in the broader sense (money + fiduciary media) the portion of money drops and the portion of fiduciary media increases. The domestic stock of money in the narrower sense is now smaller than it was previously.

Now, we assume further, the domestic money-substitutes cease to be money-substitutes. The bank which issued them no longer redeems them in money. These former money-substitutes are now claims against a bank which does not fulfill its obligations, a bank whose ability and willingness to pay its debts is questionable. Nobody knows whether and when they will ever be redeemed. But it may be that these claims are used by the public as credit money. As money-substitutes they had been considered as equivalents of the sum of money to which they gave a claim payable at any moment. As credit money they are now traded at a discount.

At this point the government may interfere. It decrees that these pieces of credit money are legal tender at their face value.[5] No trader is free to discriminate against them. The decree tries to force the public to treat things of different exchange value as if they had the same exchange value. It interferes with the structure of prices as determined by the market. It fixes minimum prices for the credit money and maximum prices for the commodity money (gold) and foreign exchange. The result is not what the government aimed at. The difference in exchange value between credit money and gold does not disappear. As it is forbidden to employ the coins according to their market price, people no longer employ them in buying and selling and in paying debts. They keep them or they export them. The commodity money disappears from the domestic market. Bad money, says Gresham's Law, drives good money out of the country. It would be more correct to say that the money which the government's decree has undervalued disappears from the market and the money which the decree has overvalued remains.

The outflow of commodity money is thus not the effect of an unfavorable balance of payments, but the effect of a government interference with the price structure.

14. Balances of Payment

The confrontation of the money equivalent of all incomings and outgoings of an individual or a group of individuals during any particular period of time is called the balance of payments. The credit side and the debit side are always equal. The balance is always in balance.

If we want to know an individual's position in the frame of the market economy, we must look at his balance of payments. It tells us everything about the role he plays in the system of the social division of labor. It shows what he gives to his fellow men and what he receives or takes from them. It shows whether he is a self-supporting decent citizen or a thief or an almsman. It shows whether he consumes all his proceeds or whether he saves a part of them. There are many human things which are not

[5] Very often the legal tender quality had been given to those banknotes at a time when they still were money-substitutes and as such equal to money in their exchange value. At that time the decree had no catallactic importance. Now it becomes important because the market no longer considers them money-substitutes.

reflected in the sheets of the ledger; there are virtues and achievements, vices and crimes that do not leave any traces in the accounts. But as far as a man is integrated into social life and activities, as far as he contributes to the joint effort of society and his contributions are appreciated by his fellow men, and as far as he consumes what is or could be sold and bought on the market, the information conveyed is complete.

If we combine the balances of payments of a definite number of individuals and leave out of account the items referring to transactions between the members of this group, we draw up the group's balance of payment. This balance tells us how the members of the group, considered as an integrated complex of people, are connected with the rest of the market society. Thus we can draw up the balance of payments of the members of the New York Bar, of the Belgian farmers, of the residents of Paris, or of those of the Swiss Canton of Bern. Statisticians are mostly interested in establishing the balance of payments of the residents of the various countries which are organized as independent nations.

While an individual's balance of payments conveys exhaustive information about his social position, a group's balance discloses much less. It says nothing about the mutual relations between the members of the group. The greater the group is and the less homogeneous its members are, the more defective is the information vouchsafed by the balance of payments. The balance of payments of Denmark tells more about the conditions of the Danes than the United States balance of payments about the conditions of the Americans. If one wants to describe a country's social and economic condition, one does not need to deal with every single inhabitant's personal balance of payments. But one must not form other groups than such as are composed of members who are by and large homogeneous in their social standing and their economic activities.

Reading balances of payments is thus very instructive. However, to guard against popular fallacies, one must know how to interpret them.

It is customary to list separately the monetary and the nonmonetary items of a country's balance of payments. One calls the balance favorable if there is a surplus of the imports of money and bullion over the exports of money and bullion. One calls the balance unfavorable if the exports of money and bullion exceed the imports. This terminology stems from inveterate Mercantilist errors unfortunately still surviving in spite of the devastating criticism of the economists. The imports and exports of money and bullion are viewed as the unintentional outcome of the configuration of the nonmonetary items of the balance of payments. This opinion is utterly fallacious. An excess in the exports of money and bullion is not the product of an unhappy concatenation of circumstances that befalls a nation like an act of God. It is the result of the fact that the residents of the country concerned are intent upon reducing the amount of money held and upon buying goods instead. This is why the balance of payments of the gold-producing countries is as a rule "unfavorable"; this is why the balance of payments of a country substituting fiduciary media for a part of its money stock is "unfavorable" as long as this process goes on.

No provident action on the part of a paternal authority is required lest a country lose its whole money stock by an unfavorable balance of payments. Things are in this regard not different between the personal balances of payments of individuals and those of groups. Neither are they different between the balances of payments of a city or a district and those of a sovereign nation. No government interference is needed to prevent the residents of New York from spending all their money in dealings with the other forty-nine stated of the Union. As long as any American attaches any weights to the keeping of cash, he will spontaneously take charge of the matter. Thus he will contribute his share to the maintenance of an adequate supply of money in his country. But if no American were interested in keeping any cash holding, no government measure concerning foreign trade and the settlement of international payments could prevent an outflow of America's total monetary stock. A rigidly enforced embargo upon the exportation of money and bullion would be required.

15. Interlocal Exchange Rates

Let us first assume that there is only one kind of money. Then with regard to money's purchasing power at various places the same is valid as with regard to commodity prices. The final price of cotton in Liverpool cannot exceed the final price in Houston, Texas, by more than the cost of transportation. As soon as the price in Liverpool rises to a higher point, merchants will ship cotton to Liverpool and thus will bring about a tendency toward a return to the final price. In the absence of institutional obstacles, the price of an order for the payment of a definite amount of guilders in Amsterdam cannot rise in New York above the amount determined by the costs involved by reminting the coins, shipment, insurance, and the interest during the period required for all these manipulations. As soon as the difference rises above this point--the gold export point--it becomes profitable to ship gold from New York to Amsterdam. Such shipments force the guilder exchange rate in New York down below the gold export point. A difference between the configuration of interlocal exchange rates for commodities and those for money is brought about by the fact that as a rule commodities move only in one direction, namely, from the places of surplus production to those of surplus consumption. Cotton is shipped from Houston to Liverpool and not from Liverpool to Houston. Its price is lower in Houston than in Liverpool by the amount of shipping costs. But money is shipped now this way, now that.

The error of those who try to interpret the fluctuations of the interlocal exchange rates and the interlocal shipments of money as determined by the configuration of the nonmonetary items of the balance of payments is that they assign to money an exceptional position. They do not see that with regard to interlocal exchange rates there is no difference between money and commodities. If cotton trade between Houston and Liverpool is possible at all, the cotton prices at these two places cannot differ by more than the total amount of costs required for shipment. In the same way in which there is a flow of cotton from the southern parts of the United States to Europe, gold flows from the gold-producing countries like South Africa to Europe.

Let us disregard triangular trade and the case of the gold-producing countries and let us assume that the individuals and firms trading with one another on the basis of the gold standard do not have the intention of changing the size of their cash holdings. From their purchases and sales, claims are generated which necessitate interlocal payments. But according to our assumption these interlocal payments are equal in amount. The amount that the residents of *A* have to pay to the residents of *B* is equal to the amount that the residents of *B* have to pay to the residents of *A*. It is therefore possible to save the costs of shipping gold from *A* to *B* and from *B* to *A*. Claims and debts can be settled by a sort of interlocal clearing. It is merely a technical problem whether this evening up is effected by an interlocal clearinghouse organization or by the turnovers of a special market for foreign exchange. At any rate, the price which a resident of *A* (or of *B*) has to pay for a payment due in *B* (or in *A*) is kept within the margins determined by the shipment costs. It cannot rise above the par value by more than the shipment costs (gold export point) and cannot fall below the shipment costs (gold import point).

It may happen that--all our other assumptions remaining unaltered--there is a temporal discrepancy between the payments due from *A* to *B* and those from *B* to *A*. Then an interlocal shipment of gold can only be avoided by the interposition of a credit transaction. If the importer who today has to pay from *A* to *B* can buy at the market of foreign exchange claims against residents of *B* as fall due in ninety days, he can save the costs of shipping gold by borrowing the sum concerned in *B* for a period of ninety days. The dealers in foreign exchange will resort to this makeshift if the costs of borrowing in *B* do not exceed the costs of borrowing in *A* by more than double the costs of shipping gold. If the cost of shipping gold is 1/8 per cent, they will be ready to pay for a three months' loan in *B* up to 1 per cent (pro anno) more as interest than corresponds to the state of the money-market interest rate at which, in the absence of such requirements for interlocal payments, credit transactions between *A* and *B* would be effected.

It is permissible to express these facts by contending that the daily state of the balance of payments between *A* and *B* determines the daily point at which, within the margins drawn by the gold export point and the gold import point, the foreign exchange rates are fixed. But one must not forget to add that this happens only if the residents of *A* and of *B* do not intend to change the size of their cash holdings. Only because this is the case does it become possible to avoid the transfer of gold altogether and to keep foreign exchange rates within the limits drawn by the two gold points. If the residents of *A* want to reduce their cash holdings and those of *B* want to increase theirs, gold must be shipped from *A* to *B* and the rate for cable transfer *B* reaches in *A* the gold export point. Then gold is sent from *A* to *B* in the same way in which cotton is regularly sent from the United States to Europe. The rate of cable transfer *B* reaches the gold export point because the residents of *A* are selling gold to those of *B*, not because their balance of payments is unfavorable.

All this is valid with regard to any payments to be transacted between various places. It makes no difference whether the cities concerned belong to the same sovereign nation or to different sovereign nations. However, government interference has considerably changed the conditions. All governments have created institutions which make it possible for the residents of their countries to make interlocal domestic payments at par. The costs involved in shipment of currency from one place to another are borne either by the treasury or by the country's central bank system or by another government bank such as the postal savings banks of various European countries. Thus there is no longer any market for domestic interlocal exchange. The public is not charged more for an interlocal order to pay than for a local one or, if the charge is slightly different, it no longer has any reference to the fluctuations of the interlocal movements of currency within the country. It is this government interference which has sharpened the difference between domestic payment and payment abroad. Domestic payments are transacted at par, while with regard to foreign payments fluctuations occur within the limits drawn by the gold points.

If more than one kind of money is used as a medium of exchange, the mutual exchange ratio between them is determined by their purchasing power. The final prices of the various commodities, as expressed in each of the two or several kinds of money, are in proportion to each other. The final exchange ratio between the various kinds of money reflects their purchasing power with regard to the commodities. If any discrepancy appears, opportunity for profitable transactions presents itself and the endeavors of businessmen eager to take advantage of this opportunity tend to make it disappear again. The purchasing-power parity theory of foreign exchange is merely the application of the general theorems concerning the determination of prices to the special case of the coexistence of various kinds of money.

It does not matter whether the various kinds of money coexist in the same territory or whether their use is limited to distinct areas. In any case the mutual exchange ratio between them tends to a final state at which it no longer makes any difference whether one buys and sells against this or that kind of money. As far as costs of interlocal transfer come into play, these costs must be added or deducted.

The changes in purchasing power do not occur at the same time with regard to all commodities and services. Let us consider again the practically very important instance of an inflation in one country only. The increase in the quantity of domestic credit money or fiat money affects at first only the prices of some commodities and services. The prices of the other commodities remain for some time still at their previous stand. The exchange ratio between the domestic currency and the foreign currencies is determined on the bourse, a market organized and managed according to the pattern and the commercial customs of the stock exchange. The dealers on this special market are quicker than the rest of the people in anticipating future changes. Consequently the price structure of the market for foreign exchange reflects the new money relation sooner than the prices of many commodities and services. As soon as the domestic inflation begins to affect the prices of some commodities, at any rate long before it has exhausted all its effects upon the greater part of the prices of commodities and services, the price of foreign exchange tends to rise to the point corresponding to the final state of domestic prices and wage rates.

This fact has been entirely misinterpreted. People failed to realize that the rise in foreign exchange rates merely anticipates the movement of domestic commodity prices. They explained the boom in foreign exchange as an outcome of an unfavorable balance of payments. The demand for foreign exchange, they maintained, has been increased by a deterioration of the balance of trade or of other items of the balance of payments, or simply by sinister machinations on the part of unpatriotic speculators. The higher prices to be paid for foreign exchange cause the domestic prices of imported goods to rise. The prices of the domestic products must follow suit because otherwise their low state would encourage business to withhold them from domestic consumption and to sell them abroad at a premium.

The fallacies involved in this popular doctrine can easily be shown. If the nominal income of the domestic public had not been increased by the inflation, they would be forced to restrict their consumption either of imported or of domestic products. In the first case imports would drop and in the second case exports would increase. Thus the balance of trade would again be brought back to what the Mercantilists call a favorable state.

Pressed hard, the Mercantilists cannot help admitting the cogency of this reasoning. But, they say, it applies only to normal trade conditions. It does not take into account the state of affairs in countries which are under the necessity of importing vital commodities such as food and essential raw materials. The importation of such goods cannot be curtailed below a certain minimum. They are imported no matter what prices must be paid for them. If the foreign exchange required for importing them cannot be procured by an adequate amount of exports, the balance of trade becomes unfavorable and the foreign exchange rates must rise more and more.

This is no less illusory than all other Mercantilist ideas. However urgent and vital an individual's or a group of individuals' demand for some goods may be, they can satisfy it on the market only by paying the market price. If an Austrian wants to buy Canadian wheat, he must pay the market price in Canadian dollars. He must procure these Canadian dollars by exporting goods either directly to Canada or to some other country. He does not increase the amount of Canadian dollars available by paying higher prices (in schillings, the Austrian domestic currency) for Canadian dollars. Moreover, he cannot afford to pay such higher prices (in schillings) for imported wheat if his income (in schillings) remains unchanged. Only if the Austrian Government embarks upon an inflationary policy and thus increases the number of schillings in the pockets of its citizens, are the Austrians in a position to continue to buy the quantities of Canadian wheat they used to buy without curtailing other expenditures. If there were no domestic inflation, any rise in the price of imported goods would result either in a drop in their consumption or in a restriction in the consumption of other goods. Thus the process of readjustment as described above would have come into motion.

If a man lacks the money to buy bread from his neighbor, the village baker, the cause is not to be seen in an alleged scarcity of money. The cause is that this man did not succeed in earning the amount of money needed either by selling goods or by rendering services for which people are prepared to pay. The same is true with regard to international trade. a country may be distressed on account of the fact that it is at a loss to sell abroad as many commodities as it would have to sell in order to buy all the food its citizens want. But this does not mean that foreign exchange is scarce. It means that the residents are poor. And domestic inflation is certainly not an appropriate means to remove this poverty.

Neither has speculation any reference to the determination of foreign exchange rates. The speculators merely anticipate the expected alterations. If they err, if their opinion that an inflation is in progress is wrong, the structure of prices and foreign exchange rates will not correspond to their anticipations and they will have to pay for their mistakes by losses.

The doctrine according to which foreign exchange rates are determined by the balance of payments is based upon an illicit generalization of a special case. If two places, *A* and *B*, use the same kind of money and if the residents do not want to make any changes in the size of their cash holdings, over a given period of time the amount of money paid from the residents of *A* to those of *B* equals the amount paid from the residents of *B* to those of *A* and all payments can be settled without shipping money from *A* to *B* or from *B* to *A*. Then the rate of cable transfer *B* in *A* cannot rise above a point slightly below the gold export point and cannot drop below a point slightly above the gold import point, and vice versa. Within this margin the daily state of the balance of payments determines the daily state of the foreign exchange rate. This is the case only because neither the residents of *A* nor those of *B* want to alter the amount of their cash holdings. If the residents of *A* want to decrease their cash holdings and those of *B* to increase theirs, money is shipped from *A* to *B* and the cable rate *B* reaches in *A* the gold export point. But money is not shipped because *A's* balance of payments has become unfavorable. What is called by the Mercantilists an unfavorable balance of payments is the effect of a deliberate restriction of cash holdings on the part of the citizens of *A* and a deliberate increase in cash holdings on the part of the citizens of *B*. If no resident of *A* were ready to reduce his cash holding, such an outflow of money from *A* could never materialize.

The difference between the trade in money and that in the vendible commodities is this: As a rule commodities move on a one-way road, viz., from the places of surplus production to those of surplus consumption. Consequently the price of a certain commodity in the places of surplus production is as a rule lower by the amount of shipping costs than in the places of surplus consumption. Things are different with money if we do not take into account the conditions of the gold-mining countries and of those countries whose residents deliberately aim at altering the size of their cash holdings. Money moves now this way, now that. At one time a country exports money, at another time it imports money. Every exporting country very soon becomes an importing country precisely on account of its previous exports. For this reason alone it is possible to save the costs of shipping money by the interplay of the market for foreign exchange.

16. Interest Rates and the Money Relation

Money plays in credit transaction the same role it plays in all other business transactions. As a rule loans are granted in money, and interest and principal are paid in money. The payments resulting from such dealings influence the size of cash holding only temporarily. The recipients of loans, interest, and principal spend the sums received either for consumption or for investment. They increase their cash holdings only if definite considerations, independent of the inflow of the money received, motivate them to act in this way.

The final state of the market rate of interest is the same for all loans of the same character. Differences in the rate of interest are caused either by differences in the soundness and trustworthiness of the debtor or by differences in the terms of the contract.[6] Differences in interest rates which are not brought about by these differences in conditions tend to disappear. The applicants for credits approach the lenders who ask a lower rate of interest. The lenders are eager to cater to people who are ready to pay higher interest rates. Things on the money market are the same as on all other markets.

[6] For a more elaborate analysis, see below, pp. 539-548.

With regard to interlocal credit transactions the interlocal exchange rates are to be taken into account as well as differences in the monetary standard if there are any. Let us contemplate the case of two countries, *A* and *B*. *A* is under the gold standard, *B* under the silver standard. The lender who considers lending money from *A* to *B* must first sell gold against silver and later, at the termination of the loan, silver against gold, the principal repaid by the debtor (in silver) will buy a smaller amount of gold than that expended by the creditor when he previously embarked upon the transaction. He will therefore only venture lending in *B* if the difference in the market rate of interest between *A* and *B* is large enough to cover an expected fall in the price of silver as against gold. The tendency toward an equalization of the market rate of interest for short-term loans which prevails if *A* and *B* are both under the same monetary standard is seriously impaired under a diversity of standards.

If *A* and *B* are both under the same standard, it is impossible for the banks of *A* to expand credit if those of *B* do not espouse the same policy. Credit expansion in *A* makes prices rise, and short-term interest rates temporarily drop in *A*, while prices and interest rates in *B* remain unchanged. Consequently exports from *A* drop and imports to *A* increase. In addition, the money lenders of *A* become eager to lend on the short-term loan market of *B*. The result is an external drain from *A* which makes the money reserves of *A's* banks dwindle. If the banks of *A* do not abandon their expansionist policy, they will become insolvent.

This process has been entirely misinterpreted. People speak of an important and vital function which a country's central bank has to fulfill on behalf of the nation. It is, they say, the central bank's sacred duty to preserve the stability of foreign exchange rates and to protect the nation's gold reserve against attacks on the part of foreign speculators and their domestic abettors. The truth is that all that a central bank does lest its gold reserve evaporate is done for the sake of the preservation of its own solvency. It has jeopardized its financial position by embarking upon credit expansion and must now undo its previous action in order to avoid its disastrous consequences. Its expansionist policy has encountered the obstacles limiting the issuance of fiduciary media.

The use of the terminology of warfare is inappropriate in dealing with monetary matters, as it is in the treatment of all other catallactic problems. There is no such thing as a "war" between the central banks. No sinister forces are "attacking" a bank's position and threatening the stability of foreign exchange rates. No "defender" is needed to "protect" a nation's currency system. It is, moreover, not true that what prevent a nation's central bank or its private banks from lowering the domestic market rate of interest are considerations of the preservation of the gold standard and of foreign exchange stability and of frustrating the machinations of an international combine of capitalistic moneylenders. The market rate of interest cannot be lowered by a credit expansion except for a short time, and even then it brings about all those effects which the theory of the trade cycle describes.

When the Bank of England redeemed a banknote issued according to the terms of the contract, it did not render unselfishly a vital service to the British people. It simply did what every housewife does in paying the grocer's bill. The idea that there is some special merit in a central bank's fulfillment of its voluntarily assumed responsibilities could originate only because again and again governments granted to these banks the privilege of denying to their clients the payments to which they had a legal title. In fact, the central banks became more and more subordinate offices of the treasuries, mere tools for the performance of credit expansion and inflation. It does not make any difference practically whether they are or are not owned by the government and directly managed by government officials. In effect the banks granting circulation credit are in every country today only affiliates of the treasuries.

There is but one means of keeping a local and national currency permanently at par with gold and foreign exchange: unconditional redemption. The central bank has to buy at the parity rate any amount of gold and foreign exchange offered against domestic banknotes and deposit currency; on the other hand it has to sell, without discrimination, any amount of gold and foreign exchange asked for by people ready to pay the parity price in domestic banknotes, coins, or deposit currency. Such was the policy of central banks under the gold standard. Such was also the policy of those governments and central banks which had adopted the currency system commonly known under the name of the gold exchange standard. The only difference between the "orthodox" or classical gold standard as it existed in Great Britain from the early 'twenties of the nineteenth century until the outbreak of the first World War and in other countries on the one hand, and the gold exchange standard on the other, concerned the use of gold coins on the domestic market. Under the classical gold standard a part of the cash holdings of the citizens consisted in gold coins and the rest in money substitutes. Under the gold exchange standard the cash holdings consisted entirely in money-substitutes.

Pegging a certain rate of foreign exchange is tantamount to redemption at this rate.

A foreign exchange equalization account, too, can succeed in its operations only as far as it clings to the same methods.

The reasons why in the last decades European governments have preferred foreign exchange equalization accounts to the operation of central banks are obvious. Central bank legislation was an achievement of liberal governments or of governments which did not dare to challenge openly, at least in the conduct of financial policies, public opinion of the liberal countries. The operations of central banks were therefore adjusted to economic freedom. For that reason they were considered unsatisfactory in this age of rising totalitarianism. The main characteristics of the operation of a foreign exchange equalization account as distinguished from central bank policy are:

1. The authorities keep the transactions of the account secret. The laws have obliged the central banks to publicize their actual status at short intervals, as a rule every week. But the status of the foreign exchange equalization accounts is known only to the initiated. Officialdom renders a report to the public only after a lapse of time when the figures are of interest to historians alone and of no use whatever to the businessman.

2. This secrecy makes it possible to discriminate against people not in great favor with the authorities. In many continental countries of Europe it resulted in scandalous corruption. Other governments used the power to discriminate to the detriment of businessmen belonging to linguistic or religious minorities or supporting opposition parties.

3. A parity is no longer fixed by a law duly promulgated by parliament and therefore known to every citizen. The determination depends upon the arbitrariness of bureaucrats. From time to time the newspapers reported: The Ruritanian currency is weak. A more correct description would have been: The Ruritanian authorities have decided to raise the price of foreign exchange.[7]

A foreign exchange equalization account is not a magic wand for remedying the evils of inflation. It cannot apply any means other than those available to "orthodox" central banks. And it must, like the central banks, fail in the endeavors to keep foreign exchange rates at par if there is domestic inflation and credit expansion.

[7] See below, pp. 786-789.

It has been asserted that the "orthodox" methods of fighting an external drain by using the rate of discount no longer work because nations are no longer prepared to comply with "the rules of the game." Now, the gold standard is not a game, but a social institution. Its working does not depend on the preparedness of any people to observe some arbitrary rules. It is controlled by the operation of inexorable economic law.

The critics give point to their objection by citing the fact that in the interwar period a rise in the rate of discount failed to stop the external drain, i.e., the outflow of specie and the transfer of deposits into foreign countries. But this phenomenon was caused by the governments' anti-gold and pro-inflation policies. If a man expects that he will lose 40 per cent of his balance by an impending devaluation, he will try to transfer his deposit into another and will not change his mind if the bank rate in the country planning a devaluation rises 1 or 2 per cent. Such a rise in the rate of discount is obviously not a compensation for a loss ten or twenty or even forty times greater. Of course, the gold standard cannot work if governments are eager to sabotage its operations.

17. Secondary Media of Exchange

The use of money does not remove the differences which exist between the various nonmonetary goods with regard to their marketability. In the money economy there is a very substantial difference between the marketability of money and that of the vendible goods. But there remain differences between the various specimens of this latter group. For some of them it is easier to find without delay a buyer ready to pay the highest price which, under the state of the market, can possibly be attained. With others it is more difficult. A first-class bond is more marketable than a house in a city's main street, and an old fur coat is more marketable than an autograph of an eighteenth-century statesman. One no longer compares the marketability of the various vendible goods with the perfect marketability of money. One merely compares the degree of marketability of the various commodities. One may speak of the secondary marketability of the vendible goods.

He who owns a stock of goods of a high degree of secondary marketability is in a position to restrict his cash holding. He can expect that when one day it is necessary for him to increase his cash holding he will be in a position to sell these goods of a high degree of secondary marketability without delay at the highest price attainable at the market. Thus the size of a man's or a firm's cash holding is influenced by whether or not he owns a stock of goods with a high degree of secondary marketability. The size of cash holding and the expense incurred in keeping it can be reduced if income-producing goods of a high degree of secondary marketability are available.

Consequently there emerges a specific demand for such goods on the part of people eager to keep them in order to reduce the costs of cash holding. The prices of these goods are partly determined by this specific demand; they would be lower in its absence. These goods are secondary media of exchange, as it were, and their exchange value is the resultant of two kinds of demand: the demand related to their services as secondary media of exchange, and the demand related to the other services they render.

The costs incurred by holding cash are equal to the amount of interest which the sum concerned would have borne when invested. The cost incurred by holding a stock of secondary media of exchange consists in the difference between the interest yield of the securities employed for this purpose and the higher yield of other securities which differ from the former only in regard to their lower marketability and are therefore not suited for the role of secondary media of exchange.

From time immemorial jewels have been used as secondary media of exchange. Today the secondary media of exchange commonly used are:

1. Claims against banks, bankers, and savings banks which--although not money-substitutes[8] --are daily maturing or can withdrawn on short notice.

2. Bonds whose volume and popularity are so great that it is, as a rule, possible to sell moderate quantities of them without depressing the market.

3. Finally, sometimes even certain especially marketable stocks or even commodities.

Of course, the advantages to be expected from lowering the costs of holding cash must be confronted with certain hazards incurred. The sale of securities and still more that of commodities may only be feasible with a loss. This danger is not present with bank balances and the hazard of the bank's insolvency is usually negligible. Therefore interest-bearing claims

[8] For instance, demand deposits not subject to check.

against banks and bankers, which can be withdrawn at short notice, are the most popular secondary media of exchange.

One must not confuse secondary media of exchange with money-substitutes. Money-substitutes are in the settlement of payments given away and received like money. But the secondary media of exchange must first be exchanged against money or money-substitutes if one wants to use them--in a roundabout way--for paying or for increasing cash holdings.

Claims employed as secondary media of exchange have, because of this employment, a broader market and a higher price. The outcome of this is that they yield lower interest than claims of the same kind which are not fit to serve as secondary media of exchange. Government bonds and treasury bills which can be used as secondary media of exchange can be floated on conditions more favorable to the debtor than loans not suitable for this purpose. The debtors concerned are therefore eager to organize the market for their certificates of indebtedness in such a way as to make them attractive for those in search of secondary media of exchange. They are intent upon making it possible for every holder of such securities to sell them or to use them as collateral in borrowing under the most reasonable terms. In advertising their bond issues to the public they stress these opportunities as a special boon.

In the same way banks and bankers are intent upon attracting demand for secondary media of exchange. They offer convenient terms to their customers. They try to outdo one another by shortening the time allowed for notice. Sometimes they pay interest even for money maturing without notice. In this rivalry some banks have gone too far and endangered their solvency.

Political conditions of the last decades have given to bank balances which can be used as secondary media of exchange an increased importance. The governments of almost all countries are engaged in a campaign against the capitalists. They are intent upon expropriating them by means of taxation and monetary measures. The capitalists are eager to protect their property by keeping a part of their funds liquid in order to evade confiscatory measures in time. They keep balances with the banks of those countries in which the danger of confiscation or currency devaluation is for the moment less than in other countries. As soon as the prospects change, they transfer their balances into countries which temporarily seem to offer more security. It is these funds which people have in mind when speaking of "hot money."

The significance of hot money for the constellation of monetary affairs is the outcome of the one-reserve system. In order to make it easier for the central banks to embark upon credit expansion, the European governments aimed long ago at a concentration of their countries' gold reserves with the central banks. The other banks (the private banks, i.e., those not endowed with special privileges and not entitled to issue banknotes) restrict their cash holdings to the requirements of their daily transactions. They no longer keep a reserve against their daily maturing liabilities. They do not consider it necessary to balance the maturity dates of their liabilities and their assets in such a way as to be any day ready to comply unaided with their obligations to their creditors. They rely upon the central bank. When the creditors want to withdraw more than the "normal" amount, the private banks borrow the funds needed from the central bank. A private bank considers itself liquid if it owns a sufficient amount either of collateral against which the central bank will lend or of bills of exchange which the central bank will rediscount.[9]

When the inflow of hot money began, the private banks of the countries in which it was temporarily deposited saw nothing wrong in treating these funds in the usual way. They employed the additional funds entrusted to them in increasing their loans to business. They did not worry about the consequences, although they knew that these funds would be withdrawn as soon as any doubts about their country's fiscal or monetary policy emerged. The illiquidity of the status of these banks was manifest: on the one hand large sums which the customers had the right to withdraw at short notice, and on the other hand loans to business which could be recovered only at a later date. The only cautious method of dealing with hot money would have been to keep a reserve of gold and foreign exchange big enough to pay back the whole amount in case of a sudden withdrawal. Of course, this method would have required the banks to charge the customers a commission for keeping their funds safe.

The showdown came for the Swiss banks on the day in September, 1936, on which France devalued the French franc. The depositors of hot money became frightened; they feared that Switzerland might follow the French example. It was to be expected that they would all try to transfer their funds immediately to London or New York, or even to Paris, which for the immediate coming weeks seemed to offer a smaller hazard of currency depreciation. But the Swiss commercial banks were not in a position to pay back these funds without the aid of the National Bank. They had lent them to business--a great part to business in countries

[9] All this refers to European conditions. American conditions differ only technically, but not economically.

which, by foreign exchange control, had blocked their balances. The only way out would have been for them to borrow from the National bank. Then they would have maintained their own solvency. But the depositors paid would have immediately asked the National Bank for the redemption, in gold or foreign exchange, of the banknotes received. If the National Bank were not to comply with this request, it would thereby have actually abandoned the gold standard and devalued the Swiss franc. If, on the other hand, the Bank had redeemed the notes, it would have lost the greater part of its reserve. A panic would have resulted. The Swiss themselves would have tried to procure as much gold and foreign exchange as possible. The whole monetary system of the country would have collapsed.

The only alternative for the Swiss National Bank would have been not to assist the private banks at all. But this would have been equivalent to the insolvency of the country's most important credit institutions.

Thus for the Swiss Government no choice was left. It had only one means to prevent an economic catastrophe: to follow suit forthwith and to devalue the Swiss franc. The matter did not brook delay.

By and large, Great Britain, at the outbreak of the war in September, 1939, had to face similar conditions. The City of London was once the world's banking center. It has long since lost this function. But foreigners and citizens of the Dominions still kept, on the eve of the war, considerable short-term balances in the British banks. Besides, there were the large deposits due to the central banks in the "sterling area." If the British Government had not frozen all these balances by means of foreign exchange restrictions, the insolvency of the British banks would have become manifest. Foreign exchange control was a disguised moratorium for the banks. It relieved them from the plight of having to confess publicly their inability to fulfill their obligations.

18. The Inflationist View of History

A very popular doctrine maintains that progressive lowering of the monetary unit's purchasing power played a decisive role in historical evolution. It is asserted that mankind would not have reached its present state of well-being if the supply of money had not increased to a greater extent than the demand for money. The resulting fall in purchasing power, it is said, was a necessary condition of economic progress. The intensification of the division of labor and the continuous growth of capital accumulation, which have centupled the productivity of labor, could ensue only in a world of progressive price rises. Inflation creates prosperity and wealth; deflation distress and economic decay.[10] A survey of political literature and of the ideas that guided for centuries the monetary and credit policies of the nations reveals that this opinion is almost generally accepted. In spite of all warnings on the part of economists it is still today the core of the layman's economic philosophy. It is no less the essence of the teachings of Lord Keynes and his disciples in both hemispheres.

The popularity of inflationism is in great part due to deep-rooted hatred of creditors. Inflation is considered just because it favors debtors at the expense of creditors. However, the inflationist view of history which we have to deal with in this section is only loosely related to this anticreditor argument. Its assertion that "expansionism" is the driving force of economic progress and that "restrictionism" is the worst of all evils is mainly based on other arguments.

It is obvious that the problems raised by the inflationist doctrine cannot be solved by a recourse to the teachings of historical experience. It is beyond doubt that the history or prices shows, by and large, a continuous, although sometimes for short periods interrupted, upward trend. It is of course impossible to establish this fact otherwise than by historical understanding. Catallactic precision cannot be applied to historical problems. The endeavors of some historians and statisticians to trace back the changes in the purchasing power of the precious metals for centuries, and to measure them, are futile. It has been shown already that all attempts to measure economic magnitudes are based on entirely fallacious assumptions and display ignorance of the fundamental principles both of economics and of history. But what history by means of its specific methods can tell us in this field is enough to justify the assertion that the purchasing power of money has for centuries shown a tendency to fall. With regard to this point all people agree.

But this is not the problem to be elucidated. The question is whether the fall in purchasing power was or was not an indispensable factor in the evolution which led from the poverty of ages gone by to the more satisfactory conditions of modern Western capitalism. This question must be answered without reference to the historical experience, which can be and always is interpreted in different ways, and to which supporters and adversaries of every theory and of every explanation of history refer as a proof of their mutually contradictory and incompatible statements. What is needed is a clarification of the effects of changes in purchasing power

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[10] Cf. the critical study of Marianne von Herzfeld, "Die Geschichte als Funktion der Geldbewegung," *Archiv fuer Sozialwissenschaft*, LVI, 654-686, and the writings quoted in this study.

on the division of labor, the accumulation of capital, and technological improvement.

In dealing with this problem one cannot satisfy oneself with the refutation of the arguments advanced by the inflationists in support of their thesis. The absurdity of these arguments is so manifest that their refutation and exposure is easy indeed. From its very beginnings economics has shown again and again that assertions concerning the alleged blessings of an abundance of money and the alleged disasters of a scarcity of money are the outcome of crass errors in reasoning. The endeavors of the apostles of inflationism and expansionism to refute the correctness of the economists' teachings have failed utterly.

The only relevant question is this: Is it possible or not to lower the rate of interest lastingly by means of credit expansion? This problem will tb treated exhaustively in the chapter dealing with the interconnection between the money relation and the rate of interest. There it will be shown what the consequences of booms created by credit expansion must be.

But we must ask ourselves at this point of our inquiries whether it is not possible that there are other reasons which could be advanced in favor of the inflationary interpretation of history. Is it not possible that the champions of inflation have neglected to resort to some valid arguments which could support their stand? It is certainly necessary to approach the issue from every possible avenue.

Let us think of a world in which the quantity of money is rigid. At an early stage of history the inhabitants of this world have produced the whole quantity of the commodity employed for the monetary service which can possibly be produced. A further increase in the quantity of money is out of the question. Fiduciary media are unknown. All money-substitutes--the subsidiary coins included--are money-certificates.

On these assumptions the intensification of the division of labor, the evolution from the economic self-sufficiency of households, villages, districts, and countries to the world-embracing market system of the nineteenth century, the progressive accumulation of capital, and the improvement of technological methods of production would have resulted in a continuous trend toward falling prices. Would such a rise in the purchasing power of the monetary unit have stopped the evolution of capitalism?

The average businessman will answer this question in the affirmative. Living and acting in an environment in which a slow but continuous fall in the monetary unit's purchasing power is deemed normal, necessary, and beneficial, he simply cannot comprehend a different state of affairs. He associates the notions of rising prices and profits on the one hand and of falling prices and losses on the other. The fact that there are bear operations too and that great fortunes have been made by bears does not shake his dogmatism. These are, he says, merely speculative transactions of people eager to profit from the fall in the prices of goods already produced and available. Creative innovations, new investments, and the application of improved technological methods require the inducement brought about by the expectation of price rises. Economic progress is possible only in a world of rising prices.

This opinion is untenable. In a world of a rising purchasing power of the monetary unit everybody's mode of thinking would have adjusted itself to this state of affairs, just as in our actual world it has adjusted itself to a falling purchasing power of the monetary unit. Today everybody is prepared to consider a rise in his nominal or monetary income as an improvement of his material well-being. People's attention is directed more toward the rise in nominal wage rates and the money equivalent of wealth than to the increase in the supply of commodities. In a world of rising purchasing power for the monetary unit they would concern themselves more with the fall in living costs. This would bring into clearer relief the fact that economic progress consists primarily in making the amenities of life more easily accessible.

In the conduct of business, reflections concerning the secular trend of prices do not bother any role whatever. Entrepreneurs and investors do not bother about secular trends. What guides their actions is their opinion about the movement of prices in the coming weeks, months. or at most years. They do not heed the general movement of all prices. What matters for them is the existence of discrepancies between the prices of the complementary factors of production and the anticipated prices of the products. No businessman embarks upon a definite production project because he believes that *the prices*, i.e., the prices of all goods and services, will rise. He engages himself if he believes that he can profit from a difference between the prices of goods of various orders. In a world with a secular tendency toward falling prices, such opportunities for earning profit will appear in the same way in which they appear in a world with a secular trend toward rising prices. The expectation of a *general* progressive upward movement of *all* prices does not bring about intensified production and improvement in well-being. It results in the "flight to real values," in the crack-up boom and the complete breakdown of the monetary system.

If the opinion that the prices of all commodities will drop becomes general, the short-term market rate of interest is lowered by the amount of the negative price premium.[11] Thus the entrepreneur employing borrowed funds is secured against the consequences of such a drop in prices to the same extent to which, under conditions of rising prices, the lender is secured through the price premium against the consequences of falling purchasing power.

A secular tendency toward a rise in the monetary unit's purchasing power would require rules of thumb on the part of businessmen and investors other than those developed under the secular tendency toward a fall in its purchasing power. But it would certainly not influence substantially the course of economic affairs. It would not remove the urge of people to improve their material well-being as far as possible by an appropriate arrangement of production. It would not deprive the economic system of the factors making for material improvement, namely, the striving of enterprising promoters after profit and the readiness of the public to buy those commodities which are apt to provide them the greatest satisfaction at the lowest costs.

Such observations are certainly not a plea for a policy of deflation. They imply merely a refutation of the ineradicable inflationist fables. They unmask the illusiveness of Lord Keyne's doctrine that the source of poverty and distress, of depression of trade, and of unemployment is to be seen in a "contractionist pressure." It is not true that "a deflationary pressure ... would have ... prevented the development of modern industry." It is not true that credit expansion brings about the "miracle ... of turning a stone into bread."[12]

Economics recommends neither inflationary not deflationary policy. It does not urge the governments to tamper with the market's choice of a medium of exchange. It establishes only the following truths:

1. By committing itself to an inflationary or deflationary policy a government does not promote the public welfare, the commonweal, or the interests of the whole nation. It merely favors one or several groups of the population at the expense of other groups.

[11] Cf. below, pp. 541-545.
[12] Quoted from: *International Clearing Union, Text of a Paper Containing Proposals by British Experts for an International Clearing Union, April 8, 1943* (published by British Information Services, an Agency of the British Government), p. 12.

2. It is impossible to know in advance which group will be favored by a definite inflationary or deflationary measure and to what extent. These effects depend on the whole complex of the market data involved. They also depend largely on the speed of the inflationary or deflationary movements and may be completely reversed with the progress of these movements.

3. At any rate, a monetary expansion results in misinvestment of capital and overconsumption. It leaves the nation as a whole poorer, not richer. These problems are dealt with in Chapter XX.

4. Continued inflation must finally end in the crack-up boom, the complete breakdown of the currency system.

5. Deflationary policy is costly for the treasury and unpopular with the masses. But inflationary policy is a boon for the treasury and very popular with the ignorant. Practically, the danger of deflation is but slight and the danger of inflation tremendous.

19. The Gold Standard

Men have chosen the precious metals gold and silver for the money service on account of their mineralogical, physical, and chemical features. The use of money in a market economy is a praxeologically necessary fact. That gold--and not something else--is used as money is merely a historical fact and as such cannot be conceived by catallactics. In monetary history too, as in all other branches of history, one must resort to historical understanding. If one takes pleasure in calling the gold standard a "barbarous relic,"[13] one cannot object to the application of the same term to every historically determined institution. Then the fact that the British speak English--and not Danish, German, or French--is a barbarous relic too, and every Briton who opposes the substitution of Esperanto for English is no less dogmatic and orthodox than those who do not wax rapturous about the plans for a managed currency.

The demonetization of silver and the establishment of gold monometallism was the outcome of deliberate government interference with monetary matters. It is pointless to raise the question concerning what would have happened in the absence of these policies. But it must not be forgotten that it was not the intention of the governments to establish the gold standard. What the governments aimed at was the double standard. They wanted to substitute a rigid, government-decreed exchange ratio

[13] Lord Keynes in the speech delivered before the House of Lords, May 23, 1944.

between gold and silver for the fluctuating market ration between the independently coexistent gold and silver coins. The monetary doctrines underlying these endeavors misconstrued the market phenomena in that complete way in which only bureaucrats can misconstrue them. The attempts to create a double standard of both metals, gold and silver, failed lamentably. It was this failure which generated the gold standard. The emergence of the gold standard was the manifestation of a crushing defeat of the governments and their cherished doctrines.

In the seventeenth century the rates at which the English government tariffed the coins overvalued the guinea with regard to silver and thus made the silver coins disappear. Only those silver coins which were much worn by usage or in any other way defaced or reduced in weight remained in current use; it did not pay to export and to sell them on the bullion market. Thus England got the gold standard against the intention of its government. Only much later the laws made the *de facto* gold standard a *de jure* standard. The government abandoned further fruitless attempts to pump silver standard coins into the market and minted silver only as subsidiary coins with a limited legal tender power. These subsidiary coins were not money, but money-substitutes. Their exchange value depended not on their silver content, but on the fact that they could be exchanged at every instant, without delay and without cost, at their full face value against gold. They were *de facto* silver printed notes, claims against a definite amount of gold.

Later in the course of the nineteenth century the double standard resulted in a similar way in France and in the other countries of the Latin Monetary Union in the emergence of *de facto* gold monometallism. When the drop in the price of silver in the later 'seventies would automatically have effected the replacement of the *de facto* gold standard by the *de facto* silver standard, these governments suspended the coinage of silver in order to preserve the gold standard. In the United States the price structure on the bullion market had already, before the outbreak of the Civil War, transformed the legal bimetallism into *de facto* gold monometallism. After the greenback period there ensued a struggle between the friends of the gold standard on the one hand and those of silver on the other hand. The result was a victory for the gold standard. Once the economically most advanced nations had adopted the gold standard, all other nations followed suit. After the great inflationary adventures of the first World War most countries hastened to return to the gold standard or the gold exchange standard.

The gold standard was the world standard of the age of capitalism, increasing welfare, liberty, and democracy, both political and economic. In the eyes of the free traders its main eminence was precisely the fact that it was an international standard as required by international trade and the transactions of the international money and capital market.[14] It was the medium of exchange by means of which Western industrialism and Western capital had borne Western civilization into the remotest parts of the earth's surface, everywhere destroying the fetters of age-old prejudices and superstitions, sowing the seeds of new life and new well-being, freeing minds and souls, and creating riches unheard of before. It accompanied the triumphal unprecedented progress of Western liberalism ready to unite all nations into a community of free nations peacefully cooperating with one another.

It is easy to understand why people viewed the gold standard as the symbol of this greatest and most beneficial of all historical changes. All those intent upon sabotaging the evolution toward welfare, peace, freedom, and democracy loathed the gold standard, and not only on account of its economic significance. In their eyes the gold standard was the labarum, the symbol, of all those doctrines and policies they wanted to destroy. In the struggle against the gold standard much more was at stake than commodity prices and foreign exchange rates.

The nationalists are fighting the gold standard because they want to sever their countries from the world market and to establish national autarky as far as possible. Interventionist governments and pressure groups are fighting the gold standard because they consider it the most serious obstacle to their endeavors to manipulate prices and wage rates. But the most fanatical attacks against gold are made by those intent upon credit expansion. With them credit expansion is the panacea for all economic ills. It could lower or even entirely abolish interest rates, raise wages and prices for the benefit of all except the parasitic capitalists and the exploiting employers, free the state from the necessity of balancing its budget--in short, make all decent people prosperous and happy. Only the gold standard, that devilish contrivance of the wicked and stupid "orthodox" economists, prevents mankind from attaining everlasting prosperity.

The gold standard is certainly not a perfect or ideal standard. There is no such thing as perfection in human things. But nobody is in a position to tell us how something more satisfactory could be put in place of the gold standard. The purchasing power of gold is not stable. But the very notions

[14] T. E. Gregory, *The Gold Standard and Its Future* (1d ed. London, 1934), pp. 22 ff.

of stability and unchangeability of purchasing power are absurd. In a living and changing world there cannot be any such thing as stability of purchasing power. In the imaginary construction of an evenly rotating economy there is no room left for a medium of exchange. It is an essential feature of money that its purchasing power is changing. In fact, the adversaries of the gold standard do not want to make money's purchasing power stable. They want rather to give to the governments the power to manipulate purchasing power without being hindered by an "external" factor, namely, the money relation of the gold standard.

The main objection raised against the gold standard is that it makes operative in the determination of prices a factor which no government can control--the vicissitudes of gold production. Thus an "external" or "automatic" force restrains a national government's power to make its subjects as prosperous as it would like to make them. The international capitalists dictate and the nation's sovereignty becomes a sham.

However, the futility of interventionist policies has nothing at all to do with monetary matters. It will be shown later why all isolated measures of government interference with market phenomena must fail to attain the ends sought. If the interventionist government wants to remedy the shortcomings of its first interferences by going further and further, it finally converts its country's economic system into socialism of the German pattern. Then it abolishes the domestic market altogether, and with it money and all monetary problems, even though it may retain some of the terms and labels of the market economy.[15] In both cases it is not the gold standard that frustrates the good intentions of the benevolent authority.

The significance of the fact that the gold standard makes the increase in the supply of gold depend upon the profitability of producing gold is, of course, that it limits the government's power to resort to inflation. The gold standard makes the determination of money's purchasing power independent of the changing ambitions and doctrines of political parties and pressure groups. This is not a defect of the gold standard; it is its main excellence. Every method of manipulating purchasing power is by necessity arbitrary. All methods recommended for the discovery of an allegedly objective and "scientific" yardstick for monetary manipulation are based on the illusion that changes in purchasing power can be "measured." The gold standard removes the determination of cash-induced changes in purchasing power from the political arena. Its general acceptance requires the acknowledgment of the truth that one cannot

[15] Cf. below, Chapters XXVII-XXXI.

make all people richer by printing money. The abhorrence of the gold standard is inspired by the superstition that omnipotent governments can create wealth out of little scraps of paper.

It has been asserted that the gold standard too is a manipulated standard. The governments may influence the height of gold's purchasing power either by credit expansion, even if it is kept within the limits drawn by considerations of preserving the redeemability of the money-substitutes, or indirectly by furthering measures which induce people to restrict the size of their cash holdings. This is true. It cannot be denied that the rise in commodity prices which occurred between 1896 and 1914 was to a great extent provoked by such government policies. But the main thing is that the gold standard keeps all such endeavors toward lowering money's purchasing power within narrow limits. The inflationists are fighting the gold standard precisely because they consider these limits a serious obstacle to the realization of their plans.

What the expansionists call the defects of the gold standard are indeed its very eminence and usefulness. It checks large-scale inflationary ventures on the part of governments. The gold standard did not fail. The governments were eager to destroy it, because they were committed to the fallacies that credit expansion is an appropriate means of lowering the rate of interest and of "improving" the balance of trade.

No government is, however, powerful enough to abolish the gold standard. Gold is the money of international trade and of the supernational economic community of mankind. It cannot be affected by measures of governments whose sovereignty is limited to definite countries. As long as a country is not economically self-sufficient in the strict sense of the term, as long as there are still some loopholes left in the walls by which national governments try to isolate their countries from the rest of the world, gold is still used as money. It does not matter that governments confiscate the gold coins and bullion they can seize and punish those holding gold as felons. The language of bilateral clearing agreements by means of which governments are intent upon eliminating gold from international trade, avoids any reference to gold. But the turnovers performed on the ground of those agreements are calculated on gold prices. He who buys or sells on a foreign market calculates the advantages and disadvantages of such transactions in gold. In spite of the fact that a country has severed its local currency from any link with gold, its domestic structure of prices remains closely connected with gold and the gold prices of the world market. If a government wants to sever its domestic price structure from that of the world market, it must resort to other measures, such a prohibitive import and export duties and embargoes. Nationalization of foreign trade, whether effected openly or directly by foreign exchange control, does not eliminate gold. The governments qua traders are trading by the use of gold as a medium of exchange.

The struggle against gold which is one of the main concerns of all contemporary governments must not be looked upon as an isolated phenomenon. It is but one item in the gigantic process of destruction which is the mark of our time. People fight the gold standard because they want to substitute national autarky for free trade, war for peace, totalitarian government omnipotence for liberty.

It may happen one day that technology will discover a method of enlarging the supply of gold at such a low cost that gold will become useless for the monetary service. Then people will have to replace the gold standard by another standard. It is futile to bother today about the way in which this problem will be solved. We do not know anything about the conditions under which the decision will have to be made.

International Monetary Cooperation

The international gold standard works without any action on the part of governments. It is effective real cooperation of all members of the world-embracing market economy. There is no need for ant government to interfere in order to make the gold standard work as an international standard.

What governments call international monetary cooperation is concerted action for the sake of credit expansion. They have learned that credit expansion, when limited to one country only, results in an external drain. They believe that it is only the external drain that frustrates their plans of lowering the rate of interest and thus of creating an everlasting boom. If all governments were to cooperate in their expansionist policies, they think, they could remove this obstacle. What is required is an international bank issuing fiduciary media which are dealt with as money-substitutes by all people in all countries.

There is no need to stress again here the point that what makes it impossible to lower the rate of interest by means of credit expansion is not merely the external drain. This fundamental issue is dealt with exhaustively in other chapters and sections of this book.[16]

But there is another important question to be raised.

Let us assume that there exists an international bank issuing fiduciary media the clientele of which is the world's whole population. It does not matter whether these money-substitutes go directly into the cash holdings of the individuals and firms, or are only kept by the various nations' central banks as reserves against the issuance of national money-substitutes. The deciding point is that there is a uniform world currency. The national banknotes and checkbook money are redeemable in money-substitutes issued by the international bank. The necessity of keeping its national currency at par with the international currency limits the power of every nation's central banking system to expand credit. But the world bank is restrained only by those factors which limit credit expansion on the part of a single bank operation in an isolated economic system or in the whole world.

We may as well assume that the international bank is not a bank issuing money-substitutes a part of which are fiduciary media, but a world authority issuing international fiat money. Gold has been entirely demonetized. The only money in use is that created by the international authority. The international authority is free to increase the quantity of this money provided it does not go so far as to bring about the crack-up boom and the breakdown of the currency.

Then the ideal of the Keynesians is realized. There is an institution operating which can exercise an "expansionist pressure on world trade."

However, the champions of such plans have neglected a fundamental problem, namely, that of the distribution of the additional quantities of this credit money or of this paper money.

Let us assume that the international authority increases the amount of its issuance by a definite sum, all of which goes to one country, Ruritania. The final result of this inflationary action will be a rise in prices of commodities and services all over the world. but while this process is going on, the conditions of the citizens of various countries are affected in a different way. The Ruritanians are the first group blessed by the additional manna. They have more money in their pockets while the rest of the world's inhabitants have not yet got a share of the new money.

[16] Cf. above, pp. 441-442, and below, pp. 550-586.

They can bid higher prices, while the others cannot. Therefore the Ruritanians withdraw more goods from the world market than they did before. The non-Ruritanians are forced to restrict their consumption because they cannot compete with the higher prices paid by the Ruritanians. While the process of adjusting prices to the altered money relation is still in progress, the Ruritanians are in an advantageous position against the non-Ruritanians. When the process finally comes to an end, the Ruritanians have been enriched at the expense of the non-Ruritanians.

The main problem in such expansionist ventures is the proportion according to which the additional money is to be allotted to the various nations. Each nation will be eager to advocate a mode of distribution which will give it the greatest possible share in the additional currency. The industrially backward nations of the East will, for instance, probably recommend equal distribution per capita of population, a mode which would obviously favor them at the expense of the industrially advanced nations. Whatever mode may be adopted, all nations would be dissatisfied and would complain of unfair treatment. Serious conflicts would ensue and would disrupt the whole scheme.

It would be irrelevant to object that this problem did not play an important role in the negotiations which preceded the establishment of the International Monetary Fund and that it was easy to reach an agreement concerning the use of the Fund's resources. The Bretton Woods Conference was held under very particular circumstances. Most of the participating nations were at that time entirely dependent on the benevolence of the United States. They would have been doomed if the United States had stopped fighting for their freedom and aiding them materially by lend-lease. The government of the United States, on the other hand, looked upon the monetary agreement as a scheme for a disguised continuation of lend-lease after the cessation of hostilities. The United States was ready to give and the other participants--especially those of the European countries, most of them at that time still occupied by the German armies, and those of the Asiatic countries--were ready to take whatever was offered to them. The problems involved will become discernible once the delusive attitude of the United States toward financial and trade matters is replaced by a more realistic mentality.

The International Monetary Fund did not achieve what its sponsors had expected. At the annual meetings of the Fund there is a good deal of discussion, and occasionally pertinent observations and criticisms concerning the monetary and credit policies of governments and central banks are brought forward. The Fund itself engages in lending and borrowing transactions with various governments and central banks. It considers its main function to be that of assisting governments to maintain an unrealistic exchange rate for their overexpanded national currency. The methods it resorts to in these endeavors do not differ essentially from those always applied for this purpose. Monetary affairs in the world are going on as if no Bretton Woods Agreement and no International Monetary Fund existed.

The constellation of the world's political and economic affairs enabled the American government to keep its promise of letting foreign governments and central banks get an ounce of gold by paying thirty-five dollars. But the continuation and intensification of the American "expansionist" policy has considerably increased the withdrawal of gold and makes people worry about the future of monetary conditions. They are frightened by the spectre of a farther increase in the demand for gold that may exhaust the gold funds of the United States and force it to abandon its present methods of dealing with gold.

The characteristic feature of the public discussion of the problems involved is that it carefully avoids mentioning the facts that are causing the extension of the demand for gold. No reference is made to the policies of deficit spending and credit expansion. Instead, complaints are raised about something called "insufficient liquidity" and a shortage of "reserves." The remedy suggested is more liquidity, to be achieved by "creating" new additional "reserves." This means it is proposed to cure the effects of inflation by more inflation.

There is need to remember that the policies of the American government and the Bank of England of maintaining on the London gold market a price of 35 dollars for an ounce of gold is the only measure that today prevents the Western nations from embarking upon boundless inflation. These policies are not immediately affected by the size of the various nations' "reserves." The plans for new "reserves" seem therefore not to concern directly the problem to the relation of gold to the dollar. They concern it indirectly as they try to divert the public's attention from the real problem, inflation. For the rest, the official doctrine relies upon the long since discredited balance-of-payments interpretation of monetary troubles.