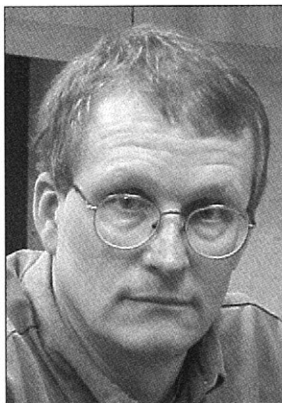
Monetary Diseases and a Proposal for Their Cure

Edward J. Dodson, USA



Ed Dodson has worked in the financial services sector of the U.S. for thirty years. He currently specializes in the development of public-private financing programs targeted for community revitalization and affordable housing. In 1997 he founded an internet-based educational project, "The School of Cooperative Individualism".

He has also been a volunteer member of the faculty of the Henry George School of Social Science since 1981. He is the author of *The Discovery of First Principles*, published in three volumes by iUniverse.

Ed is a graduate of Shippensburg and Temple Universities and lives in the Philadelphia, Pennsylvania area.

The year was 1919. In the United States, the annual meeting of the American Bankers Association was held in the nation's capital. Addressing this group of bankers, Yale University professor of economics Irving Fisher presented his plan to stabilize the global monetary system, integral to which was abandonment of the gold standard. A year later, a government commission issued a report rejecting Professor Fisher's proposals as involving "grave dangers to the stability of our financial and monetary system."[1] A considerable number of other economics professors, including E.R.A. Seligman (Columbia University) and F.W. Taussig (Harvard University) presented their own arguments in opposition to the reforms advocated by Fisher. Taussig had long been on record with his views:

> There have been suggestions or dreams of international paper money, – some sort of universally accepted token which should circulate between nations and within any one nation, should be regulated in quantity and presumably in value on a systematic plan, and should enable specie to be dispensed with as money.
>
> The change is not unthinkable, and it appeals to those who like abstract speculation and ideal construction. As a proposal of anything practicable, it is not worth discussion. The nations of the earth find it hard to come to agreement on much simpler matters, and no international compact of this sort is now within the range of possibility."[2]

We, today, have the opportunity to observe closely (or experience) whether the several nation-states of the European continent and British Isles can overcome their perceived self-interests in order to achieve the general circulation of one form of paper currency and coins as legal tender. A single paper currency certainly reduces transaction costs and the necessity for hedging one's investments against the potential of a currency devaluation. The victory is, I believe, a hollow one so long as the exchange value of the composite metals of the coins in circulation have no relation to the nominal value stamped on the coins and the paper currency is backed by a promise to pay nothing in particular.

Sustainable global commerce requires a medium of exchange possessing the unique quality of having a broadly accepted and stable exchange value. There has never been a paper currency blessed with this quality over an extended period of time; and, in fact, even coins made of gold and silver have historically required a considerable allocation of time and energy to ensure the coins were in fact what they were

represented to be. The earliest coins were stamped with the image of a king or god in an effort to add authority to claims of purity. All in all, however, coinage served well as money despite the fraudulent practices of clipping and a gradual reduction of gold or silver content.

By the time of Alexander the Great, the *drachma* had become the primary form of currency used throughout the Mediterranean and even beyond. Conquest brought enormous quantities of precious metals into Greece to be converted into coins for commerce. The monetary expansion was matched by increases in the quantity and diversity of goods and services being exchanged, so that the prices of goods in terms of *drachmas* remained remarkably stable even after the death of Alexander. Roman coins eventually displaced the Greek *drachmas* as the world currency. Unfortunately, the Roman citizen's zest for extravagance and the enormous drain on Rome's treasury eventually brought ruin. Rome resorted to debasement of its coinage during the reign of Nero. By the third century Roman coins contained just five percent silver and 95 percent copper. Roman coins lost their purchasing power, of course, as word spread that the coins contained less and less scarce precious metal.

We have all been taught the story of Rome's collapse and the subsequent dramatic reduction in commerce between the peoples of the Mediterranean. The most seriously affected were those who no longer benefited by the flow of goods inland from the seaports. Coinage disappeared from circulation and trade became localized. Gold and silver were either hoarded by generation after generation of nobles or were melted down for use in religious art. The Crusades and then the Renaissance stimulated the reintroduction of coinage to accommodate expanding commerce, but only in a few city-states did the mints and the governors see to it that the coinage was not debased. Not unexpectedly, prices for goods and services in terms of almost all coinage kept rising. Only the introduction of relatively scarce gold coins gave to commerce some semblance of stability. Then, in the fifteenth century the system was once again turned on its head.

Spain's conquest of the southern hemisphere of the Americas upset this delicate balance. Spain produced very little of what its nobility consumed. Gold and silver flowed through Spanish hands to European markets. Prices climbed because the Spanish could, in effect, outbid everyone else for what they wanted, while the methods of producing goods had not yet resulted in the means to meet increased demand. However, the market did respond by introducing improved means of settling accounts between trading partners without having to deliver

Helen Freeland, Claire Menninger, George Menninger

more and more gold or silver bullion or coinage over long distances. The bank of deposit appeared to grease the wheels of commerce. An honest banker was someone who issued certificates in exchange for the deposit of coins of known weight and metallic content, redeemable to the depositor or assignee. For this service, the banker earned a fee. Money, in the form of coinage (or bullion converted into coinage) was held until the certificate was returned. The certificates soon became the method for recording exchanges between merchants, with banks of deposit protecting the money supply.

The system of sound money was subjected to constant dilution. The kings and princes of Europe found it increasingly difficult to pay for overseas adventures or warfare by means of taxation. We need only remember that a long list of tax-resistant nobles forced the Magna Carta on their king. Peasants had little to be taxed, at any rate, and the nobility and church were either exempt from taxation or resisted with their own force of arms. Would-be conquerors increasingly found themselves forced to hire mercenaries to fight for them. To pay for these armies, they were forced to borrow from the wealthy by having the bankers sell bonds, promising to repay the bondholders with the gold and silver taken as the trophies of war. Many bondholders and some bankers found that collecting on these debts was often impossible. Either the king was killed in battle, captured by the enemy or was forced into exile. In any case, the bondholders were left with worthless paper. Committing to

repay loans at higher interest rates worked in some cases to help separate fools from their money. Threats also helped. Another approach was to issue non-redeemable paper notes, declare these notes to be legal tender and use force to require producers of goods and services to accept them as payment. One of the more interesting tactics was tried in 1640 by England's king, Charles I, who simply confiscated for his own use the stock of gold and silver stored by merchants in the Tower of London. We know what happened to Charles.

Nor could the goldsmiths turned bankers be fully trusted with money deposits. They gradually circulated their own notes that looked suspiciously like certificates of deposit. Thus, although the money supply remained stable, the claims on that money were fraudulently expanded by the bankers. In both instances, kings and bankers attempted with varying degrees of success to engage in the self-creation of credit (i.e., the theft of purchasing power from the legitimate owners of money) and thereby get away with exchanging no goods or services of their own in return for goods and services acquired from others. Critics courageous enough to challenge the status quo recognized the need to create monetary institutions that would be audited and otherwise subject to oversight. Otherwise, fraud and corruption would continue and the global economy could not expand.

One clear example exists for us to learn from as we contemplate whether and how the modern issuance of legal tender currency by central banks ought to be restructured. This is the story of the Bank of Amsterdam, chartered in 1609 to mint coinage of a standard metallic content from the hundreds of different coins then in circulation. The Bank's income consisted of a fee charged for this service. Additionally, the Bank accepted deposits of gold and silver, issuing certificates of ownership to the depositors who could then assign these certificates to others in payment for goods and services. The integrity of the Bank of Amsterdam lasted until late in the seventeenth century, when as a result of the connivance of the Bank's directors the bank tried to become a lending institution without actually having money of its own to lend. Bank notes substituted for certificates of deposit and circulated from borrower to merchant to merchant until it became clear that the bank was issuing these notes without having the corresponding quantity of money in its vault. Certificate holders presented their claims on money for redemption but the Bank had been playing a shell game and they were unable to settle their accounts with depositors. Discounting of the Bank's notes resulted in the withdrawal of money by depositors and the Bank's eventual collapse in 1819.

Across the channel in Britain, English investors sought to replicate the success of the Dutch by establishing their own bank, the Bank of England. The Bank of England began operations in 1694 but from the very beginning served not as a bank of deposit but as a lending institution. A special charter granted to the Bank the authority to issue its own notes without having to hold money. The English government promised noteholders that if the Bank was unable to redeem the notes for money, the government would do so. Eventually, the Bank was given the responsibility of holding England's gold reserves and became the nation's central bank. The next step in the partnership between the Bank and government occurred in 1844, when an Act of Parliament made the Bank's notes legal tender. By law, the Bank's issuance of notes was subject to strict controls but there was no requirement that the Bank act as a bank of deposit. Ricardo, for one, saw nothing inherently troubling about the operation of the Bank of England. "Though it [paper currency] has no intrinsic value, yet, by limiting its quantity its value in exchange is as great as an equal denomination of coin, or of bullion in that coin,"[3] wrote Ricardo. And, in terms of aggregate purchasing power Ricardo is correct; however, what his silence accepts is the legitimacy of law that permits the self-creation of credit and the transference of purchasing power from owners of money to those granted privilege. Moreover, his assertion is also dependent upon the free circulation of bank notes and certificates of deposit at all times equal to the total value of money held on deposit. In other words, some quantity of bank notes and certificates of deposit must be held out of the competitive bidding for goods and services. Ricardo thought the supply of paper currency could be adequately managed, at least in England:

> In a free country, with an enlightened legislature, the power of issuing paper money, under the requisite checks of convertibility at the will of the holder, might be safely lodged in the hands of commissioners appointed for that special purpose, and they might be made totally independent of the control of ministers.[4]

He made no comment about the experiment conducted by several of Britain's North American colonies during the middle of the previous century. Prohibited from minting coinage of their own, the colonial legislatures issued paper currency backed by the one asset readily available – land.

Ricardo seems to have possessed a good deal of faith in his nation's bureaucracy; and, perhaps, in the banker as businessman. Bankers tried

to reduce their exposure to losses and runs on their companies by requiring borrowers to provide as collateral real assets valued in excess of the nominal (i.e., stated) value of bank notes issued. More than a century later, after repeated panics, the failure of too many banks to be counted and long periods of economic downturn, John Maynard Keynes celebrated what he hoped was the end of "the age of Commodity Money,"[5]:

> Gold has ceased to be a coin, a hoard, a tangible claim to wealth, of which the value cannot slip away so long as the hand of the individual clutches the material stuff. It has become a much more abstract thing – just a standard of value; and it only keeps this nominal status by being handed round from time to time in quite small quantities amongst a group of Central Banks, on the occasions when one of them has been inflating or deflating its managed representative money in a different degree from what is appropriate to the behaviour of its neighbours.[6]

The central bank also provided government with an enhanced capacity to wage war without taxing the wealthy and powerful. Governments found it much easier to sell war bonds that paid interest, then rely on a combination of taxation of producers and commerce and additional shifting of purchasing power to themselves by means of increasing the circulation of legal tender. From the end of the eighteenth century until 1821, for example, notes issued by the Bank of England were backed by nothing. Gold was then returned as the system's reserve form of money. But, there was never any thought of restricting the Bank to the role of a bank of deposit. Across the Atlantic Ocean, the European-Americans living south of British Canada and north of Spanish Mexico were too busy settling the frontier, conquering indigenous tribal societies, protecting their claims to state citizenship from an encroaching Federalism and practicing unbridled individualism to give appropriate attention to the creation of a system of sound money and banking.

The Constitution of the United States reserved the right of minting coinage to the Federal government, and in 1792 the legislation was passed adopting standards for the nation's coinage. Both gold and silver coins became legal tender, although a shortage of these precious metals contributed to the expanded use of paper currency and prolonged debate over the necessity and wisdom of its use. Pressure exerted by a currency-starved population brought about the demise of the Second Bank of the United States in 1836, the closest thing to a central bank to

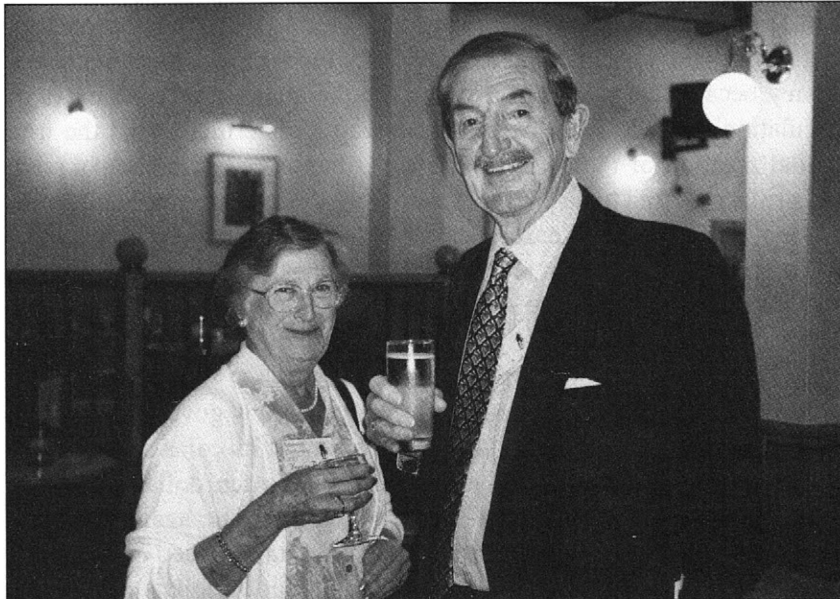
that point in the United States. By 1860, there were more than 1,500 banks in operation, each printing its own paper currency with little gold or silver coinage or bullion held on deposit to back these notes. A reform of sorts was implemented in 1864, under which banks were required to hold government bonds in an amount exceeding the nominal value of bank notes issued. A question my research has not been able to answer is what the United States government accepted as payment for these government bonds. In 1900 the Federal government adopted the gold standard, requiring that banks be prepared to redeem their bank notes for gold upon request. The problems nevertheless continued, resulting in the passage of the Federal Reserve Act in 1913.

The Federal Reserve System mandated that all banks chartered by the Federal government become members of the new system. Twelve Federal Reserve Banks were chartered to serve different parts of the United States. Commercial banks became members by purchasing shares of stock in the Federal Reserve Bank equal to three percent of the prospective member bank's capital. Much has been written about the establishment of the Federal Reserve System. Virtually nothing has been written about the method by which the Federal Reserve Bank's were capitalized. Real reform would have required that commercial banks purchase gold and silver coinage (or bullion sent to the mint for conversion into coinage) and deliver this "money" to the Federal Reserve Bank. The par value of a share of stock in the Federal Reserve Bank would, then, equal a monetary unit of gold or so many monetary units of silver. Most commercial banks would have had to purchase money because very little money backed the quantity of bank notes in circulation. And, in fact, there was no way to determine what the true capital position of the commercial banks might be. These banks were ostensibly required to be prepared to redeem their notes in gold but there was no mechanism for enforcement. If too many holders of a bank's notes presented them for redemption, the bank would not be able to honor the demands and be forced to close its doors. Calling in loans would have no benefit unless the obligations to the bank were repayable not with bank notes but in coinage or bullion.

At the dawn of the age of paper currency, the new government of the United States had set the standard gold content of its coins according to the content of the Spanish silver dollar. Thus, a ten dollar gold coin contained a quantity of gold in proportion to its value against silver – 232.2 grains of gold. A bank of deposit would have issued a certificate of deposit with a stated value equal to the number of dollars held. "The money of any particular country is, at any particular time and place,"

observed Adam Smith, "more or less exactly agreeable to its standard, or contains more or less exactly the precise quantity of pure gold or pure silver which it ought to contain."[7] If we hold Smith to his terminology, only a certificate of deposit with a stated value in terms of the gold and or silver content of money held by the bank circulates as a legitimate claim on money. The commercial banks in virtually every society were permitted to abrogate this obligation, with government a willing collaborator.

The law creating the Federal Reserve Banks required that the Banks hold in reserve gold equal to a minimum of 40 percent of the stated value of the notes in circulation. Initially,. Federal Reserve Bank notes (secured by U.S. government bonds) competed with other paper currencies. The economic collapse of the 1930s so threatened the financial system of the United States that emergency measures were passed in 1933 that totally severed the issuance of Federal Reserve Bank notes from the holding of gold reserves. Moreover, the private holding of gold coins or gold bullion was made illegal. All "one dollar" gold coins had to be sold to the United States government for the fixed price of a Federal Reserve Bank note with a stated value of one dollar. The new law also designated Federal Reserve Bank notes the only form of paper currency to be circulated as legal tender. The Federal Reserve



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Banks were, at the same time, authorized to print without restriction new Federal Reserve Bank notes for the purchase of U.S. government obligations. By this remarkable flight of fantasy, the United States government shifted purchasing power from private holders of Federal Reserve Bank notes to itself by orchestrating an increase in the quantity of notes in circulation. As always, the general price increase that subsequently occurred was felt most by those who held title to no land and few material assets. In 1934, one of the great monetary economists of his day, Edwin W. Kemmerer, concluded: "All things considered, these Federal Reserve Bank notes are probably the weakest link in our monetary chain."[8]

Desperate times had demanded desperate action, and desperate men decided time after time that debtors – and government debtors, in particular – should not be called upon to do the right things (e.g., shifting to location rent as the primary source of public revenue, and imposing taxation on those with the greatest ability to pay for any shortfall that might remain). As a consequence of the First World War, the Federal government made extensive use of its powers to self-create credit by exchanging its debt obligations for Federal Reserve Bank notes. U. S. government bonds also had been sold to acquire the remainder of needed revenue. The result was a five-fold increase in the "dollar" volume of Federal Reserve Bank notes put into circulation. Gresham would not have been surprised that the quantity of gold coins and certificates nearly disappeared from exchange (on top of which, the Federal Reserve Bank of New York made a determined effort to replace all gold coins and certificates with the Bank's notes). To counter the inflationary effects of this swift change to a new standard form of paper currency, the Federal Reserve Banks nearly doubled the rate of interest member banks were charged to borrow funds. Such a dramatic increase in the cost of borrowing could not be absorbed by producers or passed on to consumers. Soon, the United States was experiencing an economic contraction and an official unemployment rate of 12 percent. Was this the fault of the Fed's action to raise the discount rate or was the nation already on the road to recession? Harry Gunnison Brown, for one, thought the primary sources of the recession were to be found elsewhere:

> Despite the possible importance of velocity of circulation as a derivative factor, I believe we shall do well not to assume that it has any especial importance in initiating either rising prices or falling prices. And I believe we ought not to expect to find in velocity of circulation of money and

bank credit an important influence in the initiation of business depression.[9]

From the perspective of the issues being addressed in this paper, velocity (and the subordinate challenge of calculating the so-called money supply) is irrelevant. What is most important is the fact that there is no longer in the system by this time any such thing as actual money deposits. Whether most economists knew it or not, the United States had entered a new era that – in lieu of concrete structural reforms – demanded an ever-expanding range of fiscal and monetary interventionist powers, accompanied by the willingness of citizens to absorb a combination of heavier and heavier taxation and a constant, and at times accelerated, erosion of purchasing power of savings. The need for managed economies was artificially created, but the mechanisms for achieving the appropriate outcome – full employment without inflation – were absent from the managers' toolkit.

Keynes concluded that the instability of the early 1920s could not have been avoided. This was another consequence of the enormity of the First World War. Returning to pre-war conditions was neither possible nor desirable. "When the depreciation of the currency has lasted long enough for Society to adjust itself to the new values, Deflation is even worse than inflation," he wrote. "Both are 'unjust' and disappoint reasonable expectation. But whereas Inflation, by easing the burden of national debt and stimulating enterprise, has a little to throw into the other side of the balance, Deflation has nothing."[10] He also stated part of the case I believe should have carried the day:

> The advocates of gold base their cause on the double contention that in practice gold has been provided and will provide a reasonably stable standard of value and that in practice, since governing authorities lack wisdom as often as not, a managed currency will sooner or later, come to grief.[11]

Of course, Keynes was in no sense thinking in the same terms I have described; namely, the chartering of new banks of deposit as the foundation of our monetary system. He expressed a concern over the hoarding of precious metals, even by governments. Severing currency from gold seems to have eliminated hoarding altogether today. People invest in gold or silver as a hedge against inflation and to protect themselves from losing everything should the market value of equities and bonds disappear in a prolonged economic depression. The argument

is made, therefore, that precious metals are no longer needed for the establishment and protection of a sound money supply. In a very real sense the global economy has imposed stiff penalties on governments and central banks that practice what the law permits. There are many strong economies in today's world, and exchange rates between legal tender currencies float freely, changing daily. A government that causes too much paper currency to be added to the supply in circulation risks causing a "run to quality" (i.e., to the currencies of more investor-friendly countries).

Along with a more or less level playing field for producers of goods and services, the rapid expansion of electronic banking is significantly reducing the need for coinage and paper currency. We are not that many years away from majority use of debit cards to purchase goods and services. Business-to-business, business-to-government, and even government-to-government commerce is overwhelmingly electronic today. All that is needed is for bank account totals to become a claim on a specific quantity of money and no longer a nominal value subject to being destroyed by the failure of a government to act wisely and justly. The need for money itself to be in circulation – and any concern over a shortage in the supply of precious metals – is also lessened by the development of systems of electronic barter, the intermediate stage of which is already well underway.

As in so many other discussions of political economy, we can turn to the writings of Henry George for a bit of wisdom, even about money. George makes the observation:

> Since labor is the real and universal measure of value, whatever any country may use as the common measure of value can impose little difficulty upon the exchanges of its people with the people of other countries using other common measures of value. Nor yet would any change within a country from one common measure of value to another common measure of value bring more than slight disturbance were it not for the effect upon credits or obligations.[12]

Gold and silver, made into coins, had for a very long served as this common measure of value. George also saw that far more commerce could be conducted by barter than was commonly believed:

> "[I]t is not necessary to an exchange that both sides of it shall be effected at once or with the same person. One part or side of the full exchange may be effected at once, and the effecting of the other part or side may

> be deferred to a future time and transferred to another person or persons by means of trust or credit.[13]

George also knew history well enough to know that neither "princes" nor "republics" could resist the temptation to engage in the fraudulent self-creation of credit, whether by debasement of the coinage or by using a central bank to issue notes and require others to accept them as legal tender. The lesson learned, the solution is to unleash competitive forces to use sound money as the means of driving out unbacked, central bank issued legal tender. Banks of deposit are the cornerstones of this process. Electronic exchanges and transfers will make it possible. When individuals and businesses become members of these banks, they can engage in a system of exchange absent float and absent exposure to currency devaluations. In time, governments will be forced to become members and relinquish their long cherished privilege of being able to self-create credit. Sound money will have arrived. Kemmerer, perhaps, saw into what ought to become:

> All in all, under present-day economic political conditions in America, a price level anchored to a commodity of universal demand, such as gold – a commodity of which there is always an enormous marketable supply, and of which the annual product is but a petty percentage of the world's accumulated stock – is likely to be much more stable and dependable than a price level controlled by any such mechanism as that of the commodity dollar.[14]

Notes

1 Report by U.S. Currency Commission, issued October 1920. Excerpt reprinted in A. Barton Hepburn, *A History of Currency in the United States,* New York: Augustus M. Kelley edition, 1967, p.478. Originally published by The Macmillan Co., 1924.

2 Frank W. Taussig, *Principles of Economics*, Vol. I, New York: The Macmillan Company, 1911, p.326.

3 David Ricardo, *The Principles of Political Economy & Taxation*, London: J. M. Dent & Sons Co., 1911. Originally published 1817., pp.238-239.

4 David Ricardo, *Ibid.*, p. 245.

5 John Maynard Keynes, "The Return to Gold," *Essays In Persuasion*, New York: W. W. Norton & Company edition, 1963. Originally published, 1931, p.184.

6 John Maynard Keynes, *Ibid.*

7 Adam Smith, *The Wealth of Nations*, New York: Random House edition, 1737. Originally published 1776, p.46.

8 Edwin W. Kemmerer, *Kemmerer On Money*, Chicago: John C. Winston

Company, 1934, p.26. Note: The author was Professor of International Finance, Princeton University and was a former President of the American Economic Association.

9 Harry Gunnison Brown, "Policies for Full Post-War Employment," *American Journal of Economics and Sociology*, New York: Robert Schalkenbach Foundation. Reprinted in a collection of Brown's essays, with the title *Fiscal Policy, Taxation and Free Enterprise*, Undated, p.40.

10 John Maynard Keynes, "The Return To Gold," *Essays In Persuasion*, pp.192-193.

11 John Maynard Keynes, *Ibid.*, p.200.

12 Henry George, *The Science of Political Economy*, New York: Robert Schalkenbach Foundation edition, 1968. Originally published 1897, p.503.

13 Henry George, *Ibid.*, p.509.

14 Edwin W. Kemmerer, *Kemmerer On Money*, p.152.