

Vol. IV No. 1

February 1964

AMERICAN INSTITUTE
for ECONOMIC RESEARCH
Great Barrington, Massachusetts

**ECONOMIC
EDUCATION
BULLETIN**

WHY GOLD?

A Coordinated Study by the Research Staff of
American Institute for Economic Research

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I.

GOLD AS A COMMODITY AND AS MONEY

Although knowledge of man's first use of gold is lost in antiquity, we know that long ago primitive peoples made ornaments of gold, and the display of gold possessions for personal adornment and in other ways early became a mark of social status. Magnificent gold vessels found in the Middle East were made about 3500 B.C., and the skilled craftsmanship evident in these objects suggests that gold then had been in use for several hundred years, at least.

Ever since these early times gold has been one of man's most prized possessions. Monarchs waged wars in the hope of plundering treasures of gold from their conquered rivals; kings and princes sent expeditions to unknown portions of the earth in search of new sources of gold; pirates and privateers willingly risked their lives to obtain the yellow metal; and thousands of people have joined the "gold rush" to any place on earth that held either an actual or rumored prospect for finding gold. During most of the Middle Ages the practice of alchemy flourished primarily because the alchemists hoped somehow to find a means for converting less precious metals or other physical elements into gold.

Monetary Use of Gold

Although the proportions are subject to some fluctuations from year to year, on the average about half of the world's annual gold production is added to national monetary reserves. The other half is absorbed into private hoards or is used commercially and in the arts.

Because of its scarcity, permanent beauty, and ready workability, gold is one of the most treasured raw materials used by artisans and craftsmen. Perhaps less readily understood are the reasons why gold has long been and probably will continue to be an important monetary commodity.

Probably the most impelling reason for using gold as a medium of exchange is that for centuries men have been willing to accept gold in exchange for other possessions or for the products of their labor. This universal and age-old willingness of individuals and nations to accept gold in payment for goods sold or services rendered is based, of course, on the fact that the recipient has confidence in gold as a permanently valuable and exchangeable commodity, the value of which is recognized in any area of the world.

One of the primary purposes of any monetary system is to facilitate the exchange of goods and services among members of the society. In

order to fulfill this purpose the medium of exchange must be acceptable to all. Whenever it becomes unacceptable to a portion of the society, as did Confederate paper dollars during the Civil War and German paper marks after World War I, the monetary system breaks down. Gold has the unique distinction of never having become unwanted as a medium of exchange during the many centuries of recorded history.

There are those, especially among the present-day proponents of "managed money," who advocate the complete elimination of gold from the monetary systems of the world on the grounds that the prolonged use of this commodity for monetary purposes is merely a custom that has been outmoded by changing conditions. These arguments fail to recognize that, unlike customs based on fantasy or folklore, the long-continued use of gold for monetary purposes is based on sound and logical considerations. Because gold is scarce and because its extraction from natural deposits requires much effort in relation to the amount of gold produced, gold has a high exchange value. Moreover, the large accumulations now used as the basic monetary stocks of the world are many times annual production; consequently, even quite large variations in production cause relatively small changes in the accumulated monetary stocks of gold during short periods. This tends to stabilize a money-credit system based on gold. Gold cannot readily be counterfeited, and it is almost impervious to deterioration. Whether or not recognition of these characteristics was responsible for the early selection of gold as a medium of exchange cannot be known. However, there appears to be no substance better suited for use as a monetary unit.

Compelling reasons now exist why the use of gold in the monetary systems of the "free" nations of the world probably will become increasingly important during the foreseeable future. Distrust of "fiat" paper money cannot be prevented by even the most powerful dictator. The more a government abuses its money-credit system and impairs the buying power of its currency through inflation, the greater will be the demand for "hard money" (gold), the value of which cannot be altered by the whims of politicians or the money managers. Granting that each nation individually may compel its citizens to accept paper currency that is not redeemable in gold in payment of all domestic debts, no government can compel the citizens, the central banks, or the governments of other nations to accept such paper currency in settlement of international obligations.

A world supply of gold, the universal purchasing medium that is acceptable to everyone almost everywhere, greatly facilitates the conduct of international trade. Furthermore, possession of a reserve of such international money has proved to be especially desirable for a nation during periods of emergency. A reserve of monetary gold is as valu-

able as a reserve of essential raw materials because gold can be used to buy goods, even indirectly from a nation's enemies.

In addition to its usefulness as an international medium of exchange, the use of gold as the basic unit in a nation's money-credit system places a limitation on the extent to which the supply of purchasing media might be expanded by the banking system or by government action.¹ Also, gold introduces an element of steady expansion into the monetary system of which it is a part. In comparison with the annual rates of increase for world production of other natural resources, the annual rate of increase in world gold production has been remarkably steady. During the past century, gold production has increased at an average rate of about 2½ percent per year (compounded annually), and deviations from this average rate have been confined within a relatively narrow range. Moreover, changes in the rate of increase or decrease have been gradual, extremes having been separated by periods of at least 25 years.

We are firmly convinced that a greater rather than a lesser reliance on gold in the monetary system of the United States and other free-world nations would provide a far greater stimulus to sound economic growth than could be fostered under a monetary system regulated only by government fiat. Inflation has proved to be an inevitable accompaniment of managed-money panaceas, and history clearly demonstrates that inflation long continued leads to economic stagnation and financial ruin. On the other hand, the example of West Germany since the end of World War II provides indisputable evidence of the extent to which sound money and economic freedom can stimulate sound and rapid growth in a modern industrial economy. In a relatively short period West Germany has rebuilt her war-devastated industrial capacity and has enlarged the volume of industrial and agricultural output to levels far in excess of those existing before the war. Noteworthy is the fact that Germany chose to preserve a sound currency based on and exchangeable for gold, even at the cost of a drastic postwar deflation.

Gold Production

Gold producers, like the producers of other goods, are encouraged by the possibilities for profit and are discouraged, sometimes to the

¹The term "purchasing media" is used to include both currency, which may be passed from hand to hand to accomplish exchanges, and demand deposits, which can be drawn upon and transferred by check for the same purpose. Some economists use the word "money" in this broad, inclusive way. Others restrict their use of the word to the money commodity, gold, and gold certificates that are in effect warehouse receipts for gold. Still others include time and savings deposits in their definition of "money"; and some even include book credit (charge accounts) and promissory notes. Because the word "money," when used without a train of appropriate modifiers, has been for more than a century unsatisfactory for clear communication, the exactly defined though less familiar term "purchasing media" is employed throughout this study.

extent of deciding to go out of business, when losses occur. However, unlike the prices of goods produced in other industries, there is a legal "price" of gold, a "price" fixed in terms of dollars by legal definition. Consequently, gold producers are unable to adjust their selling price when prices of other goods and services are rising or falling. Therefore, when the cost of producing gold increases because of the increased cost of labor and materials, the narrowing of the gold producers' profit margin tends to discourage gold production. On the other hand, when the costs of producing gold are decreasing because of the decreasing cost of labor and materials, the fact that the "price" of gold remains the same tends to widen the profit margin and thereby encourages the production of gold.

Devaluation, which is an increase in the legal "price" for gold in terms of currency, also tends to encourage gold production, temporarily at least. Following devaluation gold producers receive for each ounce of gold produced more purchasing media with which to pay wages and other operating costs. Such costs tend to increase following devaluation, but the increase usually is gradual and may require many years to absorb the larger revenues of gold mining companies attributable to devaluation.

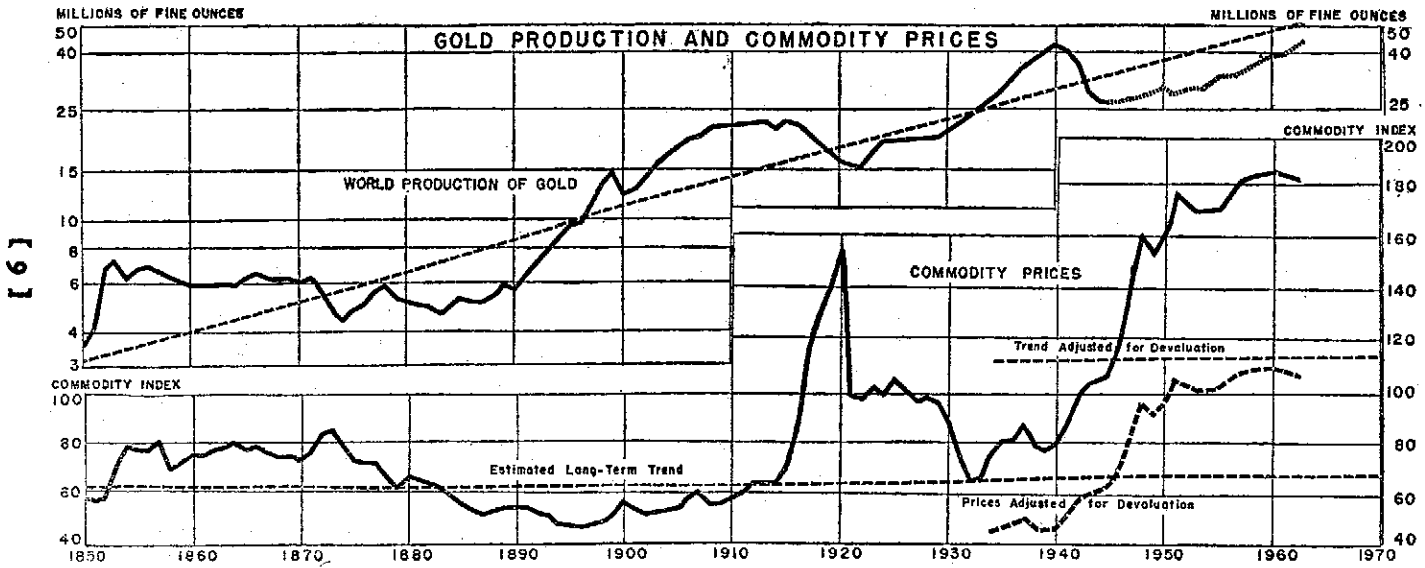
Chart I shows the fluctuations in gold production and commodity prices during the 113 years from 1850 through 1963. World gold production is plotted on a logarithmic or ratio chart with the scale shown on the left. The straight line drawn through the gold-production curve approximates the trend of gold production during the period shown.

The curve representing wholesale commodity prices is plotted on an arithmetic chart with the scale indicated at the right. Prior to 1914 an index of prices in England is shown, partly because it is more representative of world prices during that period; thereafter the curve is based on wholesale commodity prices in the United States.

The chart reflects the inverse relationship that usually has existed between gold production and price trends. That gold production continued to increase during the latter part of the 1930's in spite of rising commodity prices presumably reflects the stimulus to gold production that followed the 1934 devaluation of the dollar. Gold production also increased following the 1949 devaluation of the British pound although prices generally were increasing. The increase in gold production since 1949 is attributable primarily to expanding output from the relatively new South African mines, which are not directly affected by general price increases in the United States.

In his annual review of gold production, Dr. M. A. Kriz, writing in the *Engineering and Mining Journal* for February 1962, noted that "interest in gold has revived to an extent not seen for a quarter of a century." For those who would relegate gold to a place among relics

CHART I



of the past, 1961 must indeed have been a year of surprises. Several developments during the year demonstrated that gold remains the bulwark of monetary systems and a source of monetary discipline.

In an effort to "protect" the gold stock of the United States, President Eisenhower, a few days before leaving office, amended an earlier Executive Order so that holding of gold anywhere in the world by persons subject to U.S. jurisdiction was prohibited. And in order to remove any threat to the dollar from suspicion that the incoming Administration might devalue it or restrict its free convertibility into gold by foreign governments and central banks, President Kennedy pledged his administration to the preservation of the dollar at its current gold content.

Production of newly mined gold in the free world in 1963 totaled nearly 39 million ounces, equal to \$1.4 billion. It was 5 percent more than that in 1962 and 60 percent more than the annual production a decade earlier. Moreover, it was 8 percent more than that of 1940, when gold production reached its prewar peak following the widespread currency devaluations of the 1930's. The 5-percent increase in free world gold production in 1963 substantially exceeded the average rate for the preceding century.

In the past we have been guided by estimates (actually guesses) of the U.S. Bureau of Mines in making our estimates of gold production in the Communist countries. However, on January 9, 1964, the Central Intelligence Agency reported that Russian gold reserves were equal to only about \$2 billion, compared with previous estimates of \$4-10 billion. Moreover, Russian output of newly mined gold was estimated at \$175 million, compared with earlier estimates of \$350-600 million. We assume that these figures are nearer to the truth than those previously available.

In view of these estimates, we have revised downward our estimates of Russian gold output since 1944. The revised total world production is shown on the chart as a broken gray line.

Output in the principal gold producing areas of the world during 1963 followed generally the trends of recent years. Output in South Africa, the world's leading producer, increased the most, 8 percent, to account for 70 percent of the free world's newly mined gold. Production in both the United States and Canada decreased. United States production, equal to \$51 million, was the least for any year, excepting 1961, since that of 1946. Canadian production, equal to \$138 million, was the least for any year since that of 1948. South Africa, Canada, and the United States are the three leading gold producers of the non-Communist world, and together they account for 85 percent of the free world's output. The decreasing trend of Canadian and United States production reflects the influence of increasing mine operating costs, which have been due largely to currency inflation.

Although gold reserves of the free world increased during 1963 by

about \$0.8 billion to approximately \$44.5 billion, monetary problems continue throughout the world. The U.S. gold reserves diminished last year by about \$0.5 billion while there was an indicated increase during the year of nearly \$1 billion in foreign-held short-term dollar claims. If these additional claims had been settled in gold, the Nation's gold loss in 1963 would have approximated \$1.5 billion. Moreover, a larger diminution of U.S. gold reserves was prevented only through increased use of foreign currency swaps and prepayments of long-term debt due the United States.

The continuing weakness of the dollar, reflected in these developments, accounts largely for a continuing absorption of gold into private hoards, as revealed by 1963 statistics of gold production and use. When the gold that Russia found necessary to offer in the West is added to the \$1.4 billion of newly mined gold of the free world during the year, the gold newly available to the free world in 1963 totaled \$1.8 billion. However, only about \$0.8 billion of this was added to official gold reserves, indicating that about \$1.0 billion of gold was taken for private use. What part of this amount was hoarded is not known definitely, but the available data on gold used in industry and the arts suggest that it was large. In the United States, industry and the arts used \$125 million of gold in 1962, the latest year for which this information is available. Thus, without the benefit of corresponding data for other countries, hoarding of \$500 million of newly available gold in 1963 in the free world seems probable. Such an amount approximates the gold loss of the United States during that year.

WORLD GOLD PRODUCTION*

(In millions of dollars at \$35 per fine troy ounce)

	1955	1962
South Africa	510.7	892.7
Canada	159.1	145.5
United States	65.7	54.5
Australia	36.7	37.4
Ghana	24.1	31.1
Rhodesia	18.4	19.4
Colombia	13.3	13.7
Mexico	13.4	8.3
Nicaragua	8.1	7.8
Congo Republic	13.0	7.1
India	7.4	5.7
Brazil	3.9	4.5
All other†	66.2	62.3
World production†	940.0	1,290.0

* Federal Reserve Bulletin, October 1963.

† Estimated; excludes U.S.S.R., other Eastern European countries, China Mainland, and North Korea.

The following conclusions can be drawn from the record of gold production as it related to currencies in 1963:

1. In spite of the retarding effect on gold production of high mine operating costs resulting from inflation, world gold output continued to increase.

2. Doubts as to the future gold content of the dollar are revealed in further losses of gold by the United States and the large amount of newly available gold absorbed into private hoards.

3. Both gold production and the gold reserves of Russia have been reliably reported as being much smaller than even the minimum estimates made heretofore.

4. The ability of Russia to obtain wheat and other necessities of life in exchange for gold in markets where rubles are unacceptable further demonstrates both the universal acceptability of gold as a medium of exchange and the importance of gold reserves in times of national need.

5. Despite the availability of nearly \$1.8 billion of additional gold to the free world in 1963, the gold reserve position of the U.S. money-credit system deteriorated further.

II.

THE ROLE OF GOLD IN THE EVOLUTION OF COMMERCIAL BANKING¹

At first thought, one might believe that money-credit matters are too complicated for all but a few exceptional individuals to understand. However, commercial banking is the outcome of an evolutionary process that is simple when viewed one step at a time as it must have occurred but that is not so readily understood when one looks only at the result to date. Some words pertaining to banking have been in common use so long that many people do not know their original and more technical meanings.

In the following paragraphs, the evolution of commercial banking is described step by step. No attempt is made to date each successive step in the evolutionary process, although some dates are given. Many of the original dates for successive steps are lost in the haze of man's unwritten history; and some of the successive steps have recurred in recent decades and may be expected to recur again wherever formerly well-developed money-credit processes have been destroyed.

Primitive Markets

We begin with a primitive society where exchanges were simple barter. The grower of wheat exchanged it directly for skins obtained by the tribal hunters, for meat obtained both by the hunters and by those who had cattle, and for gold obtained in crude form by some members of the tribe from alluvial deposits. Why gold was generally desired, other than for the fact that it was used for ornaments and because it could be exchanged again for other things desired, need not concern us.

As the tribe increased in number and the exchanges to be made increased greatly, a time came when the bartering was concentrated, for the most part, at a convenient meeting place. Today we should call that meeting place a market or shopping center.

Of course, many other things than those mentioned were exchanged in the markets, but the principles we are seeking to understand can be illustrated by discussing only a few. We choose to focus attention on wheat, beaver skins, and gold.

¹Writers of many recent textbooks on this subject seem to have forgotten principles well understood in the United States only a few decades ago, principles tested by a century of modern commercial banking in England and embodied in the Federal Reserve Act. Fortunately, historical documents provided the explanation given here.

As market activity increased, the time came when some individuals became specialists in marketing. One chose to deal in wheat, another in beaver skins, and another in gold. Once these specialists had established themselves, many of those bringing in things to barter discovered a process more convenient than carrying on their backs the things they wished to offer in exchange. The processor of wheat delivered wheat to the warehouse and took in exchange a claim check or warehouse receipt for his wheat. Similarly the processors of skins and gold took warehouse receipts from the merchants specializing in skins and gold respectively.

Claim Checks

Those who thus had obtained claim checks on wheat, skins, and gold then exchanged the claim checks among themselves until they had claims on the things they wanted. When each had claim checks for whatever he wanted, he went to the appropriate merchant's warehouse and obtained wheat, or skins, or gold in exchange for the respective claim checks.

The earlier claim checks for wheat read as follows:

This certifies that John Doe has placed in my warehouse
35 bushels of wheat, which I promise to deliver to the
bearer of this claim check on demand.

Arthur Smith, Wheat Merchant.

Similar warehouse receipts or claim checks were written by the merchants handling skins and gold. In some instances the claim checks were not redeemable by the bearer unless the claim check had been endorsed or signed over to him by the original depositor of the wheat, but these details need not concern us.

Gold as the Medium of Exchange

As the market increased in size and activity men found, to an increasing extent, that gold or claim checks on gold were a convenient medium of exchange. On more and more occasions those who had gold or claim checks on gold found that they could obtain what they wanted with the least difficulty in persuading others to accept what they had to offer. Each seller saw for himself how readily he could buy other things he might want with the gold and how conveniently he could hold gold until he might wish to buy other things.

As a result of the increasing use of gold and claims on gold in effecting exchanges, men developed the habit of estimating the exchange value of other things in amounts of gold. Thus, prices, instead of being thought of and talked about in such ways as, "two bushels of wheat equal in exchange value one beaver skin," came to be thought of and talked about in such ways as, "one bushel of wheat equals one thirty-fifth

of an ounce of gold, and one beaver skin equals two thirty-fifths of an ounce of gold (also the exchange value of two bushels of wheat)."

The Goldsmiths

At about this stage in the development of banking, the gold merchants, or goldsmiths as they were called, saw the possibility of greatly simplifying the marketing and exchange processes. A goldsmith suggested to a wheat merchant that more growers of wheat would bring their wheat to his warehouse if he would give them in exchange claim checks on gold instead of claim checks on wheat. When the merchant replied that he had neither gold nor claim checks on gold to offer, the goldsmith explained that claim checks on gold could be borrowed until such time as the merchant might sell the wheat.

The wheat merchant decided to experiment as suggested. When the next wheat grower arrived with a load of wheat, the merchant offered him a choice between claim checks on wheat and claim checks on gold. When the wheat grower said he preferred claim checks on gold, the merchant stepped next door and gave the goldsmith the claim checks on wheat accompanied by his note promising to redeem the claim checks on wheat with gold or claim checks on gold. Whereupon the goldsmith gave the merchant claim checks on gold, which were delivered to the wheat grower in exchange for the wheat he had delivered. The wheat merchant's promissory note read like this:

This is to certify that I have received and now offer for sale in my warehouse 100 bushels of wheat for which this note is a claim check. Received this date from the goldsmith 100 claim checks for $1/35$ ounce of gold each. As the wheat is sold I promise to return to the goldsmith corresponding claim checks on gold with interest at 6 percent, and if I fail to return all the claim checks within 30 days the goldsmith may claim the wheat not yet sold.

Arthur Smith, Wheat Merchant

And each of the 100 claim checks on gold issued by the goldsmith read like this:

I promise to pay to the bearer on demand one thirty-fifth of an ounce of gold.

William James, Goldsmith.

Shortly thereafter, the goldsmith made an interesting discovery. At first he had issued claim checks on gold totaling no more than the gold in his possession. His discovery was that few people who obtained his claim checks ever demanded gold. Most of them used the claim checks

on gold as purchasing media to buy other things, and the sellers returned the claim checks thus obtained to the goldsmith as agreed in order to repay their borrowings. Occasionally, some individual demanded gold, but even that gold usually returned to the goldsmith, for safekeeping if for no other reason, within a short time.

Commercial Banking

The much greater convenience to all concerned provided by the claim checks on gold facilitated great increases in trade. Soon the goldsmith was being urged to issue claim checks for greater amounts of gold than he had. But by that time, he knew from experience that few who had claim checks would want gold if other things were available for purchase in the markets. Consequently, the goldsmith reasoned thus:

a. If I am prudent in judging the gold exchange value of the things the merchants have to sell, and if I am sure that they are offering those things on the markets, I can issue more claim checks on gold than the amount of gold in my possession. Few of the people who get my claim checks will want gold; most of them will use the claim checks to buy other things.

b. If I make sure that the merchants repay their loans promptly by returning to me the claim checks on gold that they receive when they sell wheat, skins, etc., I shall be sure that there are no more claim checks outstanding than the total value of things left in the market place plus my gold. Obviously, I must lend my claim checks only for short periods and must insist that a merchant promptly repay me whenever he sells the wheat or other thing that serves as security for his promissory note.

c. If, for any reason I cannot foresee, many individuals suddenly decide to demand gold for their claim checks on gold, I can refuse to lend any more and can insist that the merchants repay outstanding loans. This will force the merchants to reduce prices on what they have for sale; the lower prices will attract purchasers who have claim checks on gold; thus people who have such claims will not demand gold from me but will exchange their claim checks for other things such as wheat. Then the wheat merchants, in order to repay their borrowings, will return to me the claim checks on gold they had borrowed. In a short time, there will be no claim checks on gold outstanding, or at least no more than I can readily redeem with gold if necessary.

Thus sound commercial banking was underway. More of the goldsmiths in the first market and then in other markets undertook the new business. But for a long time they were known as goldsmiths rather than bankers.

Intermarket Trading

In a market area not far from the first, the cost of producing wheat was less because the valley land was richer. On the other hand, beaver skins were available in larger quantity with less effort in the first market area because of the many hillside waterways where beaver could be trapped. In the second market area the exchange value of wheat for gold decreased (the price of wheat declined), and in the first market area the price of beaver skins was lower than it was in the second market.

Even in the days of simple barter, exchange values of wheat and skins in the two markets had differed. But with regular use of gold or claims on golds as purchasing media, the difference in exchange ratios (price difference) became more apparent and the advantages of regular trade between the two areas became obvious. Thus inter-area commerce increased to the mutual advantage of all concerned.

At first the goldsmiths wondered whether or not the supply of gold would be adequate for the increasing number of exchanges and growing volume of commercial banking for which many more claim checks on gold were needed. But as the goldsmiths became better known, more gold was brought to them for safekeeping. In addition, producers took advantage of new inventions stimulated by the general advance of a trading civilization. Crude pumps were developed to provide water for hydraulic washing of gravel, the new wheeled carts lessened costs of hauling supplies, etc., and other costs of producing gold were similarly lessened. Thus gold production was stimulated.

In addition to their lending to merchants, which was still continued, the goldsmiths began creating and lending claim checks on gold to traders shipping from one market to another and to processors of wheat and skins, such as the millers and furriers. For a time the goldsmiths were careful to apply the basic principle of commercial banking, i.e., that each new issue of claim checks on gold created for a borrower should, in effect, represent either additional gold received by the goldsmiths or other things being offered in the markets.

Savings Deposits

In time some of the people employed by manufacturers, merchants, and traders found that their wages and salaries would buy more than their immediate needs for consumption. Consequently, they began to save and invest part of their incomes. At first, they invested directly in new houses to rent and in other productive things, but later some of them realized that the goldsmiths were in a position to make such investments, safeguard the documents concerned in their vaults, and exercise continuing supervision. By mutual arrangement the goldsmiths then undertook to receive such savings and invest them. For example, a salaried executive

would bring part of his salary each month in the form of claim checks on gold to the goldsmith. A record of this deposit was made by the latter; this record was known as a savings account or time deposit.

Of course, the purchasing media in the form of claim checks received by the goldsmiths from savers were already in existence; those claim checks had been created and issued originally by the goldsmiths as commercial loans were made; some individuals who had received the claim checks from the merchants and other borrowers chose not to buy some of the things in the market but to deposit some of their claim checks at the goldsmiths; consequently, things that those claim checks represented still were for sale in the markets, and those claim checks, although the same in all outward appearance as other claim checks, could be loaned or invested by the goldsmiths in other than commercial loans. As far as those claim checks were concerned, the goldsmiths could safely disregard the commercial-loan principle, because those claim checks had been issued in the first place to represent things being offered and *still available* in the markets. Of course, the goldsmiths promptly invested or loaned those claim checks, and anyone who borrowed them from the goldsmiths could find things of equivalent value already in the markets for him to buy.

Readers may wonder whether the goldsmiths might not become confused by making two types of loans with similar claim checks. To avoid this possible confusion, the goldsmiths kept an exact record of the savings deposited with them. Consequently, they always knew precisely how much they could invest in bonds, mortgages, or other loans that did *not* involve simultaneous offerings of things in the markets.

Inflation

During a period of peace and general prosperity when markets were functioning well and the goldsmiths were actively conducting their usual business of both commercial and noncommercial lending, an unusual event occurred. A would-be borrower who had nothing to offer on the market desired one of the new chariots then becoming fashionable. He asked his goldsmith friend for a loan, but was at first told, "I am sorry to disappoint you, but my records show that all the savings deposited with me already have been invested. As you can understand, a loan to you for the purpose you have indicated would not be a commercial loan because you would not be simultaneously offering anything on the market from which the proceeds of sale would repay the loan. Therefore, I should not create and issue new claim checks on gold in order to lend them to you. Until I receive more savings, I should not lend to you for such a purpose."

The would-be borrower, a long-established customer of the goldsmith, had his reply ready. "I realize that what I am asking is unusual,

but what harm can result? If you fear for the safety of the loan, I can give you a chattel mortgage on the chariot I buy; it will serve as security for the loan. If I fail to repay when the note falls due, you can repossess the chariot and reoffer it on the market yourself. Moreover, I am willing to pay an unusually high rate of interest. You will be well protected and can profit by the arrangement."

Now the goldsmith in this instance, although by no means stupid, was not well-informed on the principles of sound commercial banking. He had fallen into the habit of thinking more about security for his loans than about their purpose. He had had no experience with, and could not foresee, the consequences of departing from the basic principle of sound commercial banking. He therefore issued some additional claim checks on gold and loaned them to the persistent borrower. Thus was inflation begun.

As soon as the borrower had the claim checks in his hands he rushed to the market and bought one of the few chariots then available. Within the next several days, other individuals who in the usual course of events would have purchased chariots likewise sought to buy. The chariot merchant realized that demand for his product was exceeding the supply; his haggling over prices altered in tone with the result that chariots soon commanded higher prices.

The chariot merchant then dispatched a letter by mounted messenger to the manufacturer of chariots ordering an additional number for early delivery. The manufacturer was so pleased with the increasing evidence that his products were finding favor in the seemingly more affluent society that he decided to push ahead with plans long under consideration for expansion of his manufacturing facilities. He went to the goldsmith and proposed to borrow on a large scale either by giving his note or bond (another form of promissory note) in which the goldsmith could invest savings at his disposal.

More Inflation

The goldsmith's reply was, "I can see how advantageous your early expansion seems to be; but, unfortunately, I have already invested all the savings at my disposal. In fact, my noncommercial, investment-type assets (holdings of bonds, mortgage notes, etc.) already exceed the savings heretofore deposited with me plus my capital funds. You will have to wait until additional savings are brought to me for investment."

But the chariot manufacturer was eager to proceed; consequently he urged, "Your loan will be well secured. Within a year at most, I shall be producing additional chariots from the new plant, and in 8 or 10 years your loan can be repaid in full. Surely, what I am proposing is a sound loan."

Thus the goldsmith was finally persuaded to create more claim checks on gold and lend them to the chariot manufacturer. The latter then started bidding for labor and construction materials in order to construct his new plant. Of course, the new purchasing media thus made available to purchase things in the markets were in excess of the value of things then being offered in the markets for sale. Inevitably, competitive bidding forced prices and wages up. In this community a period of boom prosperity began. All makers of things found demand in the market place suddenly increased; all tried to enlarge their plants, all bid for scarce materials and labor at higher and higher prices. The goldsmiths were urged to make more and more noncommercial loans at higher and higher rates of interest, and the more they disregarded the "old-fogey" principles of sound commercial banking the more their new-found "wisdom" seemed justified by the turn of events.

At least, such were the effects at first. But subtle changes began to appear. Merchants in this market area discovered that they could buy at lower prices in other market areas. First wheat, then skins, and finally even chariots were being brought in from adjacent market areas in large quantities. The local merchants of course had to pay for the things thus brought in, and they gave the claim checks on gold issued by the local goldsmiths.

Then the goldsmiths made an important discovery. Formerly, few of the claim checks they issued were presented as demands for gold. Most claim checks had returned to the goldsmiths, as merchants repaid loans, and then were reissued for new commercial loans. Almost no one in the local market had wanted gold. But the goldsmiths in other markets (Communities B, C, etc.) preferred gold to the claim checks issued by goldsmiths in Community A, where prices (exchange values of other things for gold) had increased so greatly; consequently, the claim checks were presented as demand claims for the gold held by goldsmiths in Community A.

At first, the goldsmiths in Community A were not concerned about the outflow of gold from their vaults. Occasionally in the past, claim checks had been presented for their gold, and they had encountered no difficulty in satisfying the desires of those who, for one reason or another, wished to hold gold. In this instance however, the demand for gold persisted until the gold left in their vaults was far below the amounts that they formerly had considered sufficient in relation to claim checks outstanding.

Deflation

At this stage, the goldsmiths in Community A became alarmed. Unless some way could be found to alleviate their situation, they soon would

be bankrupt. First, they turned to the borrowers who were building new factories or who had bought new chariots and urged them to repay their borrowings. But the manufacturers told the goldsmiths, "Surely, you remember that we have bought bricks and mortar with the claim checks you loaned to us. Someone else has those claim checks now, and we shall not be able to repay for a few more years." And those who had borrowed to buy chariots said, "We simply cannot repay the claim checks we borrowed until our future earnings are received in the months ahead."

Finally, in desperation, the goldsmiths turned to the merchants and said, "We cannot loan you more claim checks to buy more goods; we must have repayment of your outstanding loans." The rush to liquidate began. Merchants marked down prices in order to persuade more shoppers to buy with claim checks that could be used to repay loans. Merchants canceled orders for things from manufacturers in order to avoid becoming obligated for incoming goods. Manufacturers reduced production, and the number of unemployed in Community A greatly increased.

As prices generally fell, prices of secondhand chariots declined rapidly. Soon some of the goldsmiths in Community A realized that their loans secured by chariots were "frozen" because the borrowers were unemployed and the chariots involved were worth much less than the unpaid loans. These goldsmiths repossessed chariots and sold them at auction, but the proceeds of such sales were insufficient to cover the unpaid loans. Some of the goldsmiths found that their own capital, and more, had been lost; they too were bankrupt and were forced to close their doors to the dismay of savings depositors and people who still held claim checks issued by those goldsmiths.

Gold Production

One interesting development during and after the boom was the trend of gold production. When businessmen were frantically bidding for raw materials and labor at rising prices and wages, gold production markedly decreased. The prices of everything gold producers had to buy and the wages they had to offer in order to attract labor rose rapidly. The gold producers thus were forced to discontinue producing in all but the richer gravel deposits and mines. Labor and new machinery that might ordinarily have been used in producing gold were diverted to other activities.

Later, after prices and wages had fallen extensively and many people were unemployed, gold miners found that old abandoned mine shafts and gravel deposits could be worked profitably again, because of lower costs. Even placer mining by individuals became popular.

Some of the economic theorists in this society had become concerned during the early days of the depression and developed learned theories about the "shortage" of gold, blaming that for the depression difficulties.

However, their books hardly were published before gold production, stimulated by lower costs, had increased to levels never before reached.

With our understanding of the entire situation in Community A, we can see that the decrease in gold production was desirable. It tended to discourage continued issuance of claim checks by the goldsmiths when they already had issued too many. Moreover, the subsequent increase in gold production during the depression had a reverse effect in that it made more gold available to the goldsmiths and encouraged them to create more claim checks on gold. For all new gold received, the goldsmiths gave claim checks; these purchasing media (the claim checks) made possible increased demand for other things. In addition, as their gold holdings increased once more, the goldsmiths were in a better position to resume commercial lending.

England's Experience

As it happened, one national economy where the goldsmiths functioned most effectively was England of the 19th century. In the early 1800's the English goldsmiths, who by then were called bankers, developed a modification of the claim-check procedures described above. English merchants found that handling claim checks was awkward and that a simpler procedure was to have the banker hold the claim checks and permit the borrowing merchant to transfer them from his account to others in whatever amounts he wished by written orders directing such transfers.

When merchants or others brought gold or claim checks on gold to the bank, the English banker wrote a credit on his books, which he called the depositor's "checking account." A depositor who held title to such a demand deposit or checking account then could write checks (written instructions to the bankers) transferring any portion or all of the gold thus represented to others.

In applying the commercial banking principle, a banker accepted borrowers' promissory notes, but instead of creating claim checks on gold for the borrowers to use, he authorized the borrowers to write checks not only for the amounts already in their checking accounts but also for the additional amount of the loan. The excess checking account purchasing media thus authorized were called "overdrafts." An English commercial banker thus had a record showing him continuously the total of overdrafts on accounts in his bank. As the total of overdrafts increased, he tended to be more cautious about making loans. Moreover, the bookkeeping record of overdrafts was a continuous reminder to him that his loans resulting in overdrafts should be short-term strictly commercial loans based on goods being offered in the markets.

Somewhat complicating the situation was the fact that many exchanges in the markets still involved the use of claim checks on gold in-

stead of checks drawn on checking accounts. The claim checks on gold issued by a bank finally were given the name "banknotes," because they were the bank's promises to pay gold on demand.

Experience in the United States

Although the basic principles of sound commercial banking were being applied with increasing success in England during the 1800's, these principles were not so widely understood in the United States. Hundreds of banks were started in the various States of the Union by individuals who knew nothing of banking beyond the fact that they wanted to participate in that mysteriously profitable business. These amateur goldsmiths were easily induced to provide claim checks on gold (their banknotes) to borrowers who wanted to speculate in land, then in the railroads, sometimes in almost anything. Moreover, unlike the English bankers who differentiated between overdrafts and the original deposits of gold and claim checks on gold by their customers, the American bankers used the same name, "demand deposits," for both. When they accepted a borrower's promissory note and created claims on gold for him, they either issued new claim checks called banknotes, or added the amount to his previously existing checking account as the borrower desired. Except for technical legal requirements as to banknotes, which need not concern us although important to students of money and banking, the American bankers lacked the constant reminder to be cautious and adhere to sound commercial banking that the English bankers had in their records of overdrafts.

The inevitable result of such banking was a long series of minor booms and recessions, with occasional great booms (whenever all or most of the bankers became especially optimistic) followed by severe depressions. Efforts were made by both the Federal and the State governments to remedy the situation. Almost every conceivable remedy apparently was tried, even the adoption of sound commercial banking for a brief period.

One of the first methods chosen for improving the functioning of the commercial banks was to limit the amount of claim checks on gold that they could legally issue in relation to their actual holdings of gold. Thus were initiated the legal reserve requirements that have become characteristic of American banking.

The reason for adopting such a crude, rule-of-thumb procedure is not difficult to understand. Evidently, the hundreds of banks that failed (many thousands as the decades passed) had overexpanded; therefore, why not limit the creation of claim checks (whether banknotes or checking accounts) to a smaller multiple of a bank's gold? This procedure did work, in a manner of speaking; at least, it tended to prevent every major boom from getting as completely out of control as had the tulip speculation in Holland, or John Law's Mississippi Bubble inflation in France, or the

French inflation of the assignats, or the Rhode Island paper-money inflation, or the Continental currency inflation of the late 1700's.

Another means by which better banking was sought was the chartering of "national banks," which began in 1863. By establishing certain safeguards, such as requiring deposits of Government bonds to secure note issues, the credit "rope" with which the Nation's bankers periodically "hanged" themselves and nearly everyone else was somewhat shortened.

At long last, after a particularly disastrous experience with an inflationary boom and panic resulting from ignoring the principles of sound commercial banking, a Monetary Commission was formed. In the course of an investigation extending over 5 years early in the 1900's, the Commission discovered the principles that had been applied in England for nearly a century.

Following the recommendations of the Monetary Commission, the Federal Reserve System was established in 1914. It consisted of 12 Federal Reserve banks and thousands of member banks. Although the resulting money-credit arrangements included many "hangovers" from earlier procedures, the new system at least recognized and attempted to apply the principles of sound commercial banking. In the 3 years from 1914 until the United States entered World War I, the bankers of the Nation came as near as they ever have to an understanding and application of those principles.

Wartime Inflation

During World War I, the governments of the warring nations, including England, chose inflation as the expedient means of financing their war efforts. In England, the long-established principles of commercial banking were put aside as the commercial banks were persuaded to create claims on gold for the national Treasury in the form of both banknotes and checking account deposits in exchange for Government bonds. The resulting great and unwarranted increase in purchasing media had the usual inflationary effect on prices, wages, and business activity.

In the United States during the years of World War I similar procedures were followed. The new Federal Reserve System was used as an "engine of inflation" by inducing the commercial banks and the 12 Federal Reserve banks to accept Government securities in exchange for additions to the Treasury's checking accounts.

Shortly after the war, the Federal Reserve Board caused the Federal Reserve banks to sell large amounts of Government securities and thereby forced deflation. Thus most of the inflationary purchasing media created by the banking system during the war were removed from circulation, and sound commercial banking could have been resumed.

The "New Era" and the 1929 Panic

Unfortunately, the wartime practice of letting the banking system create new purchasing media in exchange for noncommercial debt soon was resumed, although mostly private instead of public obligations were involved. The reasons were complex. They included a misguided and in the end unsuccessful effort to help England restore and remain on the gold standard as well as efforts to stimulate business in the United States by means of an "easy-money" policy. The result was another great inflation, the effects of which, and in part the means, were found in unbridled stock market speculation. The speculators who borrowed to buy stocks obtained newly created purchasing media, a part of which became the profits of those who sold at higher prices; and when successful speculators bought new cars, new homes, etc., with their gains, the boom in business was augmented until, for a time, increasing business profits seemed to justify the rise in stock prices.

The outcome, when the speculative bubble burst in 1929, was drastic deflation and accompanying depression. By mid-1932 the process of liquidating prior inflationary borrowings was completed. Hundreds of banks had failed as had thousands of others during earlier similar periods, but the remaining banks had liquidated inflationary loans and were back on a sound basis. Also, as on past occasions, a recovery of business began as soon as the necessary deflation with accompanying reductions in prices and wages was accomplished. By the fall of 1932, the recovery was well underway.

The Banks Close

As it happened, however, a presidential election was held in that year. Although the President-elect had espoused sound money and had ridiculed assertions concerning threats to the gold standard, he permitted some close advisers to learn in December 1932 that he favored managed-money panaceas and that he intended to do something about the seeming shortage of gold.

Rumors spread, and a run on the banks was begun by many depositors who feared that claims on gold would not be honored after the new Administration came into office. The run reached startling proportions during February 1933 as the President-elect declined to reassure the public as to the new Administration's intentions. By early March every bank in the Nation was forced to close its doors, although nearly all were soon found to be in excellent condition and were reopened. (Most of the few that failed at that time subsequently paid depositors every dollar owed to them.)

In January 1934, through authority conferred on him by Congress, the President ordered a reduction of approximately 40 percent in the

gold content of the dollar. By this action each ounce of gold was transformed from \$20.67 to \$35.00.

But this devaluation of the dollar failed to raise prices immediately and restore prosperity as some naive advisers had predicted. Another experiment, planned inflation as specifically recommended in detail by Lord Keynes, was undertaken. By again persuading the commercial banks to accept Government bonds in exchange for newly created additions to Treasury checking accounts, the Government's deficits were "monetized" in substantial part. The initial result was a short-lived boom that still left 7,500,000 unemployed; and the aftermath was one of the most extensive and most rapid business contractions in the Nation's history. By 1939 nearly 10,000,000 were unemployed.

World War II and Postwar Inflation

Then came World War II with the repetition on a larger scale of the inflationary wartime financing of World War I. While so great an amount of inflationary purchasing media was being created and issued in monetizing Treasury deficits, the early recipients could not find the things they wanted to buy. New cars and new homes desired by individuals simply were not available, and businesses could not obtain new plant and equipment except for wartime needs. Consequently, a large portion of the inflationary purchasing media in the form of both currency and checking accounts was hoarded or held idle until the postwar years.

Instead of forcing deflation, as was done shortly after World War I, the Federal Reserve Board (the money-credit policy agency in the United States) continued its easy-money program, apparently influenced by an Administration fearful of a great depression. (Many Keynesian economists then were predicting a relapse into depression, with millions of unemployed.) Inflation continued with only minor cyclical interruptions, each of which was cut short primarily by the continuing flow of hoarded inflationary purchasing media into circulation and secondarily by further monetizing of public and private debt.

By 1958 the economy of the United States, in relation to other leading industrial nations, had become like Community A in relation to Communities B, C, etc., as described earlier in this discussion. Foreign claims on U.S. gold and foreign withdrawals of gold from the Nation's monetary system increased rapidly. Although some understanding of the situation was evidenced by the Federal Reserve Board when it pursued its tighter money policy throughout 1959, this policy was abandoned by mid-1960, apparently because a business recession was developing. Even after the threat of a run on gold occurred in October 1960, the Board failed to force deflation. Foreign claims on U.S. gold have continued to increase, and the status of the dollar has steadily weakened.

III.

THE GOLD STANDARD AND THE GOLD DOLLAR

Elements of the Gold Standard

For a country to be on the full gold standard the following conditions must be met:

1. The standard monetary unit is a fixed amount of gold.
2. All domestic currency and coin are freely exchangeable at their face value for gold, and whoever obtains gold is free to use it in any way he chooses.
3. There is no limit on the amount of gold that may be brought to the mint for coinage.
4. Gold is full legal tender for payment of all obligations.
5. There is no restriction on the importation or exportation of gold.

Variants of the Gold Standard

A country is on a *gold coin standard* when the foregoing requirements are met and its currency and nongold coin are freely exchangeable for gold coins that are multiples of the amount of gold constituting the monetary unit. The dollar, for example, as legally defined, is 15.238 grains of gold, nine-tenths fine. If ten-dollar gold pieces were being minted, each one would consist of 152.38 grains of gold, nine-tenths fine.

In a country that is on a *gold bullion standard*, currency and nongold coin are redeemable in gold bullion at a fixed amount of gold for each monetary unit, the minimum obtainable being the amount in a gold bar of a certain specified weight. When the purpose of this kind of gold standard is to discourage the circulation of gold and so economize in its use, the gold bars in which the currency is redeemable are of considerable weight. For example, when England was on the gold bullion standard from 1925 to 1931, currency could be redeemed only in gold bars weighing 400 ounces. This variant of the gold standard has been objected to on the grounds that "A gold bullion standard is a rich man's standard, operating above, and out of reach of, the man of small means. It would be responsive only to the behavior of the rich man, the banks, other business enterprises, and the government . . . [with a gold coin standard] there is no discrimination against any individual, particularly the man with small capital, and it is most

important that he be able to exercise his preferences and thereby to register his doubts because these are part of the machinery of automatic braking which the gold coin standard provides."¹

In a country that is on the *gold exchange standard*, the domestic currency is redeemable in currencies of foreign countries that are on either the gold coin or the gold bullion standard. Such foreign currencies are used as backing or cover for the domestic currency, often in conjunction with a certain amount of gold. Although the country's monetary system is thus one stage removed from gold, the value of its currency is kept at the established gold parity because of the indirect convertibility of the currency into gold. The principal hazard inherent in this variant of the gold standard is the possibility, which can never be entirely absent, that at some time the currencies of the gold standard countries on which the system depends will be devalued.

The most important features of the gold standard, whether redemption is in gold coin or gold bullion, are the fixed amount of gold in the monetary unit and the freedom with which gold and currency are interchangeable at the Treasury or central bank. Fixity in the amount of gold in the monetary unit makes gold and the currency representing it an efficient medium of exchange and a relatively stable measure and store of value. The free interchangeability of gold and currency by citizens and foreigners alike provides an automatic mechanism that tends to restrain unsound monetary and fiscal practices. Extreme currency and credit inflation is not possible while the rules of the gold standard prevail.

The significance of these features of the gold standard will be considered at greater length in subsequent sections of this study. Here it is sufficient to note that it is the lack of full and free redeemability of U.S. currency for gold that keeps the United States from being on a full gold bullion standard. Although foreign governments and central banks can exchange U.S. currency for gold at the U.S. Treasury, individuals and firms, whether American or foreign, are not allowed to do so, except under license for certain purposes. Thus, the United States, while internationally on a restricted gold bullion standard, is on an inconvertible paper currency standard domestically. This bifurcated departure from the full gold standard has been at the root of the Nation's money-credit problem for three decades.

What Is a Dollar?

An article in the *Financial Times* (London), September 1, 1960, included the following statement: "The U.S. dollar made a further

¹Walter E. Spahr, *The Case for the Gold Standard*, New York, Economists' National Committee on Monetary Policy, 1940, pp. 28-29.

recovery, rising 1/2 cent to regain its peak level of \$35.24-26." Americans who read this surely wondered what it could mean. It must have surprised them to be told that a dollar was \$35.24-26! Moreover, the terms "recovery," "rising," "regain," and "peak level" all misled because they implied that what occurred was favorable to "the U.S. dollar." The sentence quoted epitomizes the confusion of terms, unwarranted connotations, and disregard for accurate definition that are often apparent in discussion of monetary matters.

Perhaps the most common semantic error in the field of money and credit is that due to mistaking *claims* on dollars for the dollars themselves. This error appears in various ways, one of which is the phrase, "the dollar price of gold." Those who use this expression are thinking perhaps of the dollar as a piece of paper currency or a credit to a checking account. However, the fact is that *a dollar is a specified amount of gold*. By authority of the Gold Reserve Act of 1934 the dollar was defined as 15 5/21 grains of gold nine-tenths fine, which is the equivalent of 1/35 of an ounce (troy weight) of pure gold. Paper currency and paper credits are not dollars. They *represent* and may serve as claims upon actual dollars, each of which is the specified amount of gold.

To refer to the dollar price of an ounce of gold is like referring to the price of potatoes in terms of potatoes. It would be foolish to say that the price of a bushel of potatoes is 60 pounds of potatoes. If, however, there were certificates or book credits representing potatoes, one might have to offer in the market place certificates or credits representing 61 or more pounds of potatoes in order to obtain a 60-pound bushel of actual potatoes. This might be the situation if there were some cost or other impediment to the conversion of the certificates or credits directly into the potatoes that they purported to represent. The situation in the London gold market and other gold markets abroad is similar to this whenever the amount of U.S. currency required to obtain an ounce of gold exceeds \$35 plus the cost of obtaining gold from the U.S. Treasury and transporting it to the foreign market.

In the London market British currency is exchanged for gold (subject to certain restrictions, among which is the prohibition of gold purchases by British subjects), but the amount of that currency required to obtain an ounce of gold can be translated easily into an equivalent amount of U.S. currency which a foreign holder who wanted gold could use to buy the necessary British currency in the foreign exchange market.

Thus, the financial reporter quoted above should have said, in order to be accurate, that the amount of U.S. *currency* required to purchase an ounce of gold in London *represented* \$35.24 (or \$35.26). He should have made clear that *two different things* were involved in the exchange.

IV.

HOW THE UNITED STATES WENT OFF THE GOLD STANDARD AND DEVALUED THE DOLLAR¹

The Gold Standard Act

The Gold Standard Act of March 14, 1900 (31 Stat., 45), provided that the dollar, consisting of 25 8/10 grains of gold nine-tenths fine, as established by Section 3511 of the Revised Statutes, "shall be the standard unit of value, and all forms of money issued or coined by the United States shall be maintained at a parity of value with this standard and it shall be the duty of the Secretary of the Treasury to maintain such parity." The weight and full legal-tender quality of the silver dollar remained unchanged. Thus the gold dollar became by law definitely and exclusively the standard monetary unit of value in the United States.

Abandonment of the Gold Standard and Devaluation of the Dollar, 1933-34

On March 4, 1933, a new administration, supported by a strong and determined majority in Congress, took office. Its avowed objective was recovery from the deep depression into which the country had sunk. Its policy was frankly inflationary. Currency expansion, devaluation, and abandonment of the gold standard were part of the program by which it attempted to promote recovery.² Its first step, however, was to meet the banking emergency that had developed in the preceding several months.

On March 6, 1933, a proclamation (48 Stat. 1689) by the President, under authority of the Trading With the Enemy Act of October 6, 1917 (40 Stat. 411), ordered all banks closed for 4 days in view of the national emergency "and in order to prevent the export, hoarding, or earmarking of gold or silver coin or bullion or currency * * *."

The Emergency Banking Act of March 9 (48 Stat. 1) approved

¹The material in this section, except for minor changes, principally to bring it up to date, is taken from a supplement to the testimony of E. C. Harwood, of American Institute for Economic Research, before a Subcommittee of the Committee on Banking and Currency of the U.S. Senate in 1954. See *Gold Reserve Act Amendments*, Hearings, 83d Cong., 2d Sess.

²"Never before had a great and wealthy nation voluntarily debased its currency to test whether or not the change would result in trade expansion, business stimulation, and enhanced social well-being." Leonard P. Ayres, *The Economics of Recovery*, New York, The Macmillan Company, 1933, p. 122.

the proclamation of March 6 and, because of "a serious emergency", extended the President's wartime power with regard to the export, circulation, and hoarding of gold. It authorized the Secretary of the Treasury, when he deemed it necessary, to require all persons or corporations to deliver gold coin, gold bullion, and gold certificates to the Treasury in exchange for other forms of coin or currency.

By a proclamation on March 9 (48 Stat. 1691), the bank holiday and the embargo on gold were continued.

An Executive order⁸ (No. 6073), dated March 10, empowered the Secretary of the Treasury to permit the reopening of banks under licenses to be issued by him. It prohibited "until further order" the export of "any gold coin, gold bullion, or gold certificates, except in accordance with regulations prescribed by or under license issued by the Secretary of the Treasury." It also provided that "no permission to any banking institution to perform any banking functions shall authorize (it) * * * to pay out any gold coin, gold bullion, or gold certificates except as authorized by the Secretary of the Treasury."

From March 6 until the promulgation of this order the Nation was completely off the gold standard, for gold could not be obtained either for domestic purposes or for making international settlements. This order, however, in a measure lifted the embargo by permitting gold exports under license by the Secretary of the Treasury. Under its provision some gold was exported to settle trade balances. For a short time a very limited gold standard, with respect only to international settlements, was thus permitted.

In an Executive order (No. 6102) dated April 5, the President prohibited "the hoarding of gold coin, gold bullion, and gold certificates." Every person possessing gold in these forms was required to exchange it for other coin or currency. Banks were required to deliver gold and gold certificates held by them to the Federal Reserve banks and receive credit or payment. Rules for enforcing the order were set forth, and certain exceptions were specified. Gold could be used in industry, the professions, and the arts. Gold and gold certificates held in amounts of less than \$100, and also "rare and unusual" gold coins, were exempted. Possession of "gold coin and bullion earmarked or held in trust for a recognized foreign government or foreign central bank or the Bank for International Settlements", as well as "gold coin and bullion licenses for other proper transactions" was permitted.

⁸Throughout 1933 and January 1934, the following Executive orders were issued with respect to the hoarding, payment, export, and sale of gold; the consignment and sale of newly mined gold; gold coin collections; and export of gold certificates; March 10, 1933, No. 6073; April 5, 1933, No. 6102; April 20, 1933, No. 6111; August 28, 1933, No. 6260; August 29, 1933, No. 6261; October 25, 1933, No. 6359; January 12, 1934, No. 6556; and January 15, 1934, No. 6560.

By this order the Nation was, in effect, completely off the gold standard, for gold could not be obtained to make settlements except as specified. On April 20, an Executive order (No. 6111), establishing an embargo of indefinite duration on shipment of gold to foreign countries, made it entirely clear that the gold standard had been abandoned.

The so-called Thomas inflation amendment to the Agricultural Adjustment Act of May 12 (48 Stat. 31) gave the President authority, "in his discretion," to reduce the gold content of the dollar by not more than half, authorized him to initiate unlimited coinage of silver at whatever ratio to gold he might determine, and permitted him to direct the Secretary of the Treasury to issue \$3 billion of United States notes to be put in circulation by purchase or redemption of Government securities and to be retired and canceled at the rate of 4 percent annually. Another provision of the amendment authorized an arrangement with the Federal Reserve banks to expand credit by purchasing \$3 billion of Government securities.

This legislation not only delegated to the Executive the constitutional power of Congress to coin money and regulate its value, but it permitted him to devalue the standard dollar, institute a bimetallic standard, and issue "greenback" currency (United States notes) identical with that which had been authorized and issued during the Civil War, but in a vastly larger amount.⁴

As a result of the restrictions placed upon gold, the administration was confronted with the fact that many obligations, public and private, contained a clause specifically promising payment in gold, yet it was now impossible for debtors to acquire the gold to meet those obligations.

Congress, therefore, at the behest of the President, declared by joint resolution, on June 5 (48 Stat. 112), that any obligation giving "a right to require payment in gold or a particular kind of coin or currency, or in an amount in money of the United States measured thereby, is declared to be against public policy; and no such provision shall be contained in or made with respect to any obligation hereafter incurred. Every obligation, heretofore or hereafter incurred * * * shall be discharged upon payment, dollar for dollar, in any coin or currency which at the time of payment is legal tender for public and private debts. Any such provision contained in any law authorizing obligations to be issued by or under authority of the United States, is hereby repealed. * * *"

⁴The act cited the legal-tender legislation of that period as the basis for the President's authority to issue such currency. It also provided that the United States notes authorized by it "and all other coins and currencies heretofore or hereafter coined or issued by or under the authority of the United States shall be legal tender for all debts public and private."

The resolution amended the legal-tender provision of the Thomas amendment to the act of May 12 to read as follows: "All coins and currencies of the United States (including Federal Reserve notes and circulating notes of Federal Reserve banks and national banking associations) heretofore or hereafter coined or issued, shall be legal tender for all debts, public and private. * * *"

By this joint resolution of Congress the gold clause in all existing private and governmental contracts and obligations was abrogated.

By an Executive Order (No. 6359), dated October 25, 1933, the gold purchase plan was initiated in order to drive down the value of United States nongold currency in terms of gold on the theory that a higher "price" for gold would bring an increase in the general price level. It authorized the Reconstruction Finance Corporation to buy newly mined domestic gold "subject to such regulations as may from time to time be prescribed by the Secretary of the Treasury." Periodically the "price" of gold in terms of irredeemable paper currency was raised from \$31.36 per fine ounce on October 25, 1933, to \$34.45 on January 16, 1934.

The Gold Reserve Act of January 30, 1934, required the Federal Reserve banks to transfer all gold held by them to the Treasury for gold certificates; it amended the Act of May 12, 1933, by providing that the weight of the gold dollar should not be set "at more than 60 per centum of its present weight"; it required all monetary gold to be converted into bullion and prohibited the minting of United States gold coins; domestically the exchange of other forms of money for gold was forbidden, but foreign governments and central banks were permitted to obtain gold bullion in exchange for United States currency; it empowered the Secretary of the Treasury to buy and sell gold at rates that he deemed advisable and to issue regulations for the use of gold in industry and the arts, for foreign shipment, and for other purposes; it established a stabilization fund from the increment obtained by the reduction in weight of each dollar;⁵ it made Federal Reserve notes redeemable only in "lawful" money; it gave the President power to alter the weight of silver and other subsidiary coins to the same extent as the gold dollar and to issue silver certificates against overvalued silver; and it authorized the Federal Reserve banks, with the President's approval, to increase or decrease reserve balances maintained by the member banks.

The devaluation of the gold dollar was made effective by a proclamation of the President (48 Stat. 1730) on January 31, 1934, which

⁵The Government's profit through acquisition of the Nation's monetary gold (most of which was obtained at the rate of \$20.67 per ounce and all of which was revalued at \$35 per ounce) was approximately \$2.8 billion. Of this amount, \$2 billion was used to establish a stabilization fund to support the dollar in international exchange markets, 645 million was used to retire national-bank notes, and the remainder was applied to other purposes.

established the weight of the gold dollar at 15 5/21 grains, nine-tenths fine. This reduced its gold content by 40.94 percent.⁶

As a result, an ounce of fine gold (480 grains) could be coined into 35 dollars, compared with 20.67 dollars before the devaluation. This was a 69.3 percent increase in the number of dollars that could be minted from a given quantity of the metal.⁷ At the same time the Secretary of the Treasury issued regulations governing the use of gold and announced that he would buy and sell gold at \$35 per ounce subject to one-fourth of 1 percent handling charge.

Although the Silver Purchase Act of June 19, 1934 (48 Stat. 1178), did not bear directly on the status of the standard gold dollar, it was a significant part of the monetary legislation of the period in much the same way as other measures that sought to increase the amount of irredeemable currency in circulation.⁸ The act directed the Secretary of the Treasury to buy silver at prices set by him until the amount of silver in the Treasury was equal in value to one-fourth of the total value of all gold and silver held by it, or until the price of pure silver rose to \$1.2929 per ounce. Subsequent legislation extended this subsidization of silver, but a comparatively small part of the amount designated by law was acquired.

In the period March 6, 1933, to January 31, 1934, two distinct changes were made in the United States monetary system: (1) The suspension of specie payments, whereby the currency could no longer be freely exchanged for gold, removed the Nation from the gold standard, and (2) the devaluation of the dollar reduced its gold content by 40.94 percent. The status of the standard monetary unit with respect to both these changes during that period can be summarized as follows:

March 6 to October 25, 1933 — Suspension and the natural depreciation of an inconvertible currency.

October 25, 1933, to January 16, 1934—Suspension and enforced depreciation of the currency.

January 16 to January 31, 1934—Suspension without further enforced depreciation.

January 31, 1934 — Devaluation.

The Gold Clause Decisions

On February 18, 1935, three decisions of the Supreme Court deter-

⁶That is, the gold content of the new dollar was 59.06 percent of the old. The weight of the gold dollar was thus changed from 23.22 to 13.714+ grains of pure gold, or from 25.8 to 15-5/21 grains of standard gold 0.900 fine.

⁷The expectation that devaluation would cause an increase in exports, a decrease in imports, and a rise in the domestic price level was not realized. Imports actually increased more than exports in the next several years, and the price level did not rise to correspond with the cheapening of the dollar.

⁸Silver certificates issued against silver held in the Treasury are convertible into silver dollars; but neither the certificates nor the silver dollars can be exchanged for gold.

mined the constitutionality of the Joint Resolution of June 5, 1933, whereby the gold clauses in many public and private obligations had been abrogated.

The first decision concerned two cases arising out of certain railroad bonds that specified payment in gold dollars of a certain weight and fineness. In a five-to-four division of the Court it held that the clauses in question interfered with the constitutional authority of Congress to regulate the value of money. The majority opinion stated: "The contention that these gold clauses are valid contracts and cannot be struck down proceeds upon the assumption that private parties, and States and municipalities, may make and enforce contracts which may limit that authority." (*Norman v. Baltimore & Ohio Railroad*; and *United States et al. v. Bankers Trust Co. et al. Trustees*, 294 U.S., 240).

The second decision (*Nortz v. United States*, 294 U.S., 317), was upon an action for damages against the United States by an individual who had been in possession of gold certificates at the time they were called in by the Government. The plaintiff asserted that the market price of gold on the date that he had presented the certificates for payment (January 17, 1934) made the gold represented by the certificates more valuable than the currency received for them. By a five-to-four decision the Court denied the claim. The gist of the majority opinion was that a gold certificate is not a warehouse receipt or a contract for a certain amount of gold as a commodity, but is currency; that Congress has complete authority over the currency system, including authority to provide that all gold bullion, coin, and certificates shall be taken over by the Government; and that the plaintiff did not suffer actual loss, for if gold had been paid to him he would have had to surrender it to the Treasury; and that, furthermore, a free market for gold did not exist at the time.

In the third decision (*Perry v. United States*, 294 U.S., 330) the Court determined the constitutionality of the Joint Resolution with respect to the gold clause in obligations of the United States Government. The owner of a \$10,000 Liberty Bond, which had been called for redemption with payment at its face value in currency tendered by the Government, sought damages in the amount of \$6,931.25 on the grounds that he had been deprived of property without due process of law. In a unanimous opinion the Court held that the gold clause was binding upon the Government and that legislation abrogating it was unconstitutional. It stated: "There is a clear distinction between the power of the Congress to control or interdict the contracts of private parties when they interfere with the exercise of its constitutional authority and the power of Congress to alter or repudiate the substance of its own engagements when it has borrowed money under the authority which

the Constitution confers." No damages were allowed, however, because the plaintiff did not show definite loss in relation to buying power.

For a period of 6 months after August 27, 1935, Congress permitted suits against the Government in the United States Court of Claims. Claimants, however, could not prove damages in terms of purchasing power, for up until that time no substantial rise in prices had occurred.

Other, later decisions of the Supreme Court upheld the constitutionality of the Joint Resolution of June 5, 1933. In *Holyoke Water Power Company v. American Writing Paper Company* (300 U.S., 324), decided March 1, 1937, the Court held that under a contract calling for rental payments in gold of a specified weight and fineness or its equivalent in currency the lessee's obligation "was for the payment of money, and not for the delivery of gold as upon sale of a commodity." In *Guaranty Trust Company, Trustee v. Henwood, Trustee, et al.* (307 U.S., 247), decided May 22, 1939, the Court held that bonds originally issued in the United States but payable at the option of the holder abroad in a specified amount of a foreign currency based on a former exchange equivalent "are domestic obligations, to be interpreted and enforced according to the law of this country * * * (and) are payable dollar for dollar in present legal tender." In *Bethlehem Steel Company v. Zurich General Accident & Liability Insurance Company* (307 U.S., 265), decided May 22, 1939, the Court held that bonds of an American corporation sold in the United States, payable at the option of the holder in a fixed amount of foreign currency, but purchased by foreign companies after the effective date of the Joint Resolution, were subject to the Resolution and "payable dollar for dollar in United States legal tender."

The Present Status of the Standard Monetary Unit of the U.S.

By the Gold Reserve Act of January 30, 1934, and the measures taken to implement it, a new legal monetary unit was established for the United States, and the Nation was provided with "a currency system of a type substantially different from any ever before known throughout the world's monetary history."⁹ The coinage of gold, the circulation of gold and gold certificates within the United States, the free redemption of currency in gold, and dealing in or holding gold except under license by the Treasury are forbidden. The Treasury, however, is empowered to buy and sell gold and to make gold bullion available, under license, for settling international balances. As the act forbade further coinage of gold and directed that all gold coin be melted into bars, the required security for gold certificates, United States notes, and Treasury notes of 1890 is bullion instead of coin. Gold certificates are the final reserves of

⁹Edwin Walter Kemmerer, *Gold and the Gold Standard*, New York, McGraw-Hill Book Co., 1944, pp. 128-129.

the Federal Reserve banks; and the Federal Reserve notes are redeemable only in "lawful money"¹⁰ rather than gold. (Although the purchase, holding, and sale of gold abroad by Americans was permitted under the Gold Reserve Act of 1934, these were later forbidden by Executive Order, January 14, 1961.)

The power of the President to vary the gold content of the dollar within a range of 50 to 60 percent of its former weight expired on July 1, 1943. Nevertheless, the Gold Reserve Act of 1934, in section 8, still permits the Secretary of the Treasury, with the President's approval—and in Section 9 without his approval—to alter the price of gold. Legally, it may be held that these sections of the Gold Reserve Act have been repealed by the Bretton Woods Participation Act of July 31, 1945 (59 Stat. 512), which sets forth the terms for United States participation in the International Bank for Reconstruction and Development and the International Monetary Fund. In that act (sec. 5) provision is made that "Unless Congress by law authorizes such action, neither the President nor any person or agency shall on behalf of the United States * * * propose or agree to any change in the par value of the United States dollar * * * or approve any general change in par values * * *."

For three decades the United States standard gold dollar or monetary unit has been one thirty-fifth of an ounce of fine gold. The Nation and, in fact, the world have become adjusted to a dollar of that weight. The reduction in the dollar's gold content from approximately 1/21 of an ounce to 1/35 being long an accomplished fact, whatever inequities or injustices were wrought by the change they cannot now be corrected by a return to the former, heavier, gold dollar. Such a change would cause other and greater inequities, create serious maladjustments domestically and abroad, and make almost impossible—at least for years to come—a return to the gold standard by the United States and by other nations.

Under prevailing laws all forms of U.S. currency and coin are full legal tender. The only "lawful money," however, that can serve as reserves against Federal Reserve notes and deposits is gold certificates, and they are prohibited from being paid out. Thus, domestically, the United States is on an irredeemable paper standard.

¹⁰Prior to the act of June 12, 1945 (59 Stat. 237), all currency and coin except Federal Reserve notes were lawful for reserves against deposits in Federal Reserve banks, but only gold certificates were lawful as reserves against Federal Reserve notes. That enactment made gold certificates the only lawful money for reserves against Federal Reserve notes and deposits. Yet gold certificates cannot be used to redeem Federal Reserve notes or pay depositors at the Federal Reserve banks! Foreign central banks can, however, convert their Federal Reserve notes and deposits into gold.

¹¹Under art. IV, secs. 5 and 7, and art. XX, sec. 4, of the articles of agreement of the Fund.

V.

ECONOMIC BENEFITS
OF THE GOLD STANDARD

More than six decades have elapsed since the Great Commoner denounced the gold standard in these words, "You shall not press down upon the brow of labor this crown of thorns. You shall not crucify mankind upon a cross of gold."

Bryan was defeated by McKinley in 1896, and fiat money notions were temporarily sidetracked. Nevertheless, time has proved that Bryan was a prophet whose words would be honored even in his own country. All the leading nations of Western civilization were on the gold standard when Bryan's prediction was made, but in less than 20 years the departure from the gold standard had begun. By 1934 even the United States had set aside the "cross of gold."

In the nearly three decades since that event, how has the Nation fared; what important benefits have men lost by setting aside the so-called "cross of gold"? One clue to the answer is impressive.

Black markets in gold and currencies have become commonplace. In 1951 Dr. Franz Pick prepared a report on world black-market prices and trading in currencies and gold.¹ This book is dedicated to "the more than 2,000,000,000 victims of inflation, who, for obeying the law, have been punished by the law."

In his foreword, Dr. Pick reported:

"Distrust of every system of planned economy, fictional official values of gold, currency, and government bonds cannot be wiped out. People cannot and will not accept arbitrary confiscation through inflation, as practiced by every government in the world today.

"During the last 13 years, the paper currencies of 11 countries * * * serving 729,000,000 people, were destroyed by complete depreciation.

"During the past 12 years, 20 other principal currencies, trading, wage, and saving units of 718,000,000 human beings, lost 50 percent and more of their value.

"During the last 27 months, under the increasing pressure of international rearmament, at least 55 currencies have undergone legal devaluation. This is a rather technical expression for the much simpler term of 'partial or complete state bankruptcy.'"

¹Franz Pick, 1951 *Black Market Yearbook*, published by Pick's World Currency Report, New York.

And in another report 8 years later,² Dr. Pick discussed the continuation of the inflations and devaluations that were debasing the currencies of most nations (17 in the preceding 12 months). He pointed out that "Most nations are still reluctant to accept limitations of their expenditures and to balance fiscal outlays. The temptation to print banknotes and bonds or to draw huge amounts from the central banks against non-existing funds still prevails during all monetary emergencies of the majority of the lands of the capitalistic world. These techniques, favoring the creation of debts by methods of pure inflation, will not cease. The curse of floating bonds of constantly shrinking purchasing power will continue to expropriate all those who, either through lack of knowledge or under the unethical pressures of so-called patriotism, have acquired these certificates of guaranteed confiscation. * * * Therefore, for as long as can be forecast, currencies are going to be used as instruments to expropriate all those who believe in their stability."

Thus we see that harm has resulted from putting aside the "cross of gold." The available evidence indicates that men should have more faith in gold than in the promises of their more or less representative governments and that the gold standard offers economic benefits that have been inadequately appreciated by its opponents.

Nevertheless, in discussing the economic benefits of the gold standard, we should face frankly the fact that it is not a panacea for all economic ills. Those who offer patent medicines alleged to be cures for all the physical ailments of mankind have long been regarded as quacks. So likewise should we regard individuals who offer any single simple remedy for all economic ills.

Particularly important is it to realize that there are both short-term and long-run economic problems, the business cycles of boom and depression as well as the long-term trends. The major economic benefits of a return to the gold standard will not include solutions for all present or short-term economic problems but will be related more definitely to the industrial progress and even the survival of the United States in the longer run.

Inhibiting Unwise Fiscal and Banking Policies

Readers who think that an inflationary trend may be quickly reversed by some happy coincidence of events may be underestimating the temptations involved. In France and most other nations the takings of government-planned embezzlement through depreciation of the currency have been relatively small, because the savings and life insurance of the citizens

²*Pick's Currency Yearbook*, 1959, published by Pick Publishing Corporation, New York, 1959.

have been only a fraction of the amount per capita here in the United States. In the United States the present value of life insurance policy reserves, Social Security trust funds, individual holdings of Government and other bonds, and the savings accounts of American citizens approximates \$500,000,000,000. This can readily be stolen by the subtle processes of inflating and repeated devaluations.

If redeemable currency were restored, the wiser and more farsighted of the Nation's citizens who saw the dangers in unsound fiscal or banking policies could demand gold, and Treasury and bank officials ordinarily would act with awareness of this fact. A possible resulting outflow of gold would force the Federal Reserve authorities and the Government to reconsider unwise policies.

Instead of depending on the wisdom of a selected few who might err disastrously, the Nation would provide freedom of action for the many hundreds of thousands of its wisest citizens who presumably can best foresee the probable effects of unwise policies and so act as to counteract those policies. In the absence of the combined judgment of a multitude of keen and experienced observers, there may be no effective check on unwise policies until they have resulted in serious disaster. No truly wise monetary authority or fiscal policy maker should want to be without such an important guide to policy as a redeemable currency provides, any more than a sensible automobile driver would want to discard speedometer and brakes.

Although all money-credit systems require some control, if only to prevent abuses, the automatic features of the gold standard give early warning of credit abuses or unsound procedures and therefore facilitate corrections by a minimum of management. Because it minimizes the excuse for controls, the gold standard is especially disliked by those who seek to enmesh the economy in a network of socialistic restrictions.

The Federal Reserve Board should be free to act when there are warning signs of unsound financial developments. An independent agency to provide the minimum degree of appropriate control has been proved by long experience to be the only effective means of managing a nation's money-credit system.

Confidence in the future worth of the dollar is essential to long-term Government financing. Experience has shown that a nation that meets its promises to pay enjoys the best credit standing. When the United States resumed gold redemption of its currency in 1879, one immediate and striking result was the reestablishment of the Government's credit standing. Government bonds could be floated at substantially lower interest rates.

Redeemable promises to pay presumably would not be issued as recklessly as irredeemable promises might be, in fact usually have been.

Throughout the course of history, governments relieved of fulfilling their promises to redeem currency on demand sooner or later have taken advantage of such an invitation to reckless irresponsibility.

The fixed amount of gold in each dollar has a relatively stable purchasing power in the long run. Specifically, when not disturbed by the inflating or deflating of other purchasing media, the exchange value of gold has remained remarkably stable for generations. Changes in prices based on gold usually have been gradual rather than seriously disruptive.

When prices continue rising in a country on the gold standard, gold tends to move out from the reserves securing currency and bank deposits, thereby limiting or preventing the further expansion of credit and a subsequent rise in prices.

Gold is universally accepted as a medium of exchange. Even when practically all nations of the world have been "off the gold standard" as far as domestic redeemability was concerned, they have sought gold; and the people of the world, whenever there was widespread fear of monetary depreciation, have done likewise. Gold is universally recognized as a valuable substance that does not deteriorate in storage. The fact that a currency is convertible into gold should assure for that currency virtually the same value in exchange and acceptability as gold itself. Such was the Nation's experience for the several decades during which the United States adhered to the full gold standard. Moreover, history shows that experiments with managed paper-money standards, tried by many of the principal nations of the world in the past 250 years, inevitably failed.

Restoration of Investors' Confidence

Another important benefit of the full gold standard would be a restoration of confidence, among those who save, in the future value of their savings. Here in the United States, the small annual savings of individuals, largely accumulated by those who labor, reach an astronomical total each year. For example, during 1962 individuals saved more than \$25,000,000,000.

Since mid-1950 the confidence of small investors in the future value of United States savings bonds seems to have decreased. Redemptions have exceeded sales with the result that the total held has decreased about 15 percent in the past decade.

To what extent the cashing of savings bonds has reflected distrust of the future value of the dollar, no one knows. Nevertheless, long experience in many countries of the world clearly indicates that such developments, on a much larger and far more devastating scale, are to be expected when public confidence in money diminishes. As our Nation figuratively walks a monetary tightrope above the abyss of national disaster, little imagination is required to visualize the torrent of demand

that could flood the Nation's market places if fear finally impelled the multitude of small savers to buy goods, whether needed or not, as an alternative to seeing the value of their savings rapidly diminish.

Also to be considered in this connection is the desirability of ending the search for "hedges" against inflation. Small investors are faced with the question, How much of my funds should I invest in such a way that I will be protected against continuing depreciation? Unfortunately it is those individuals who can least afford to take the risks that all equity investments involve who may not have enough income, even for the necessities of life, unless they risk such losses in the hope that an increasing income will offset any further rise in living costs.

When assured of the future value of their savings, men have confidence and are willing to invest. Such confidence and the resulting long-term commitments facilitate orderly progress. When they have a fixed standard and a redeemable currency the future of which is not being questioned, men can recognize "bargains" and act accordingly. Probably this accounts in part for the fact that firm adherence to the gold standard has invariably hastened recovery from business depressions.

When there is no fixed standard and redeemable currency or its future is in question, men have an inadequate basis for judging "bargains" accurately. Consequently, they hesitate to make commitments; and while potential employers hesitate, the unemployed wait in government-induced idleness. Such was the Nation's experience during the money-juggling years after 1932.

Ending Adjustments for a Fluctuating Dollar

Another benefit that could result from return to the full gold standard is the ending of those statisticians' nightmares, the adjustments of indexes for fluctuations in the value of the dollar. Of course, the gold standard would not prevent in the future, any more than it did in the past, the serious distortions of economic values that are attributable to credit inflation and deflation, (the twin evidences of incompetent and unwise banking). Such distortions, however, are relatively limited in magnitude and duration as long as a fixed gold standard is maintained. Return to the gold standard would make unnecessary the elaborate efforts to adjust statistical value-series that have been necessary in recent years.

Without adequate bases for economic comparisons even the simplest representations by labor seeking a higher wage or by capital seeking a greater reward become almost unintelligible. The complications resulting from adjustments for a rubber dollar are to many people incomprehensible.

Thinking for the moment only of labor's aspect of the problem, we should ask how John Doe is to judge what a pension payable in 1980

dollars is worth to him today? Will the dollar he knows today shrink in value as rapidly as the dollar has during the past two decades, perhaps even more? If so, what is the use of Social Security and company pension benefits anyway? Is the whole game of trying to provide for the distant future to be a fruitless one that few laboring men can hope to understand?

But labor is not the only economic factor cheated by the fluctuating dollar. When plant depreciation charges are based on values long outdated by a shrinking dollar, capital likewise loses. The ordinary books of account reveal profits that are illusory and encourage policies that ultimately can lead many business firms into bankruptcy.

When both parties to a contract have a fixed standard unit as the measure of their respective obligations, they can judge the risks involved far more accurately than when their contract promises are stated in the necessarily vague and fluctuating terms of a managed currency.

Although, under the gold standard, the buying power of the dollar may be distorted temporarily either by unsound credit expansion (inflation) or the collapse of such unsound credit expansion (deflation), in the long run the exchange value of gold varies relatively little; no other medium of exchange as yet has proved to be so stable.

In the long run, with an irredeemable paper-currency system, the inevitable distortions of economic value judgments are reflected in the attitudes of individuals and business organizations. Expedient adaptation to the exigencies of the near future becomes the dominating policy; long-range considerations are forgotten or disregarded. When such views predominate, will the United States continue to be one of the leading nations of the World?

Lifting the Veil That Conceals Basic Economic Problems

Another economic benefit that would result from returning to the full gold standard would be removal of the "money veil" or "money illusion" that conceals from most people the Nation's basic economic problems. Removing the "veil" would not *guarantee* that those now in a position to solve the problems would see them clearly and promptly take appropriate actions, but throughout the Nation many for whom the problems were clarified might press in various ways, including the political, for their solution.

For example, the present monopoly power of organized labor in basic industries may not be understood by the general public as long as inflationary additions to the supply of purchasing media readily permit wage and price increases. This monopoly power has been made possible by discriminatory statutes and abused by some labor leaders with despotic

control on an industrywide basis. While the inflationary process goes on, however, such monopoly becomes more firmly entrenched, more determined to get an increasing share of the wealth produced. The longer the public remains blind to the issue, the more difficult and disruptive the final settlement probably will be.

Insofar as the depreciation charges of business are based on prices lower than those currently prevailing and are therefore inadequate for the replacement of capital equipment, business profits are in part illusory; they reflect a hidden consumption of capital.

Taxes based on illusory gains are destructive of real wealth. They hamper the sound growth of the economy, the continued growth that appears to be essential to survival in the world as we know it today.

An inflation-stimulated boom is not sound prosperity. There have been several such booms in the Nation's history, and all have been followed by severe depressions. Never have managers of a "managed irredeemable money" been able to create a sound and lasting prosperity.

The creation of deposits and currency based on Government debt and noncommercial bank loans does not create real wealth. Such a procedure only deludes those who strive to measure and exchange wealth, and it invites overspeculation; paper gains are lost in the inevitable depression aftermath.

Men are free to the extent that the culture or society in which they live permits them to plan and choose their goals, provides equality of opportunity to act effectively in pursuit of those goals, and permits them to retain the fruits of their labors. There is much evidence to indicate that increasing departure from economic freedom is destroying Western civilization, including our own country; but the economic relationships involved are so obscured by the veil of manipulated money that all too few have any understanding of what the Nation's greatest economic problem is.

"To Promote Maximum Employment, Production, and Purchasing Power"

The experience of history shows that an irredeemable currency endangers the economic system that uses it. Innumerable instances testify to the truth of this assertion, and none refute it. A fixed monetary standard, on the other hand, facilitates the achievement of equilibrium among the economic factors of production, without which there can be neither full employment nor optimum output of products to be purchased.

Only if labor has a fixed and simple standard of value free from the misconceptions attributable to a depreciating currency can it judge the real value of its present gains and possible future pension benefits.

¹The declared purpose of the Employment Act of 1946.

The efforts of those who labor to obtain Social Security benefits and company pensions will be fruitless if the depreciation of the dollar continues at the rate of the past two decades.

John Maynard (Lord) Keynes, who was a leader among the advocates of a so-called "managed irredeemable currency," openly avowed that his scheme was a means of deceiving those who labor and who neither pretend to understand nor are in a position to take advantage of the vagaries of "managed" irredeemable paper money. (See Keynes' *The General Theory of Employment, Interest, and Money*, Chapter II, Part 2.) Only the shrewd speculator and the man of great wealth can expect to profit in the long run from a "managed" irredeemable currency.

In the absence of a fixed monetary standard and a redeemable currency the pressure for continued inflation tends to rob those who have the least economic power, depleting the only resources they have. The widows and orphans, the elderly and the ill in health, are virtually defenseless against the ravages of a depreciating dollar that diminishes the buying power of their savings and depreciates the values of life insurance and annuities.

Technological progress, given a fixed monetary unit and sound fiscal and banking policies, ordinarily would result in a gradual lowering of costs and prices that would benefit all consumers. Especially beneficial would this be for those whom most men strive hardest to protect, their potential widows and their children.

Facilitating Long-Term Industrial Progress

But of all the benefits to be expected from a return to the full gold standard, perhaps the most important in the present and foreseeable future would be the achievement of the most rapid rate of long-term industrial growth that the economy can sustain. We do not imply that a return to the gold standard alone would ensure this highly desirable outcome (future military strength will, even more than in the past, depend on industrial progress); but failure to restore the gold standard almost certainly will prevent the optimum rate of economic growth.

Restoration of the full gold standard would, in all probability, be followed by a long-term downward trend of prices that might continue for some years as the inflationary purchasing media now in circulation were slowly eliminated. That a long-term downward trend of prices could be a greater aid to industrial progress than continually rising prices may surprise many who have accepted the widely publicized notion that the reverse is true.

However, as has been true of many widely accepted notions, the idea that perpetually rising prices are better than falling prices in the interests of an expanding economy in the long run seems to have no basis in

recorded economic experience and lacks even theoretical justification. As far as can be discovered, the only seemingly valid argument in support of this notion is based on the fact that prices usually rise during the recovery phase of business-cycle changes. But business cycles are short-term changes; we must turn to other considerations to learn the truth about the relation between rising or falling prices in the long run and economic progress.

First, what light can be obtained from a brief review of the relationships that appear to be involved? Industrial progress results from taking advantage of the scientific and technological advances that make possible more effective use of the three basic factors of production: land, labor, and capital. Now the scientific and technological advances are not distributed evenly over all industries or all types of industries, nor are they evenly distributed over all the companies in any one industry. Therefore, in order to derive the utmost industrial advantage from new developments, land, labor, and capital must be shifted from those companies, industries, and types of industries where the scientific and technological advance is slow or nonexistent and must be moved into the companies and industries where the technological advance is the most rapid and most fruitful at particular times.

As it happens, only one effective way to judge the relative economic worth of various technological changes has been discovered, and that is the test of relatively free competitive markets. Continually rising prices induced by more and more inflating as a long-run policy have the effect of permanently distorting the markets as long as the policy is continued. Under such circumstances, Company A, if it is leading the technological advance, will enjoy not only the profits attributable to that leadership but also the "windfall" profits attributable to inflation. Company B, if it is lagging in the technological advance, might be experiencing losses in the absence of inflation, but under the conditions assumed might be able to report profits in spite of its inability to keep up with the technological progression.

Under the circumstances just described, what will happen? The management of Company A will of course try to expand rapidly and will have profits available that can be used for that purpose. But A can expand its plant and labor force only by bidding a higher price for the three economic factors than B can. If B is encouraged by inflationary profits to continue its existing rate of operations or perhaps even expand somewhat, from what source can A get those factors of production?

One would expect industrial growth to be hampered by such conditions, because resources cannot be shifted readily to more effective uses from inefficient companies that continue to operate.

On the other hand, when technological progress is reflected in a price level not artificially supported by inflationary monetary manipulation and accompanying currency depreciation, one could expect the long-term trend of prices to be downward, gradually perhaps, but nevertheless downward. And the absence of inflation, accompanied by a downward trend of prices, would prevent windfall profits in the lagging companies and industries, which would experience losses. Such concerns would be forced to release land, labor, and capital to other uses. The shifts that must be made if industrial progress is to be at the optimum rate will then be readily effected. Surely there are few facts more obvious than that the price of progress is *change*.

So much for theoretical aspects of the problem. Is there any proof that the reasoning offered is sound?

In 1879, 14 years after the end of the Civil War, the United States returned to the gold standard. For the decade of the 1870's, the average level of commodity prices measured by one comprehensive index was 117.5. For the three successive 5-year periods beginning with 1880-84, the average levels of commodity prices measured by the same index were 101, 84, and 78. The decline was almost continuous, and by the end of the 15-year period following 1879, prices were down 40 percent from the average level for the 1870's.

During the same period industrial production increased at the most rapid rate for the most prolonged period in the Nation's history. Specifically, if the average physical volume of manufacturing production for the 1870's be considered the base or 100-percent level, the average index numbers for each of the next three successive 5-year periods were 158, 196, and 245. In 15 years the gain was 145 percent, more than 6 percent compounded annually. Moreover, for 11 of the 15 years, industrial production remained well above the estimated long-term trend. These developments showed how groundless were the widespread fears, preceding the return to a currency redeemable in gold, that resumption of the gold standard would be calamitous and that a prolonged fall of prices must inevitably be accompanied by industrial stagnation.

Lest the foregoing be misunderstood, we should make clear that the figures just presented are not offered as conclusive proof that the preceding theory is sound. But the facts of history seem to place the burden of proof on those who sponsor and defend the Nation's long-continued, inflationary monetary policies, who urge that prolonged inflating and continually rising prices will ensure rapid long-term industrial progress.

We have a right, even a duty, to ask the proponents of inflation, Are you not denying to your country the known and demonstrable benefits of a sound monetary system; are you not jeopardizing the industrial progress on which our survival in a possibly hostile world will have to depend?

Maintaining the Freedom of American Citizens

Foreign governments and central banks can obtain gold on demand in exchange for the Government's promise on our paper currency to make such payments; but American citizens cannot obtain from their Government fulfillment of its specific promise to pay on demand. All Federal Reserve notes, which constitute most of our present currency, carry the unequivocal pledge that the United States "will pay to the bearer on demand" the number of dollars indicated. Instead of giving to the bearer on demand the dollars promised, the Treasury merely will give other paper promises to pay dollars. Such subterfuge, the substitution of promises for promises instead of the thing promised, is unworthy of a great Nation and an honest people.

A fully redeemable currency would restore to the people some degree of control over unsound banking and spendthrift government. Since the departure from the gold standard in 1933, the people of the United States have lost, in large part, their control over the public purse. The full gold standard would restore that control and help prevent the large losses that continuing inflation causes. It would help to preserve the system of free enterprise and free markets that has made the Nation the leading industrial power of the world, and without which the people cannot remain free. It would provide the best assurance that this Nation would remain free and would continue to grow stronger than its enemies.

VI.

QUESTIONS OFTEN ASKED ABOUT GOLD AND THE GOLD STANDARD

What Is the Role of Gold in the U.S. Money-Credit System?

All of the country's monetary gold is in the possession of the Treasury, at Fort Knox and elsewhere. Claims upon most of it, in the form of gold certificates amounting to about \$15.5 billion, are held by the 12 Federal Reserve banks. These certificates and other assets (principally Treasury securities) of the Reserve banks are balanced by liabilities including the currency (Federal Reserve notes) that they issue and the deposits that they hold. In November 1963 the ratio of gold certificate reserves to the combined note and deposit liabilities of the Federal Reserve banks was about 30 percent. Three years before it was about 38 percent. The statutory minimum reserve ratio originally was 40 percent but in recent years has been 25 percent and of course may be any percentage that Congress may choose to establish. Treasury currency also, except silver and silver certificates, is partially backed by gold.

How Does Gold Become a Part of the Money-Credit System?

Gold enters the monetary system when it is purchased by the Treasury, which pays for it with a check drawn upon its account with one of the Federal Reserve banks. The Treasury places the gold in a vault for safekeeping and issues gold certificates equal in amount to the value of the gold. These it deposits to its account with the Federal Reserve bank, thereby restoring the amount withdrawn by check and increasing the bank's gold-certificate reserve. The seller of the gold may use the payment he receives to increase his bank balance or he may exchange it for currency. In either event the gold is represented in circulation by the demand deposit or currency. Conversely, when purchasing media are used to claim gold from the Treasury, gold is thereby removed from the reserve and its equivalent in purchasing media is taken from circulation through cancellation of demand deposits or retirement of currency, for with the proceeds the Treasury redeems gold certificates held by a Federal Reserve bank. Accessions of gold thus increase *both* the gold reserve and the supply of purchasing media, and gold withdrawals reduce them *both*.

Did the Gold Standard Cause the Great Depression?

Many people believe that because the Nation was on the gold standard in 1929 the gold standard was the cause of the Great Depression.

However, the available evidence suggests otherwise. Apparently the gold standard tended to limit the extent of the maladjustments that preceded the Great Depression on the one hand; and, on the other hand, subsequent departure from essential features of the gold standard unnecessarily prolonged the Great Depression. The grounds for these assertions are discussed in the paragraphs that follow.

The Great Depression included much of two complete business cycles.¹ The first extended from the 1929 peak, through the 1933 trough, to the 1937 peak of business activity. The second extended from the 1937 peak, through the 1938 trough, and through part of the recovery to the next peak of business activity.²

The business cycle that extended from 1929 to 1937 was the second-longest in the Nation's history. As measured by the National Bureau of Economic Research, its duration was 93 months compared with 101 months for the business cycle that extended from 1873 to 1882. From the viewpoint of the present discussion, the interesting features of this comparison are as follows:

(a) The longest business cycle in the Nation's history began when the Nation had been off the gold standard for several years. The same is true of the third-longest business cycle in the Nation's history, that from 1937 to 1945.

(b) In the 109 years after 1854 there were 17 peacetime business cycles during which the Nation was on the gold standard, and their average duration from peak, through trough, to subsequent peak was only 40 months.

Those who argue that the gold standard caused the Great Depression therefore should consider these questions:

(1) Why were the cyclical recessions or depressions that occurred when the Nation adhered firmly to the gold standard all so much shorter than those when the Nation was off the gold standard?

(2) How did it happen that two of the three most prolonged cyclical depressions began, in each instance, when the Nation had been off the gold standard for several years?

¹We have included the entire period from 1929 to 1941 as the years of the Great Depression for the following reasons:

(a) Not until 1941 did industrial production again move above the projected long-term trend, and

(b) Even in 1937 the average number of unemployed was 7,700,000, and as late as 1939 the average number of unemployed exceeded 9,000,000.

Thus, for 11 years after 1929, unemployment remained as serious a problem as it had been during the Nation's earlier severe but brief depressions, and industrial production failed to increase above its estimated long-term trend.

²The next peak was not reached until early in 1945, but the recovery had brought business activity to a level well above its calculated long-term trend by 1941, the year when the prolonged period of subnormal business activity and severe unemployment ended.

(3) Why, if the gold standard tends to cause depressions, did the most rapid and most prolonged increase in industrial production that the Nation ever experienced occur during the decade and more following the return to the gold standard in 1879?

But of course it is not enough to show some of the important reasons why the assumption that the gold standard causes depressions seems to be unsound. Were there other and more plausible reasons for the Great Depression? In view of the fact that whole volumes have been written on this subject, we cannot expect to cover all aspects of the problem in this brief discussion, but we can point out certain facts that are highly significant.

Beginning about 1924, and continuing until 1929, there occurred one of the great real estate speculations in the Nation's history. The Florida boom, with its hundreds of thousands of participants throughout the Nation, was one of the more striking features of this great speculation. But there were other, perhaps more serious, aspects from the viewpoint of the economy as a whole.

In nearly every city and even the larger towns, the availability of "easy money" for mortgages on new buildings fostered a wave of speculation in large hotels, luxury apartments, and skyscraper office buildings. The promoting and financing of such enterprises became highly profitable, for the time being, as eager investors bought mortgage bonds promising what they expected would be "safety and 6%."

By these actions the economy became seriously distorted in that huge amounts of labor and capital were diverted to the construction of such facilities far in advance of actual needs. Much of the funds provided was in the form of inflationary bank credit, with resulting excessive stimulation of business generally and support of prices at relatively high levels. Instead of the gradual lowering of prices that otherwise would have accompanied the great technological advances of the 1920's, prices of goods were held up on a high plateau by the excess demand made possible by continuing inflation.

The speculative fever also spread to the securities markets, which by 1929 had become a gambler's paradise. The increasing bank loans to finance the mounting speculative activity became the inflationary source of huge gains, gains that soon appeared in the markets in the form of demand for fur coats, expensive cars, fabulous houses, and other luxury items.

Not for 250 years had there been speculation in securities comparable to the boom of 1928-29. We must go back to the Mississippi Bubble in France (by which John Law's easy-money scheme brought widespread ruin) and to the South Sea Bubble in England, similar situations, both of which culminated in 1720, to find a comparable period.

In the light of the exposures since 1929 of developments during the boom years, it should not be necessary to belabor the point that serious maladjustments occurred. The frenzied activities in the stock market, the general conversion of leading commercial banks to purveyors of dubious bonds, the prostitution of the banking system generally to the services of speculation via the reckless expansion of real estate, security, and accommodation loans, surely must make most observers agree, in the light of hindsight, that all these developments caused serious maladjustments, unsound distortions, that ultimately had to be corrected.

From history we learn that failure to correct such maladjustments has more than once resulted in a complete disruption of economic activities with virtual paralysis of business and, in many instances, with an overturning of the existing government. Such was the case in France after the Mississippi Bubble burst; such was again the case when the inflationary paper currency, the assignats, fostered similar distortions in France nearly a century later; such was the case in Germany in 1923; and again such was very nearly the outcome in France a few years later.

In our own country, on several occasions, we had experienced great speculations similar in some respects, if not so severe. Reckless real estate speculation, unsound banking, and widespread bank failures were prominent features of several great "booms and busts."

What part did the gold standard play in the Great Boom that preceded the Great Depression? At least it provided a standard of value by which a few saner citizens could judge the extent of the distortions that developed. Although their wiser actions did not prevent the depression, they surely tempered it. Even at the worst of the decline in industrial production, reached in the summer of 1932, such production was still about two-thirds of the estimated long-term trend. Bad as this situation was, it was far better than the virtually complete cessation of business activity that presumably would have resulted if the Great Boom had carried on, without the potential restraining influence of the gold standard, until the distortions had become even more serious.

Nor was adherence to the full gold standard the cause that prolonged the depression into 1933, as is sometimes maintained. It was the domestic banking situation that must be blamed. With the public's confidence in the banks at a low ebb and with sporadic bank failures initiating depositor runs on other banks, it is little wonder that even the ablest bankers gave more thought to strengthening their cash positions than to meeting the credit needs of their community. Thus, even applications for sound loans were apt to be refused and many banks sold bonds in a falling market to bolster up their cash in order to be able to meet possible deposit withdrawals. With accommodation at the banks extremely difficult to obtain and with an exceptionally weak market for securities, there was

little chance of business recovery until many of the boom-time distortions that had caused this situation were corrected.

Perhaps inadequate measures were taken to restore the public's confidence in the banks and thus hasten business recovery. However that may have been, it was the unsound banking situation, not the gold standard, that accounted for the severity of the first long phase of the depression.

Moreover, the recovery that began in late 1932 and was interrupted by the bank moratorium of early 1933 was resumed with great speed until the definite abandonment of the gold standard in the summer of 1933. Then followed more than 18 months of indecisive fluctuations in business activity until the Supreme Court's "gold clause" decisions were rendered early in 1935. Not until then were doubts about the partial return to the gold standard resolved for the time being. A prolonged upward surge of industrial production followed for two years.

Thus it would appear that those who blame the gold standard for the Great Depression do so in disregard of the evidence provided in that and earlier periods. It is much as though an inebriate lying in the gutter were to blame the sound constitution that enabled him to survive his excesses instead of his own unwise actions for his resulting unfortunate condition.

Would a Return to the Full Gold Standard Prevent Further Inflation?

Adoption of the full gold standard, or at least establishing by statute a future date when the Government would again redeem its currency in gold, would be only a beginning in the prevention of more inflation. Although some inflation can occur under the gold standard, it cannot become extreme, if that standard is to be maintained. Under inflationary conditions, people want gold instead of paper currency simply because it is the one absolute hedge against inflation. It is the money commodity itself. If a nation is determined to take measures, when necessary, to remain on the gold standard, those measures will necessarily be contra-inflationary.

Are the Large Losses of Gold From the U.S. Treasury in Recent Years a Matter for Serious Concern?

Yes. The U.S. Treasury gold stock, which amounted to almost \$23 billion early in 1958, had dwindled to less than \$15.5 billion at the end of 1963. Moreover, the net amount of foreign-held short-term claims that could be used to withdraw gold from the Treasury had increased during that period from about \$13 billion to more than \$20 billion. The significance of these developments and the seriousness of the problem they involve are discussed at length in subsequent sections of this study.

What Constitutes an Adequate Gold Reserve?

If U.S. currency were freely convertible into gold, demand deposits then being indirectly so, the minimum gold reserve would be an amount sufficient to assure domestic and foreign holders of currency and other dollar claims that the money material would continue to be freely available. Without conjecturing just how large such a gold reserve need be, we can say that if four necessary conditions of a sound monetary system prevail, the reserve may be much less than when one or more of those conditions is lacking. With full confidence in the monetary system and its ability to regain losses of gold that must sometimes occur, there would be little inclination on the part of our citizens and of foreigners to exchange their dollar claims for the precious metal.

The four conditions are, briefly: (1) noninflationary commercial banking; (2) noninflationary fiscal policy; (3) a fully redeemable currency and (4) an independent central bank.

If all of these conditions were met, an excessive drain on the gold stock would be improbable. At times, gold would move out of or into the country to settle international balances, but the quantity so employed ordinarily would be small and the movements would tend to offset each other. An unusually large flow of gold in either direction, due to war or other conditions that distorted economic relationships, could be dealt with by the monetary authorities by means of special measures that would minimize the effect upon the domestic economy.

An excessive acquisition of gold could be separated from the monetary reserve or otherwise rendered ineffective as a base for the expansion of currency and credit. An excessive outflow of gold could be halted by various measures, rigorous if need be (by a marked increase in the discount rate, for example). But with the four conditions that we have postulated, it is hard to imagine any circumstance or occurrence other than enemy invasion that would cause a run on the gold reserve. In such an event, total mobilization probably would include suspension of redemption.

We cannot determine from historical experience just what amount of gold would suffice to assure redeemability when all elements of a money-credit system are on a sound basis. Presumably, it could be much less than that needed in a system that was defective but permitted redemption. Conceivably, even under the best conditions there might be some low point at which the reserve would be regarded as inadequate and a run upon it would commence. But under sound monetary conditions, measures to maintain the reserve or to attract foreign gold would be taken by prudent monetary authorities long before such a point was reached.

The problem of a minimum gold reserve is for countries seeking to establish or reestablish a redeemable currency.

Should the U.S. Gold Reserve Requirements Be Rescinded?

In May 1961 a bill to abolish the gold reserve requirements for the Federal Reserve System was introduced in the House of Representatives. Although so much opposition was aroused that the bill was "shelved," it was introduced again in January 1963.

Present law requires the Federal Reserve banks to hold a minimum of gold certificates (which represent gold in the possession of the U.S. Treasury) equal to 25 percent of the reserve deposits placed with them by the member banks and 25 percent of outstanding Federal Reserve notes, which constitute more than nine-tenths of the Nation's currency. Thus, more than \$12 billion of the U.S. gold stock, which totals about \$15.5 billion, represents the minimum gold backing required by law for all of the Nation's purchasing media (currency and checking deposits). Although individuals, whether U.S. citizens or others, cannot exchange U.S. currency for the gold that backs it, foreign governments and central banks may do so.

Presumably supporters of the bill to abolish the gold reserve requirements wanted to assure potential foreign claimants of the gold that all of it would be at their disposal, without any hindrance from the existing legal requirements.

The foreign-held claims on U.S. monetary gold are valid. So too is the right of our own citizens to the protection of their currency by a gold reserve. This right has long been recognized and assured by laws requiring monetary gold reserves. From 1879 to 1933 anyone who wanted to exchange U.S. currency for gold could do so. When this particular right was taken away from Americans, the gold reserve requirements remained, nevertheless, to prevent an unlimited expansion of currency and bank credit.

Rescinding these requirements would remove even their limited protection of U.S. currency in order to reassure potential foreign claimants that we will honor their future demands for gold. The proposal usually is made as if there were no alternative to it, yet the sound alternative is obvious: If we were to restore the prestige of our currency abroad, foreigners who hold the currency (and credits that represent it) would not want to exchange it for gold. If there were little or no risk of its depreciation, they could invest their U.S. currency in American securities and time deposits and receive an assured return, whereas the gold itself would yield them nothing.

Evidently the supporters of the proposal do not expect a return to sound monetary and fiscal policies that would restore confidence in claims

on dollars. Evidently they assume that the Government will continue to follow policies that weaken confidence in the dollar and assume also that Government deficits will be financed by issuing securities to be monetized by the banking system. In other words, they expect further inflating, with the same adverse effect on the purchasing power of the dollar that it has suffered since 1940, when a dollar could buy almost 2½ times as much as it can today.

There is every reason to suppose that rescinding the gold reserve requirements would weaken the banking system and encourage bankers to indulge in more inflationary lending to both private and governmental borrowers. The reserve requirements have been, at the least, an underlying restraint on the unwarranted expansion of currency and bank credit. A more effective restraint would be an understanding by bankers generally of what constitutes sound banking procedure, but that is too much to hope for in the near future in a nation that has always lacked a tradition of sound banking.* Because of that lack, we have had to rely on formal reserve requirements for the arbitrary and limited protection that they afford.

Without the gold reserve requirements, the Governors of the Federal Reserve System no longer could point to the limit on credit expansion established by law as justification for restraints; if we may judge by past experience, they probably would succumb to the continual political pressure for more and more inflating of the Nation's purchasing media. In the absence of the disciplinary influence of gold reserve requirements, we should expect that any vestige of restraint on inflationary practices would quickly disappear as one "stimulating" dose of inflationary purchasing media was followed by a larger dose, and so on.

Rescinding the gold reserve requirements would only temporize with the worsening situation of the dollar abroad. It would do nothing to remove the influences that continue to affect the Nation's international financial position adversely. Such a measure would surely reveal to foreigners a preference for makeshift expedients rather than a willingness to face the unpleasant fact that the United States is approaching a point at which it will be unable to honor foreign claims on gold without reducing

*Briefly stated, sound banking principles permit the creation of additions to checking accounts (demand deposits) only to the extent that short-term, self-liquidating loans are made for commercial purposes so that added purchasing media will represent goods produced and *en route* to markets. Other loans should be made only to the extent that the banks can transfer savings and bank capital to the borrowers.

Formal, fixed-reserve requirements can give an illusion of money-credit soundness, but when the requirements are not accompanied by sound commercial banking practices, they are not an adequate safeguard for a money-credit system. Although the original Federal Reserve Act recognized the principles of sound commercial banking (now almost forgotten), it continued the American custom of prescribing fixed-percentage reserve requirements.

the amount of gold in what it would continue to call a "dollar." This would be devaluation, of course. Whether undertaken deliberately or forced by a "run" on the gold stock and depreciation of the currency in foreign exchange markets, it would be a repudiation of a part of all public and private obligations payable in the devalued currency.

How could doing away with the gold reserve requirements, which afford at least some protection against a massive inflationary increase in currency and checking deposits, possibly relieve the Nation's international financial difficulties? Even in the short run it could induce gold withdrawals rather than prevent them. In the longer run it probably would be recognized as another step down the pathway to monetary degradation.

Are Foreign-Held Short-Term Claims on U.S. Gold Analogous to Bank Depositors' Claims on Currency?

Many observers who have commented on the increasing total of foreign short-term claims on U.S. gold have attempted to reassure the public by arguing that such claims are analogous to the claims that depositors have against their banks. The contention is that no bank expects to have cash on hand equal to all deposits and so there need be no great concern over the fact that foreign short-term claims on U.S. gold now greatly exceed the gold that is not pledged as a reserve for our own banks. (See Chart V)

The widespread use of this analogy seriously misleads those whom it reassures about the Nation's international financial position. Foreign short-term claims on U.S. gold are *not* analogous to bank deposits as we shall explain in the following paragraphs.

Banking based on small holdings of cash in relation to deposit liabilities is feasible because depositors, as long as they have confidence in the bank with which they deal, will not suddenly, or in a short period of time, exercise all of their potential claims against the bank. Ordinarily, a bank's officers can judge the amount of cash reserve that is adequate to meet the demands of its customers; and, if a bank has been properly operated, it readily can liquidate assets in order to restore its reserve should the demand upon it become unexpectedly large. A bank may meet an increase in withdrawals by letting its short-term commercial loans be paid off at a faster rate than it makes new loans, or it may sell other liquid assets on the open market. For brief periods it can borrow funds from its Federal Reserve bank, but during a protracted period of heavy withdrawals it would have to liquidate loans or other investments. Unless a bank's assets are in a substantially frozen condition it can continually replenish its reserve and thereby meet all claims against it.

If the assets of all banks consisted preponderantly of short-term commercial loans (the banks' investment-type, or long-term, assets be-

ing not in excess of the amount of the banks' time and savings deposits plus capital and surplus), the payment of maturing commercial loans with funds received by sale on the market of goods (which both the loans and the demand deposits created by the loans would represent) would meet the withdrawals. If withdrawals were larger than usual, they would tend to restrict bank credit; and prices of goods would decline. As prices declined, goods would become more attractive to potential buyers. If banks also sold investment-type assets to replenish reserves, lower prices for such investments would attract buyers. Both buyers of goods and buyers of investments presumably would use demand deposits primarily to pay for such purchases rather than claim cash from the banks. The sellers of merchandise would then repay their borrowings from the banks, thereby canceling the purchasing media created when the loans originally were made and also ending the problem of meeting depositors' demands.

Thus, whether we consider the reserve situation of a single commercial bank or of the banking system, fractional cash reserves are practicable when the assets that offset deposit liabilities can be liquidated readily.

As a Nation with a gold reserve that is fully subject to foreign short-term claims, the United States is not in the same position as banks with demand deposits that are offset by short-term, automatically self-liquidating loans and readily marketable securities. By late 1963 the United States had permitted its demand and short-term liabilities to foreigners to reach the huge total of \$26.3 billion but had offsetting demand and short-term claims on foreigners of only \$5.6 billion.

This has occurred partly because we have spent and given away our funds abroad without acquiring things in exchange. We have *given away* demand credits, our I.O.U.'s, to all the world without receiving assets of a kind that could be used to liquidate those credits.

Although the net amount of our long-term foreign assets exceeds our net short-term foreign liabilities, most of those assets are not liquid and therefore not available to meet current claims that may be made upon us. If our short-term liabilities to foreigners were caused largely by the financing of goods in transit to our own and other world markets, and so were represented by things that were readily salable, the situation would be different. Our short-term liabilities to foreigners then might be several times the amount of our gold stock without jeopardizing it, because the sale of goods would continually provide funds to meet a part of the indebtedness. There would be no need to give up gold. Moreover, if the United States' international financial relationships were not so extremely distorted, as they have been for some years, our short-term claims upon

foreigners could be expected to approximate the amount of their short-term claims upon us.

If the Nation's gold reserve is to be compared with the fractional reserves of commercial banks, and if short-term foreign claims on U.S. gold are to be compared with the demand deposit liabilities of the banks, we should also compare with the assets of those banks the amount and kind of assets available to meet the potential foreign demand claims. Those assets, other than the gold stock, are small as is shown above. Our potential demand claims on foreigners are only about one-fifth of their potential demand claims on us. Large as our Nation's long-term foreign assets are, enormous as its total wealth is, its foreign creditors nevertheless can demand overnight all of its gold reserve. This is because the United States, with its prevailing monetary and fiscal policies, including its give-away foreign aid program, cannot replenish its stock of gold as foreign claimants draw upon it. The inflationary effect of these policies has priced many American goods out of world markets. Lower prices, achieved through a substantial amount of deflation, and smaller foreign aid grants could lead to a favorable balance of international payments, a decrease in the amount of our net foreign short-term liabilities, and an end to the drain on our gold stock as confidence in the future value of the dollar was restored.

What Is Earmarked Gold?

Earmarked gold is not included in the U.S. Treasury gold stock, because the Treasury does not have possession of it and has no right to it. Such gold is the specific property of the foreign institution or agency that has placed it on deposit under earmark with a Federal Reserve bank. It is either gold withdrawn from the U.S. Treasury by foreign governments, central banks, and international financial institutions, such as the International Monetary Fund, or gold shipped to the United States and placed under earmark instead of being exchanged for United States funds which could be loaned at interest or invested in other ways. As soon as gold withdrawn from the U.S. Treasury is earmarked for a foreign government or its central bank, it becomes part of that government's gold reserve.

It seems probable that the increase in earmarked gold since early 1958, by almost as much as the amount withdrawn from the Treasury, indicates that the United States is still considered a good place, geographically and militarily, for keeping gold in storage. It seems to indicate, also, as it properly should, that foreign owners of earmarked gold anticipate no difficulty in obtaining all the gold thus held for them, whenever they want it and regardless of whatever measures our Government might sometime take with reference to the gold held by the Treasury. An embargo

on gold shipments or devaluation of the dollar presumably would not apply to gold held under earmark, because such gold is the property of others, in contrast with gold legally owned by the U.S. Treasury although subject to foreign demand claims. The fact that earmarked gold is not legally in the possession of the United States Government, and that the foreign owners have actual title to the gold, gives earmarked gold a different status from that of gold held in the U.S. Treasury.

Will Higher Foreign Wages Solve the U.S. Gold Problem?

From several sources have come optimistic assertions that the Nation's gold problem soon would be solved because greater percentage increases in wages abroad would lessen the price gap that makes many American goods noncompetitive in export markets.

In many U.S. industries wage rates are inordinately high because of increases forced upon them by powerful labor unions that were aided in making their demands effective (without bankrupting many of the firms they dealt with) by a continual inflation of the Nation's purchasing media. In other industrialized countries, however, as lower production costs, lower prices, and increased capacity to produce have attracted a larger part of world demand for their products, wage rates also have increased; and recently the percentage increase has exceeded that in the United States. Although in the United States, in 1961, the average wage rate increased by an estimated 4 percent, in Western Europe the increases ranged from 6 to 10 percent. In West Germany, where the increase for 1961 was 10 percent, it had averaged about 6½ percent annually for the preceding 7 years.

When wages in Germany increase 10 percent and wages in the United States increase only 4 percent, many observers assume that of course the price differential between German and American goods must soon decrease, at least insofar as it reflects wages as a cost of production. However, by means of elementary arithmetic one can readily prove that this seemingly obvious conclusion is false.

In the table on page 61 we show the estimated hourly wage rate in the American steel industry increased at 4 percent each year through 1987. In the next column we show a rough average of hourly wage rates in the steel industries of all major Western European nations and Japan⁴ increased by 10 percent each year. The cost differential that would be attributable to wages in each year also is shown.

If in 1962 the average hourly wage rate for steel production in foreign countries had been \$1.00, compared with \$4.13 in the United

⁴*U.S. News & World Report* (October 1, 1962) shows estimates of hourly wages including fringe benefits in the steel industries of various nations ranging from 60 cents for Japan to \$1.29 for West Germany. We have used \$1.00 as a rough average for illustrative purposes in the table.

States, the cost differential attributable to wages would have been \$3.13. Assuming that thereafter the average annual rate of increase in wage rates would be 10 percent abroad and 4 percent in the United States, after 1 year the U.S. average wage rate in the steel industry would exceed that of the steel industry abroad by \$3.20; after 2 years by \$3.26; and after 3 years by \$3.32. Thus, even with the large difference in the annual percentage increases, after 10 years the hourly rate paid by the U.S. steel industry would be \$3.52 more than that paid by the industry abroad. After the 10th year, the difference in the hourly wage rates would gradually decrease until in the 16th year it would be back to \$3.12, or about what it was in 1962. Thereafter this difference would decrease until the 25th year, when it would be practically eliminated.

Obviously, rising wages abroad will not solve the gold problem for many years unless foreign wages increase much more rapidly or wage rates in the United States decrease, or increase at a lesser rate than 4 percent. In fact, the price differential of American exports attributable to wage levels will increase until 1972 and will not be less than it is today until 1978 if recent trends in wage rates continue. In the meantime, further contraction of American sales abroad would result.

Potential Differentials in Costs of Steel Exports
 Attributable to Increasing Wage Rates in the
 United States vs. Other Nations
 Assumed annual rates of wage increases:
 United States, 4 percent; Other Nations, 10 percent

Year	United States	Other Nations	Differential
1962	\$4.13	\$1.00	\$3.13
63	4.30	1.10	3.20
64	4.47	1.21	3.26
65	4.65	1.33	3.32
66	4.84	1.46	3.38
67	5.03	1.61	3.42
68	5.23	1.77	3.46
69	5.44	1.95	3.49
1970	5.66	2.15	3.51
71	5.89	2.37	3.52
72	6.13	2.61	3.52
73	6.38	2.87	3.51
74	6.64	3.16	3.48
75	6.91	3.50	3.41
76	7.19	3.85	3.34
77	7.48	4.24	3.24
78	7.78	4.66	3.12
79	8.09	5.13	2.96
1980	8.41	5.64	2.77
81	8.75	6.20	2.55
82	9.10	6.82	2.28
83	9.46	7.50	1.96
84	9.84	8.25	1.59
85	10.23	9.08	1.15
86	10.64	9.99	0.65
87	11.07	10.99	0.08

Are Russian Gold Holdings a Threat to the Free World?

From time to time the Institute receives inquiries about the "threat" that Russian gold holdings constitute for the free world economies. Sometimes these inquiries refer to articles in newspapers or elsewhere that have discussed the supposed harm that would be done by "dumping" of Russian gold. We cannot too strongly emphasize that all such assertions are nonsensical and groundless. We cannot prove that the many statements of this kind that have been published are deliberately intended to mislead, but we caution readers to inquire carefully into the sources of any such assertions.

In the first place, gold, in the world as it is today and probably will be for the indefinite future, is the primary war reserve of last resort. With gold, any nation can buy somewhere in the world whatever it needs, including materials essential to war industry and even including traitors or fifth-columnists within an enemy nation. Without gold, a nation may be unable to buy abroad in time of war when no foreigner will trust its paper currency; with gold, a nation can buy, through intermediaries if necessary, whatever it needs.

For many years Russia has maintained an elaborate network of spies and subversive agents. No nation knows better than Russia how essential gold is for the financial support of such an organization. Gold is the only sure means of obtaining the currency of any country in the world for the pay and operating expenses of spies and the Communist network within that country.

No one knows how much Russian gold has been exported, but estimates have placed it at about \$250 million annually for recent years. Because of the need to buy large quantities of wheat abroad, Russia's gold exports in 1963 are believed to have increased to about \$400 million.

The amount of gold held by Russia and the amount produced annually are supposed to be known only at the highest level of Soviet officialdom. Although earlier estimates placed Russia's gold holdings as high as \$10 billion or more, the most reliable information now available, which was made public early in 1964 by the Central Intelligence Agency, indicates that they do not exceed \$2 billion. The CIA also reported that Russia's annual output of newly mined gold is approximately \$175 million.

The notion that Russia might "dump" her gold in exchange for dollar currency or dollar credits is fantastically ridiculous for two reasons: (1) this would constitute an interest-free loan by Russia to the United States; (2) it would remove from Russian hands the "gold bullets" that, as in the past, almost certainly would be an important factor in a major war of the future. We do not doubt that any member of Russian upper levels of government who seriously urged the exchange of Russian gold for American dollars would be summarily shot.

Of one thing we feel sure: Russia well knows that the United States, if stripped of gold, would be a weak enemy. The leaders of Russia long have maintained that inflation is their most potent weapon in other countries, and certainly the United States will become increasingly vulnerable to inflation as its gold reserve diminishes. Without gold the United States would lack effective means of aiding some of its allies, and without gold the United States would find its credit abroad inadequate for wartime needs. We assume that Russian agents are doing all in their power not only to get gold out of the United States but also to lull Americans into a sense of false security while the extraction proceeds. For that reason we recommend not that readers ignore assertions of the type we have referred to but that they do what they can to trace such assertions to their source. We should not be surprised to find that much of the talk about the "threat" of Russia's gold is a smoke screen intended to cloud the view of those who would otherwise be more concerned about the loss of U.S. gold.

Is There Any Sound Reason for Having Some Other Monetary Standard Than Gold?

"If it be granted that gold is the money material most widely desired, as it is, does it not follow that any other standard money is less desirable and will pass at a discount in terms of gold? Is it not perfectly clear that every currency in the world today which has been cut loose from gold passes at a discount in terms of the parity with gold which it formerly maintained? And is it not equally clear that when any people must use a currency which is at such a discount in terms of gold they are at a great disadvantage in trying to buy goods and services?

"All these questions suggest their own answers. Since nothing ordinarily can purchase as effectively as gold under all conditions there can be no logical basis for any government, which has a choice in the matter, to say to the people: 'We will not provide you with a currency which buys most easily and anywhere at any time, without discount in terms of some better currency, but we will provide you with one which buys with difficulty, one which cannot buy anywhere at any time except at a discount in terms of a better currency.'

"If a nation decides to provide its people with something less than the best, just how inferior must the currency be before it is deemed 'satisfactory'? All over the world today one can see currencies of varying degrees of inferiority. Which of them is the proper one to choose in the opinion of those who desire something less than the best? What principle is to guide a government in its choice of an inferior currency?

"A remarkable thing about the contention that we should have some standard money other than gold, is that its authors seem unaware of the

fact that they are arguing that an inferior currency is more desirable than the best! They argue this in the face of facts that would seem to be perfectly clear. Foreign exchange rates, which reveal the various rates of discount at which the nongold currencies pass in terms of gold, would seem to provide ample refutation of their contention."⁵

Did Anyone Foresee the Consequences Of U.S. Money-Credit Follies?

Yes, *some* economists correctly foresaw the present consequences of the money-credit juggling that was initiated in 1933. In that year, a group formed the Economists' National Committee on Monetary Policy. Thanks in part to their efforts, some of the worst schemes for inflating were blocked; but the inflating that has occurred in spite of their efforts has had consequences that threaten the Nation's future.

Since 1933, the Economists' National Committee on Monetary Policy has maintained a membership of about 75 economists, and a total of 174 have served to date. The late Edwin Walter Kemmerer, who probably advised more nations on money-credit problems than any other economist before or since his time, described the work of the Committee thus:

"Our Committee was organized on November 17, 1933. That year will always stand out in American history as a field day for monetary crackpots. It witnessed the wide acclaim, by millions of our people, of the monetary panaceas of Father Coughlin. It witnessed the advocacy by some so-called 'technocrats' of an electric dollar. It saw the revival of long-discredited greenbackism. It saw the resuscitation of what we had thought for a generation was the corpse of bimetallism. Nineteen hundred thirty-three was the year in which our gold-coin standard was discarded, in which it became a criminal offense for an American to own United States gold coins, coins which had circulated lawfully in the United States for nearly a century and a half, and which bore the emblem of Liberty and the legend, 'In God We Trust.'

"As scientific men, monetary economists believe in freedom of speech and freedom of the press. We are willing to permit those who have new ideas to speak freely, however heterodox those ideas may be. This is the way progress is made.

"When, however, monetary schemes, alleged to be new but which in fact had long since been discredited by science and repeatedly by the experience of many countries, gained such widespread acceptance among our people that they were finding their way in large and increasing volume on our statute books, then, many of us became frightened. We concluded

⁵Quoted from Walter E. Spahr, *The Case for the Gold Standard*, New York, Economists' National Committee on Monetary Policy, 1940, pp. 6-7.

that the time had come for us to come out of our academic halls and publicly talk back, in fact that it was our patriotic duty, as men who were devoting their lives to the scientific study of these problems, to organize and to undertake a campaign to help educate the public on what we believed to be sound monetary policies, and what we believed to be dangerous monetary heresies.

"We are willing to let the astrologists astrologize, but we don't want to put them in charge of our weather bureaus. We are willing to let the perpetual motion advocates talk, but we don't want them to design the machinery for manufacturing our implements of war. And likewise we do not wish to put our public health services in the hands of sorcerers and witch doctors, however well-meaning they may be. For the same reasons we don't like to see fall into the hands of economic illiterates and quacks the control of our American dollar in terms of which are paid all our wages, rents and taxes, and all our debts, public and private, including our bank deposits, our life insurance, our social insurance, and our great public welfare endowments.

"The value of our dollar is affected with a tremendous public interest. Probably never before in our history as a nation has it been so threatened as it is today. Never before has the maintenance of sound monetary policies been more urgent.

"It is to the task of educating the American public on this subject that the Economists' National Committee on Monetary Policy is dedicated."

*We recommend to readers the work of the Economists' National Committee on Monetary Policy. Two members of the Institute Faculty are members of the Committee. (They derive no compensation therefrom. Institute bylaws prohibit arrangements that could result in financial gain to the Institute or members of its staff from such recommendations.)

We suggest that you write for further information and send a contribution if you can (deductible from income before taxes) to: Economists' National Committee on Monetary Policy, 79 Madison Avenue, New York 16, New York. You will receive their monthly bulletin, *Monetary Notes*, as well as information about other publications sponsored by the Committee and a list of members.

CHART II

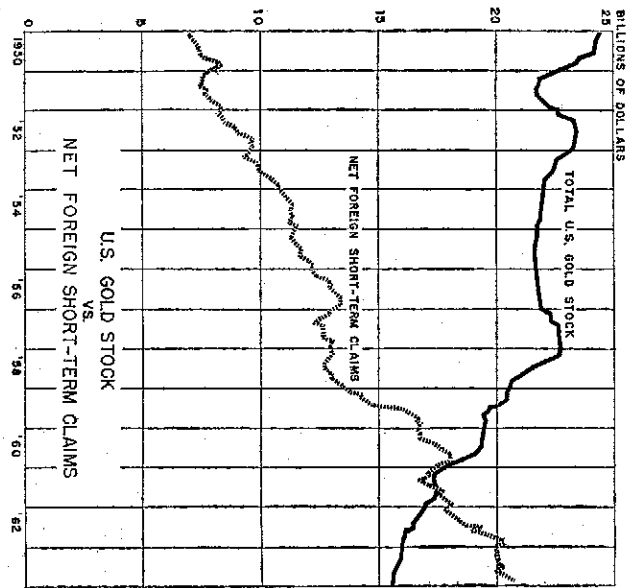
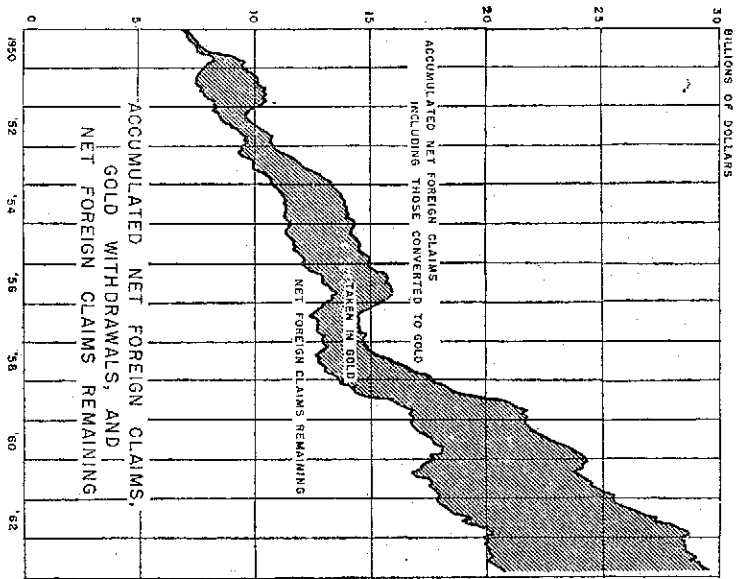


CHART III



VII.

THE APPROACHING CRISIS: THE U.S. GOLD STOCK IN JEOPARDY

"Let us be happy and live within our means even if we have to borrow the money to do it with."—Artemus Ward.

The Present Gold Situation

The United States has become the greatest debtor in all history, if one measures such greatness by the total amount of a debtor's demand I O U's in relation to his cash resources. Never before has any debtor (individual, corporate, or governmental) obligated himself for so much, payable virtually on demand, that he could not pay if called upon to do so.

We refer not to the debt of the U.S. Government owed to its citizens, domestic banks, and other institutions or businesses, but to the foreign short-term claims on U.S. gold, claims that almost overnight could become payable on demand. The short-term debts of the Government to domestic creditors can be paid by stuffing more Government bonds into the commercial banks thereby monetizing the debt as was done on such a large scale during World War II. Consequently, Uncle Sam cannot be forced into bankruptcy or its equivalent by his domestic creditors.

The situation with reference to foreign creditors is quite different. Unless the Treasury pays the gold claims of foreign creditors on demand, the United States will stand discredited before the world, a virtual bankrupt as incapable of managing its financial affairs as the most improvident countries.¹ Instead of an economic bulwark of the free world, the dollar would be just another piece of paper in a world where paper-money cancer has become a chronic and seemingly ineradicable disease. This is the disease that Lenin advocated as a means of destroying the nations of Western civilization.

As is apparent from the accompanying charts, the progress of the United States toward insolvency has not been a sudden turn in that direction as a result of unforeseeable catastrophe. For years the trend of events has been evident to all who would look at the record. In Chart II can be seen the almost continuous decrease of the Treasury's gold holdings as foreign holders of the increasing demand claims on dollars have chosen

¹The gold stock of the United States was approximately a half billion dollars less at the end of December 1963 than it was a year earlier. Net foreign short-term claims were estimated to exceed the gold stock by more than five billion dollars, compared with about four billion dollars a year earlier.

CHART IV

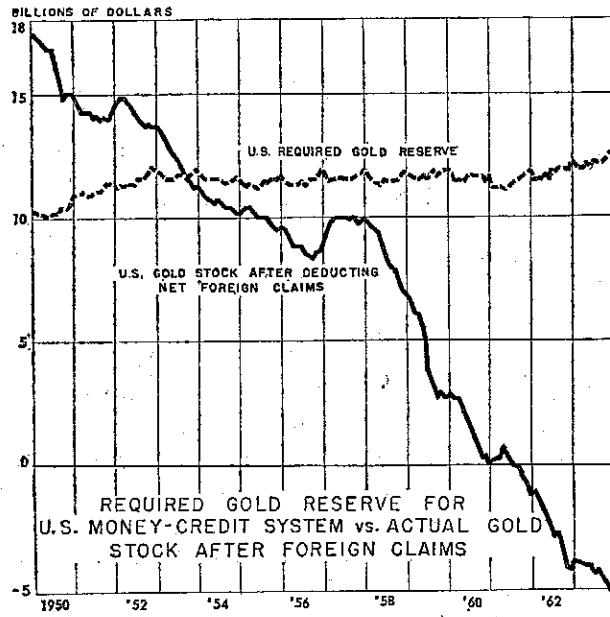
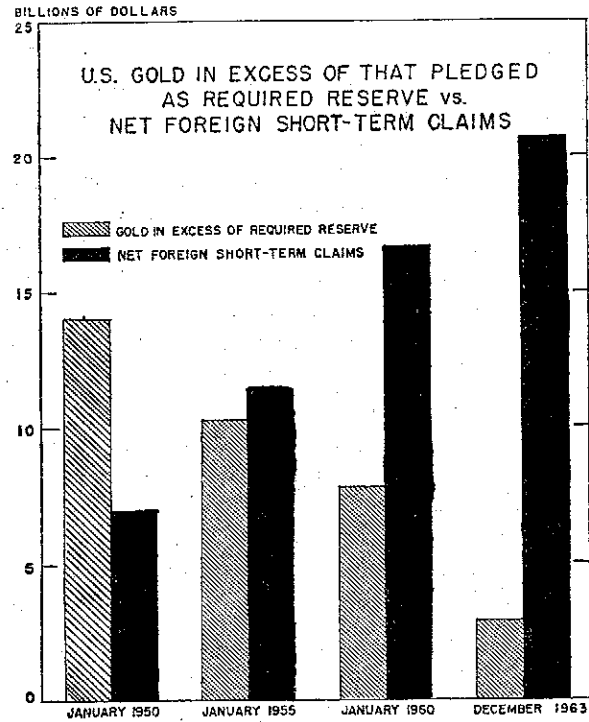


CHART V



to exercise those claims. Nevertheless, the total of such claims remaining unsatisfied has steadily increased until now the potential demand claims of foreigners on U.S. gold substantially exceed all the gold held by the Treasury including the portion pledged to the Nation's banking system as its basic reserve.

Chart III shows the total of foreign short-term claims accumulated since 1950, the amount of them already used to claim gold on demand, and the remaining total of potential demand claims against U.S. gold. Here is the clearest possible warning, increasingly emphasized year after year, that the United States in its financial relationships with the rest of the world has been and still is living beyond its means, like a careless spendthrift, heedless of the serious risk of economic disaster incurred by such improvidence.

What Will Happen if Foreign Claimants Increase Their Demand for Gold?

From a position of relatively great strength after World War II the Nation's money-credit system has deteriorated under the influence of continued inflating at home and lavish giving and lending to nations abroad.

What will happen if foreign claimants choose to demand their gold? The U.S. Treasury finally may refuse to honor foreign claims on gold. If and when that time comes, dollar currency will depreciate in foreign markets. What will U.S. citizens do then; will they rush to convert dollar claims and fixed-dollar investments into stocks, real estate, etc.; or will U.S. citizens ignore a flight from the dollar abroad? No one knows.

Or the U.S. Treasury may honor all foreign claims until the Nation's gold reserves are exhausted. How will U.S. citizens react to that situation, especially to the deflation that will occur unless purchasing media retired when gold is claimed are replaced by other newly created purchasing media? Will U.S. citizens fearing deflation rush to sell stocks and other equities in order to hoard currency and accumulate idle checking accounts or perhaps invest in bonds; or, especially if new purchasing media are created by monetizing more Government debt, will U.S. citizens fearing more inflation rush to buy stocks, etc.? Again, the only truthful answer is that no one knows.

However, we do know this: If Russia had been able to plant its agents, unknown Alger Hisses and Harry Dexter Whites, in key positions in the United States Government with instructions to carry out Lenin's plan for destruction of a "capitalistic" economy by means of inflating, they hardly could have accomplished a more thorough job of "gutting" the economy by extracting its basic gold reserves.

Some people have argued that the situation is not serious, that it

merely reflects the fact that the United States has become banker for much of the world and that, as for any other banker, the demand claims against it exceed its basic reserves. However, this view is erroneous. A banker ordinarily has short-term claims on those whose notes he has discounted; these claims counterbalance the short-term or demand deposit claims against the bank in excess of its basic reserves. Such is not the position of the United States with reference to the foreign short-term claims on its gold. The claims shown in the accompanying charts are net after deducting counterbalancing liabilities of foreigners to the United States.

How the Status of the Dollar Abroad Has Deteriorated

In 1950, after allowing for the net amount of short-term claims held by foreigners against the U.S. gold stock, that stock, nevertheless, exceeded by about \$7 billion the amount of gold legally required as a basis for the U.S. monetary system. (See Chart IV). At that time the U.S. gold position was strong, although the influences that would weaken it were already at work. Early in 1958 there began an outflow of gold that has continued almost without interruption to the present time.

By 1960 the Government began to evidence awareness of this potentially serious situation. In the London gold market U.S. dollar claims (i.e., U.S. currency, bank deposits, and other dollar credits) sold at a discount that steadily increased during that summer. In October 1960 the London market for such claims broke badly as the "price" of gold in terms of these paper claims on gold dollars soared to more than \$40 (paper) per ounce. Then the Secretary of the Treasury went, hat in hand, to beg a little financial help from West Germany. Well before this time the U.S. Treasury had borrowed more than \$1 billion of gold from the International Monetary Fund in exchange for Treasury securities, having given its promise to repay in the full weight of gold borrowed even if the dollar were devalued.

The efforts of the world's greatest spendthrift nation to borrow from more Peters in order to pay the Pauls who now wanted their loans repaid were continued in subsequent months. More gold was borrowed indirectly from the International Monetary Fund by means of a "deal" with another nearly insolvent debtor, Great Britain. Still more was borrowed directly from the IMF. West Germany was persuaded to prepay an obligation to the United States, partly with German marks, some of which were used to meet the foreign demands for gold.

Then the United States tried, through the IMF, to arrange standby credits available on demand from other member nations of the IMF who attended a meeting in Vienna. But the creditors were in no mood for

such commitments. Instead of promises to lend more on demand, the United States received some lectures on the urgency of adopting sound financial policies, on putting its house in order. Later such credits were arranged, but on a highly tentative basis.

During the early months of 1961 the U.S. balance-of-payments deficit had been greatly reduced, and some observers assumed that a marked turn for the better had occurred. However, Germany's prepayment of debt was an important factor in the apparent improvement. The situation was worse in the second quarter and much worse in the third, when the deficit increased to a rate of more than \$3 billion per year. Thus, the opportunity provided by a temporarily diminished gold outflow was lost. Instead of using that time to force some deflation and begin restoring a sound financial position, the authorities followed the opposite course. Lulled by a temporary respite, the Federal Reserve Board and the Administration failed to act effectively.

By late 1963, the situation was such that, after allowing for short-term foreign claims, no gold at all would remain as a monetary reserve, and in fact an actual deficiency of more than \$5 billion would exist. Or, from another point of view, as is shown in Chart V, the amount of the gold stock then in excess of the required monetary reserves was exceeded by net foreign short-term claims of more than \$17 billion.

Thus, the U.S. gold stock can be likened to a \$15,000 house that is subject to a \$20,000 mortgage that becomes due and payable whenever the mortgage holder decides to demand payment. There is no question as to whether the foreign holders of short-term claims on U.S. gold are entitled to the gold if they want to take it. They acquired the claims on it and hold them, trusting in the good faith of the United States to continue to honor them by redemption in gold at the rate of 1/35 of an ounce per dollar. They regard these dollar claims as being as good as the gold itself; and in many countries the claims are used to supplement the gold reserve on which their monetary systems are based. If the United States were to refuse to meet any of these claims when payment is asked, or if it decided to meet them with a smaller amount of gold per dollar (which would constitute devaluation), perhaps 1/70 instead of 1/35 of an ounce, the world would be profoundly shocked by such repudiation.

Failure to Solve the Problem

What has caused this enormous accumulation of potential claims against the U.S. gold stock, and why does the amount of the claims continue to increase, even while some claims are continually being redeemed with gold? The answer is simple. For many years the United States has disbursed abroad more U.S. currency and credits than it has received from abroad. Through its vast and overly generous foreign aid program and

through large military expenditures in other countries it has placed these claims against it in the hands of foreign governments, central banks, and individuals. They are in the form of U.S. currency and interest-bearing credits, such as U.S. Treasury bills and deposits in U.S. banks. Some of the disbursements abroad have come back to this country in payment for goods and services or as long-term investments. In its foreign trade the United States receives more than it spends, but the large volume of commercial transactions that results in a trade surplus is made possible by the large gifts and other nontrade expenditures of the United States abroad, which in almost every year have exceeded the favorable trade balance by a large amount.

The Nation's net deficit in its international payments continues at about the same rate as the average rate over the past 13 years, despite assertions of the Administration that it would put an end to the deficit. Thus far, the measures taken have been superficial or temporizing, mere palliatives that can have little or no effect on the underlying causes.

The determination to continue foreign aid on a vast scale seems to rule out the improvement in the dollar's position abroad that would result from a large reduction in that area of expenditures. To what extent the Administration can induce other countries to assume a part of the Nation's foreign military expenditures remains to be seen. The campaign to increase U.S. exports is limited by two circumstances: (1) most of the profitable export opportunities are already being exploited, and (2) the high cost of many U.S. products makes them unsalable in competitive world markets. The fact that the United States might draw against the International Monetary Fund in an emergency merely means that the day of reckoning for extravagant and unsound financial policies would be delayed if the fund proved to be liberal in its attitude toward such a borrower. Moreover, the supposed increase, in 1962, of \$6 billion in the IMF's resources may prove to be illusory because the subscribing countries all have reserved the right to reject requests for funds. The much publicized foreign exchange operations of the U.S. Treasury and the Federal Reserve System may postpone gold outflows temporarily but they cannot solve the basic problem.

Although these and other stopgap measures were declared to be at least partial solutions of the problem, they merely helped to conceal the seriousness of it while the situation worsened. Gold has continued to flow from the Treasury, and the amount of foreign-held potential claims on the gold stock has continued to increase.

The Nation's solvency now depends on the forbearance of its foreign short-term creditors. By far the largest of them are the central banks of

Western European countries; and, if the dollar were devalued, their losses would be very great. As long as the United States continues in its course of profligate spending, however, the principal foreign governments and their central banks can continue to add to their wealth of dollar claims. Thus greed and perhaps other considerations encourage them to help the United States (by such arrangements as lending us their currencies) while at the same time fear of the possible consequences makes their successive decisions increasingly difficult. At what point will prudence and good sense be permitted to call a halt to the process that greed so obviously favors?

If any one important central bank decided to convert a large amount of its dollar claims into gold for fear that U.S. gold would be embargoed or that the dollar would be devalued, a run on the gold stock by many other central banks soon would be underway. This might be impossible to halt except by repudiating, in part at least, the foreign-held dollar claims.

"Easy-Money" Management

When Congressman Multer introduced his bill in the House of Representatives in May 1961, proposing to eliminate the Nation's gold-reserve requirements, hearings were scheduled but then were indefinitely postponed. Apparently because so many people wanted to testify in opposition to the bill, it was considered to be a "hot potato."

Those who would eliminate the legal requirements of a gold reserve argue that such evidence of means with which to meet the basic promise on the Nation's currency is quite unnecessary, that the integrity of a country's currency can be entrusted to the "responsible men" who serve on the Federal Reserve Board and elsewhere in the Nation's money-credit system.

Anyone inclined to rely on management by "responsible men" might well reflect on the evidence shown in Chart IV. Since 1950 the Nation's gold stock that would be left after satisfying net foreign short-term claims has steadily decreased. Although originally the gold was well in excess of the legally required reserves, none would remain now in U.S. reserves if foreign creditors chose to demand payment. This is conclusive evidence, as every European central banker and many of the world's economists well know, that the supposedly "responsible men" have been ignoring their primary responsibility. When they should have forced deflation they timidly retarded inflation, and when they should have stood firmly opposed to more inflation they weakly acquiesced in successive resumptions of easy-money policies that fostered it. The record is clear and unmistakable.

In Chart V the situation is shown from another point of view. If,

as now seems probable, elimination of the legal minimum gold reserve would be so strongly opposed that it would not be approved by Congress, what would be the effect on the United States' ability to pay foreign claimants on demand? The "free" gold held by the Treasury is that portion of the total not pledged to the Nation's commercial banking system as the basic monetary reserve. In the chart is shown the available "free" gold held by the Treasury compared with net foreign short-term claims. Obviously, if the rate of gold outflow in 1958-63 continues, the Treasury's supply of "free" gold will be exhausted within a few more years. Will foreign creditors delay in presenting their claims until the "free" gold is gone, or will they soon rush to present their claims while some gold is left? If the United States continues inflating instead of taking the medicine, deflation, required to restore economic health, the risk of a "run" on the Treasury's gold will increase greatly.

Money-Credit Developments Leading up to the Crisis

The actual developments that have led to the present situation are shown in Chart VI. It illustrates not some theoretical or imagined relationships but the actual course of money-credit events during recent decades.

The purchasing media used in the United States consist of the coins and paper currency that citizens carry in their pockets and the checking accounts or demand deposits of the commercial banks. The sum total of these items is the total of purchasing media available for use; and the portion regularly used for purchases, rather than hoarded or held idle, is the total of purchasing media actively in use.

Purchasing media are created in the following ways:

1. When the U.S. Treasury receives gold, it issues gold certificates representing the number of dollars of gold received. It deposits the certificates with a Federal Reserve bank, receiving a credit to its deposit account. To pay for the gold, the Treasury gives a check payable to the seller for the amount involved. He deposits the check in his local bank for credit to his account; his commercial bank sends it to the Federal Reserve bank for credit to the commercial bank's reserve account; and the Federal Reserve bank debits or deducts the amount of the check from the Treasury's account. Two important aspects of the resulting situation should be remembered:

a. No matter how many times the deposit made by the seller of gold may be transferred to others by drawing checks to make payments, the purchasing media (in the form of a credit to somebody's checking account) will remain in existence, available for use, as long as the gold

remains in the Nation's money-credit system (which includes the Treasury's gold holdings).

b. The amount added to the commercial bank's reserve account also remains in existence and can serve as a basis for the creation of more checking deposits through the lending activities of that commercial bank or some other if the additional reserve funds have been transferred.

2. An important part of the purchasing media in use consists primarily of checking account deposits created by the commercial bankers when making commercial, agricultural, and industrial loans. Merchants and producers borrow from time to time on short-term notes (sometimes secured by bills of lading or other documents) to finance production and distribution of many things en route to markets. The commercial bankers who discount the notes (make the loans) simply increase the merchants' and producers' checking accounts by the amounts loaned. In effect, such newly created purchasing media represent newly produced things en route to markets. As the things are sold, merchants and producers receive the purchasing media needed to repay their short-term loans, thereby withdrawing from circulation the purchasing media representing the things sold; and their accounts at the commercial banks are reduced by the amount of loans repaid. Of course, the borrowing and repaying processes are continuous and overlapping with the result that large amounts of commercial (short-term and automatically self-liquidating) loans are in existence at all times. The purchasing media created by such loans are not inflationary, because they represent things being brought to the markets for sale.

3. A relatively small amount of the purchasing media in existence consists of paper currency issued by the U.S. Treasury and representing either silver or U.S. debt. This item is so small that it need not concern us further in this discussion for general readers.

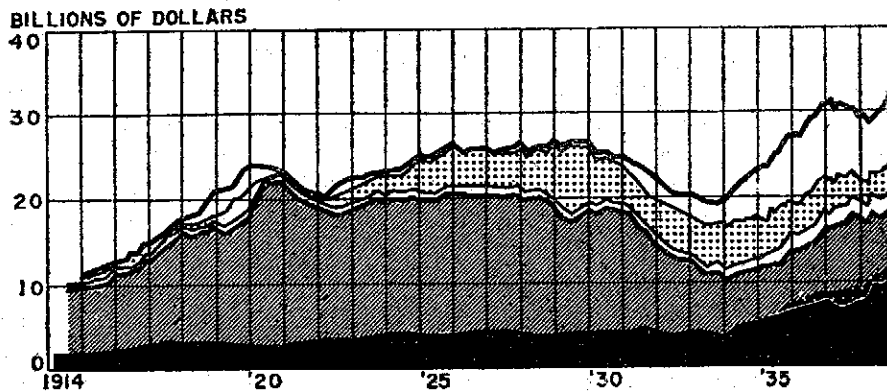
4. Commercial bankers sometimes create purchasing media in the form of new additions to borrowers' checking accounts by making *non-commercial* loans or investments in excess of the savings or long-term funds currently being deposited with them. When bankers thus *create* purchasing media (by simply crediting a borrower's checking account), the process is called "monetizing private debt." But the new purchasing media do not represent things newly produced and en route to the Nation's markets. Such purchasing media are inflationary. When used by the borrowers, they make possible an excess of demand in the markets over supplies at current prices with a resulting tendency for prices to be bid up to higher levels.

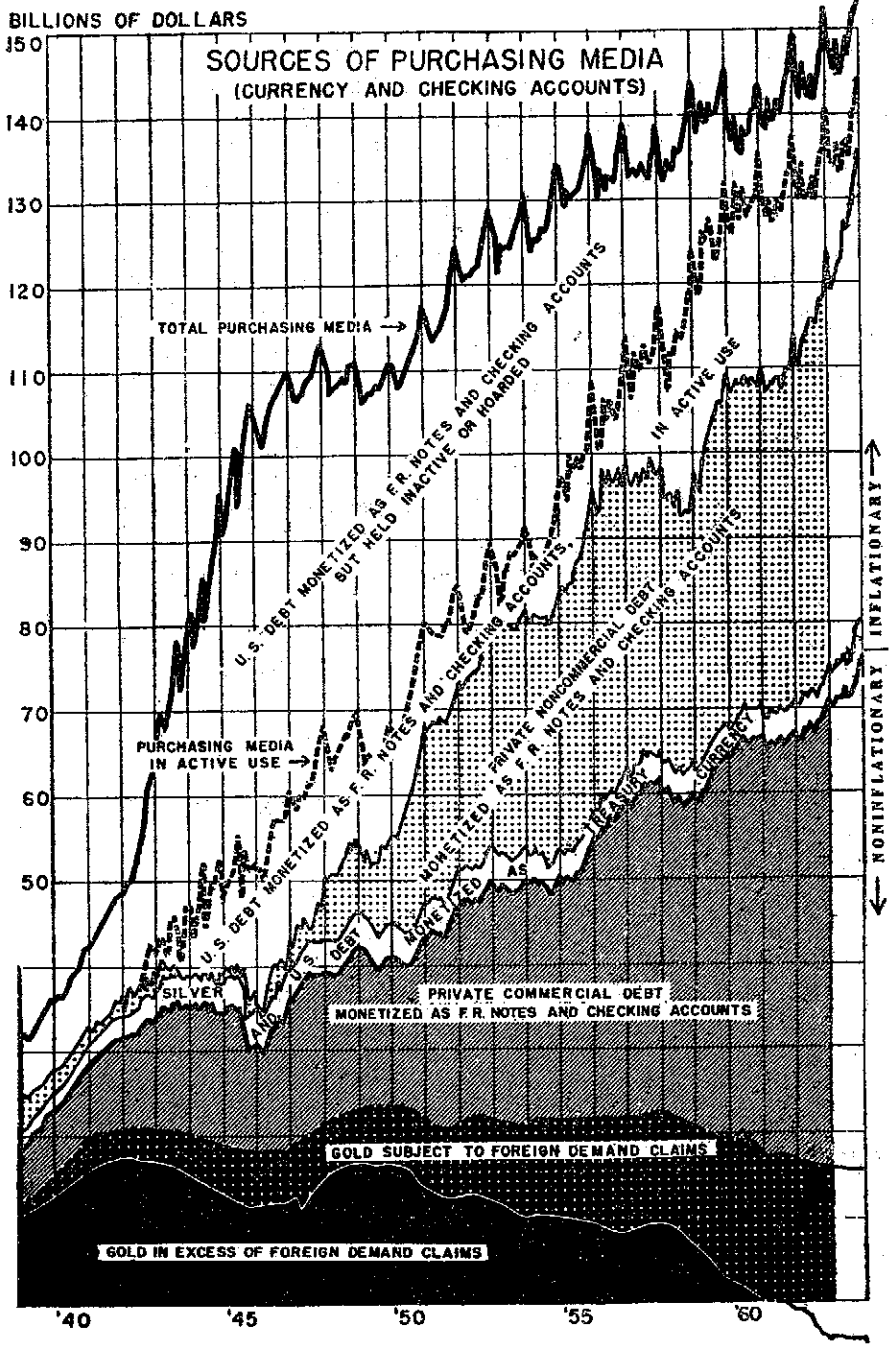
5. At times the commercial banks also create purchasing media in the form of additions to U.S. Treasury checking accounts in exchange for Government securities. This process, also inflationary to the extent

CHART VI
SOURCES
OF
PURCHASING MEDIA

This chart shows the Nation's money-credit record since 1914. Clearly evident are the World War I and World War II monetizations of Federal debt with the resulting creation of excess or inflationary purchasing media. Also apparent are the private credit inflations that followed each World War. Not only was the monetization of Federal debt proportionately greater during World War II than it was during World War I, but also the private credit inflation in subsequent years has been greater in the more recent period.

Note the loss of gold since 1950.





that the banks concerned do not have uninvested savings deposits available for purchasing the securities, is called "monetizing Government debt."

Referring now to Chart VI, we begin at the lower right-hand portion. What was, until 1961, the lowest segment (in solid black) showed the gold in the Nation's money-credit system (including the U.S. Treasury) that was not subject to foreign short-term claims. The amount of such gold has become a minus quantity of more than \$4 billion. The segment immediately above shows the gold held by the Treasury that is subject to net foreign short-term claims but that has not yet been demanded by foreign holders of such claims. All of this gold is represented by purchasing media (either paper currency or checking accounts) actually in use. All of the gold also is represented by reserve accounts of the member commercial banks of the Federal Reserve System, as described in paragraph 1, above.

The purchasing media derived from private commercial debt (commercial, industrial, and agricultural loans) complete the noninflationary part of total purchasing media. In the long run, except during business recessions, the amount of such purchasing media presumably should increase with the increasing production of things to be sold in the Nation's markets.

The small segment marked "Silver and U.S. Debt Monetized as Treasury Currency" marks the lower portion of the inflationary purchasing media. This segment and those above show inflationary purchasing media that do not represent either gold or goods produced and en route to markets.

Obviously, the purchasing media derived by monetizing private debt have increased greatly since the end of World War II.

The purchasing media derived by monetizing U.S. debt are shown in two segments. The lower one shows the portion of such purchasing media actively in use, and the upper shows the portion of such purchasing media estimated to be hoarded or held idle.

In 1946 the amount of hoarded or idle purchasing media was large, about \$45,000,000,000. Gradually, as new cars, houses, and other desired things became available in subsequent years, much of the hoarded purchasing media was used and thus came into circulation. (A considerable amount of U.S. debt that had been monetized by the banking system has been absorbed by, *i.e.*, sold to, savers since World War II, but monetized private debt has increased and added to the inflationary purchasing media in use.) The latest figures available show that the amount of purchasing media now hoarded or held idle is only a little more than the total of such purchasing media prior to World War II.

Such are the developments of recent years and the facts of the present situation. Although students of money-credit matters could see in 1950 and each year thereafter that the situation was becoming worse, those in positions of authority have been slow to recognize the dangerous trends and even slower to act. Now the Nation is confronted with the possibility of a flight from the dollar and a major crisis.

How Inflation Destroys an Organized Society

That prolonged inflation is a destroyer of organized society is well known to every student of money-credit history. Lenin prescribed inflation as the chief weapon in the Communist arsenal for the ultimate defeat of other nations. Inflation played a key role in the "success" of the Russian revolution; it paved the way for Hitler in Germany; it reduced France to a second-rate and at times virtually impotent nation. For centuries the record has repeatedly demonstrated inflation's power to destroy.

Inflation may be likened to a wedge driven horizontally into the social pyramid, a wedge that forces its victims down under increasing pressure and raises to the heights of power its beneficiaries. Thus it divides a society into those who are being cheated on the one hand and those who get the unwarranted gains on the other hand.

More specifically in our own Nation at this time, the cheated victims are the widows and the children dependent on life insurance, the retired individuals who have Social Security or other pensions fixed in dollar amount, and every holder of savings deposits, U.S. savings bonds, and other assets having a fixed dollar value as well as the majority of those who work for a living and whose wages and salaries lag behind in the race to keep abreast of the rising cost of living.

The beneficiaries of inflation are the shrewd speculators, the citizens of great wealth who can afford to take large risks, holders of monopoly privileges, and the minority of labor that is organized in industry-wide monopolies. All such individuals are in a position to "get theirs while the getting is good." For example, the organized steel workers have been able to obtain wages more than 4 times their pre-war earnings while the cost of living has a little more than doubled. Of course their gain has been in part at the expense of the victims of inflation, who have lost during the same period through the decreased buying power of their life insurance and savings dollars.

One of the conspicuous victims of inflation has been the Nation's educational system. Many of the most effective teachers at all levels from the grammar schools to the colleges have been forced, in order to support their families, to seek higher paying jobs offered by inflation-stimulated industries. More than the usual proportion of incompetents have perforce been accepted in the teaching profession. Thus inflation depreciates the

quality of education of the Nation's youth on whom its future must depend.

Inflation has been continued so long that delusions of economic grandeur have become widespread. In Government, billions have been dissipated abroad with no better results than to continue in office dictatorial and socialistic governments whose "success" cannot aid our Nation's long-run objectives. And at home, pressure groups sedulously cultivated by spendthrift politicians and labor monopolists, whose power is government-created, clamor for still more inflation.

"The Promises Men Live By"

Inflation also undermines the very foundation of organized society, "the promises men live by." The whole structure of modern industrial and commercial society rests on promises, on loans made and credit granted in expectation of future payment and on contracts that promise one thing for another. The essential feature of this system of promises is that the promises are almost invariably fulfilled. Especially in an economic society such as ours, with its huge structure of long- and short-term debt, its elaborate contractual relationships, and its multibillion-dollar life insurance and pension plans, the certainty of economic promises is of profound importance. This certainty may well have been the greatest single influence in the economic progress of the United States and other great nations. A nation in which economic promises ceased to be kept soon would retrogress to a primitive condition of economic life, similar perhaps to that of the Dark Ages. And any impairment of the trust inherent in the whole complex pattern of promises within an economic system must surely impair the efficiency with which that system produces and distributes wealth.

In almost all economic promises the money aspect is dominant, because something definitely measurable and of constant value, a stable monetary unit, is necessary for their effective and satisfactory fulfillment. Inflation, however, through the resulting depreciation in buying power of the currency, breaks faith with those who considered the currency a thing of stable value; and, when carried far enough, inflation can lead to a devaluation of the monetary unit, which would be a repudiation of the promise represented by the currency.

The Government's promise when it issues currency that purports to be exchangeable (in various denominations) for the monetary unit, is especially important, because the currency will be used to fulfill not only the promises represented by the Government's securities but also all other promises made throughout the economic system. Yet our Government does not fulfill the promises of its currency. See, for example, the promise you find on a \$10 bill, which reads: "The United States of America will

pay to the bearer on demand ten dollars." This promise to pay dollars on demand is a contract to pay gold, because each "dollar" is defined by law as one thirty-fifth of an ounce of pure gold (in an alloy nine-tenths fine).

Not only has the Government failed to keep this promise to its citizens to redeem their currency in gold; it also has permitted the currency to lose more than half its value, to that extent reducing the value (in purchasing power) of its own obligations. At the same time, it has forced upon private debtors and creditors a depreciating means for fulfilling the promises made and accepted by them. Creditors may be as willing as ever to trust debtors, but when they cannot trust the medium in which debts will be paid, economic processes are hampered and distorted. Under the influence of inflation a nation becomes divided into two opposing groups, those who profit and those who lose by the subtle embezzlement of savings from the thrifty.

Thus, as continuing inflation invalidates economic promises, it erodes the foundation of organized society, an integral part of which is a continuing trust in the promises of individuals and government. No matter how strong and wealthy the nation where inflation occurs, this at first insidious process ultimately can wreck the nation's economic system and deform the moral character of its people. Such has been the invariable experience of mankind in all the centuries of recorded history without a single exception to date.

VIII.

DEVALUATION, A PSEUDO-REMEDY

Foreigners who have dollar claims will continue to demand U.S. gold rather than U.S. goods as long as they thus can obtain more of the things they want. By taking U.S. gold and using it to buy in various countries abroad, they obtain better bargains, just as many U.S. citizens have found that they can buy more for their dollars abroad than in the United States. (When U.S. citizens buy abroad, they give claims on dollars to foreigners who can use the claims to obtain the corresponding U.S. gold. Thus, in effect, U.S. citizens can spend for purchases abroad the gold that they are not permitted to demand in exchange for their currency in the United States.)

This situation could be corrected either by reducing the weight of each gold dollar that the Treasury gives to foreigners for their claims on dollars (i.e., by devaluation) or by reducing prices of American goods to such levels that foreigners would use their claims on dollars to buy U.S. goods rather than to acquire U.S. gold. Deflation would force a general reduction in prices and, no doubt, in the dollar amount (but not necessarily the buying power) of some wages.

Gold Production, Prices, and Devaluation

A monetary unit, such as the dollar, ordinarily is fixed by law as to weight and purity of the monetary material. For countries on the full gold standard, or even a limited gold standard like that of the United States, the unit is specified to be a given quantity of gold. When the monetary unit consists of a fixed quantity of gold, mine production of gold automatically responds to changes in the general price level. As prices of goods and services rise, i.e., as mining costs increase, mining performance is discontinued at the higher cost mines and is reduced at lower cost mines where marginal operations become too costly. As prices fall, this response is reversed with a resulting increase in gold production. Or, conversely it can be said, increasing gold production tends to raise prices and decreasing gold production tends to lower prices, as more or less gold is added to the monetary stock. Thus, through opposite changes in the price level and in gold production there is a tendency toward relative price stability where currencies are based on gold. (This assumes, of course, the probability that a large and inexpensive source of new gold is not discovered.) Experience of the past century indicates that an annual average increase of about 2½ percent in

mine output of gold will meet the growing needs of the world economy without significantly affecting the general level of prices.

As long as gold production increases roughly in proportion to the increased production of other things and therefore with the increased need for purchasing media to facilitate exchanges, individual prices in a free economy will fluctuate with changes in the supply of and demand for particular goods and services, but the long-term price trend will be neither markedly upward nor downward. Alternating short-term changes in the price level will tend to offset each other. Such a horizontal price trend is illustrated in diagram 1 by the line $p-p'$. Partly because the United States has not been on a full gold standard, continued inflation has been

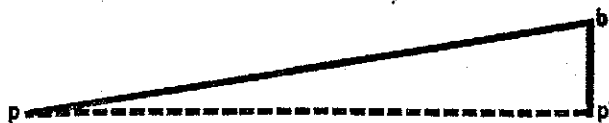


Diagram 1

facilitated and has resulted in a prolonged rise in prices. That is, domestic prices have not followed a horizontal trend but have advanced substantially. This upward trend is represented by $p-b$ in diagram 1. Because the gold content of the dollar has remained unchanged, a given amount of gold now exchanges for less of other things within the United States than it did prior to the inflationary rise in prices represented by line $p-b$. Gold mine operators' costs have increased steadily, but the "price" of their product has remained unchanged.

Each year as gold mining costs increased, some higher cost mines closed down, and others reduced output. The effect of the withdrawal of this productive capacity is illustrated in diagram 2 by $g-c$, which shows a decreasing rate of increase in gold production instead of the more nearly constant rate of increase that would be associated with price stability, as illustrated by $p-p'$ in diagram 1.

Although the lines in the accompanying diagrams do not measure specific changes that have occurred, they do illustrate general trends. The line $p'-b$ represents price distortion resulting from inflation; the line $g'-c$ represents an insufficiency in current gold production as a result of the price distortion. Diagrams 1 and 2 thus represent price and

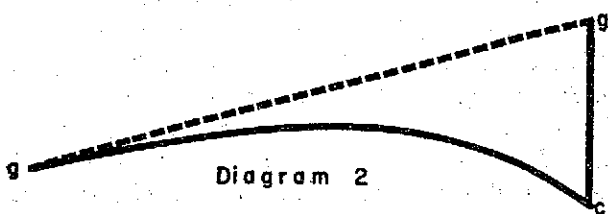


Diagram 2

gold developments since devaluation of the dollar in 1933-34. The present situation can be corrected either by rapid deflation, by gradual deflation (i.e., "growing up" to our inflationary purchasing media), or by reducing the amount of gold in the dollar (devaluation), or a combination of these procedures.

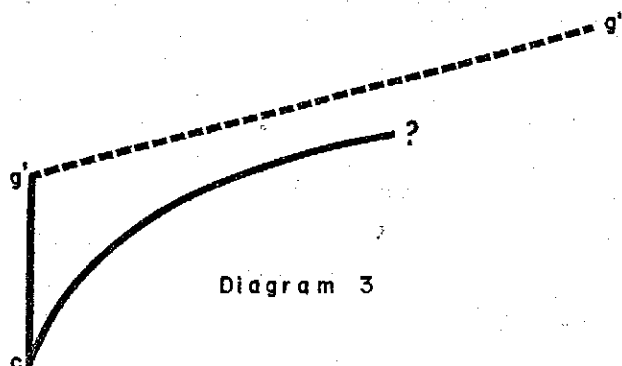


Diagram 3

As an aid in understanding why devaluation would not solve the Nation's money-credit problem, the effect of devaluation on the conditions of disequilibrium depicted in diagrams 1 and 2 is illustrated in diagram 3. The line $g' - g''$ is an extension of $g - g'$ in diagram 2, and therefore is a projection of the trend line of gold production under conditions of a gold-price equilibrium. Presumably, gold production at the rate of increase represented by that line would be sufficient to meet the need for monetary gold. Because of the present disequilibrium, mine output of gold is falling short of this projected rate, and this shortage is represented by $g' - c$ in diagram 3.

Devaluation, which would reduce the weight of the gold dollar, would correspondingly increase the quantity of goods and services that a given amount of gold could buy (as long as prices remained unchanged) and thereby would make gold mining more profitable. In effect the "price" of the mines' product would be increased without a corresponding increase in their production costs. Mines that had been taken out of production as prices generally, including wages, had risen would be returned to production; and the output of mines that had continued in operation would be increased.

As the monetary gold stock increased, the amount of purchasing media available for use would also increase. Gold delivered to the Treasury would be paid for with a check drawn on the Treasury's account at one of the Federal Reserve banks. The Treasury would give a certificate representing the gold to the Federal Reserve bank, and the number of dollars represented by the certificate would be credited to the Treasury's checking account, thereby restoring the amount withdrawn to pay for

the gold. Total checking account deposits thus would increase by the dollar amount of new gold acquired by the Treasury. In this way all monetary gold (except in rare instances that need not be explained here) has become represented in the channels of trade by checking account deposits and currency.

As those who obtained the purchasing media representing the increased gold production bought things in the Nation's markets, the augmented demand would tend to raise prices, unless inflationary purchasing media previously issued were simultaneously withdrawn from circulation (the process of deflation). Again gold mining would be discouraged by rising costs; and gold production, instead of increasing to the line $g' - g''$ in diagram 3, would fall short of that trend, as indicated by $c - ?$. The end result would be another seeming "need" for devaluation in a few years.

Arbitrary Devaluation and "Free Market" Devaluation

Those who favor devaluation point out that when inflationary purchasing media are in circulation, the resulting high prices and wages discourage gold production by making it more costly, thereby reducing the amount of gold becoming available for monetary use. Most proponents of devaluation urge putting an end to inflationary procedures once the reduction in the gold content of the dollar has been made. Some favor not only the establishment of sound banking principles following devaluation but also a return to the full gold standard, whereby free convertibility of the currency into gold would inhibit an inflationary expansion of currency and bank credit in the future.

Some devaluationists would arbitrarily reduce the amount of gold in the dollar by such a proportion that the devalued dollar would be $1/70$, $1/100$, or some other fraction of an ounce of gold instead of the present $1/35$ of an ounce. Other devaluationists would prefer to see established what they call a "free market" for gold. In such a market everyone would be allowed to exchange currency for gold and gold for currency at whatever "price" those who offered gold and those who sought to acquire it might agree upon. Perhaps this ratio of currency to gold would fluctuate widely at first; but in time, according to the proponents of the so-called free market, it would reveal the number of paper promises to pay dollars that an ounce of gold exchanged for and thus the appropriate weight of a new gold dollar. The standard dollar then would be fixed permanently at whatever fraction of an ounce of gold was indicated. To the extent that the fraction were smaller than the $1/35$ of an ounce of gold that now constitutes a dollar (and there is little doubt that it would be smaller) the dollar would have been devalued.

One defect in this "free market" proposal is that none of the Government's vast stock of gold would be allowed to come on the market

and thus serve as a restraint upon what could otherwise be a substantial increase in the "price" of gold. (If the Treasury were permitted to buy and sell gold freely in the market, it could hold the "price" at any point it chose as long as its gold lasted. That is what the Treasury has been doing in the London market by offering gold through the Bank of England at approximately the legally established parity of \$35 per ounce.) There is no way of knowing in advance how large the exchange ratio of currency to gold would become in the proposed "free market."

Deflation versus Devaluation

The ideal money-credit situation is one in which there is a complete absence of inflationary purchasing media. All currency and all credits to checking accounts would represent either goods coming on the market or gold, and the amount of purchasing media in use would vary with the requirements of business and the flow of gold into and out of the gold reserve. Prices and wages would not be subject to the influence of excessive demand resulting from increments of purchasing media that did not represent an increase in either gold or other marketable commodities.

Once inflationary purchasing media have been placed in circulation, there are two ways in which sound money-credit relationships may be restored: (1) by means of *devaluation*, that is, reducing the gold weight of the monetary unit so much that the increase in the number of (smaller) gold dollars equals or exceeds what had been the inflationary part of total purchasing media or (2) by means of *deflation*, that is by removing inflationary purchasing media from circulation.

In order to give a gold backing to all of what is now inflationary purchasing media, a devaluation would have to transform the present gold stock from the 15.5 billion monetary units of which it now consists to about 90 billion smaller monetary units. It would have to reduce the weight of the dollar from the present 1/35 of an ounce of gold to about 1/190 of an ounce; that is, the "price" of gold would have to be raised from \$35 to about \$190 per ounce. Each present gold dollar would have to be made into about 5½ new (devalued) gold dollars. The new dollar would have a gold content equivalent to the amount of gold now represented by about 18 cents. Thus, current proposals for devaluation, most of which contemplate \$70 or \$100 per ounce of gold, would only partially resolve the present inflationary situation.

Those who favor devaluation do not acknowledge the possibility or desirability of deflation as a solution of the money-credit problem. Although the Nation has experienced many deflations in the past with beneficial results, individuals who urge devaluation assert that deflation is politically unfeasible or that the adjustments involved would do more harm than good. Some argue that a sound money-credit situation should

be achieved before the devaluation, but they do not explain why devaluation would then be necessary. Others would establish sound money-credit principles after devaluation, apparently in the belief that those principles would be less likely to be violated than they had been before, in spite of the fact that nothing in the act of devaluing makes it easier for the Nation's money managers to resist the temptation to inflate again. In fact, the temptation to inflate probably would be increased because of the larger number of (smaller) gold dollar units that could serve as a base for a fresh inflationary expansion of currency and bank credit.

Deflation can be rapid or gradual. A rapid reduction in the amount of inflationary purchasing media, through a contraction of bank loans that had been made for other than commercial purposes, would have some drastic effects. In the comparatively short period during which such a deflation occurred business activity would contract; failures would multiply; unemployment would increase; prices of goods, securities and other forms of property would fall; and some wages would be reduced.

Although such a transition would be painful to many people, experience shows that it can be comparatively brief. Such a deflation occurred in 1920 when the Federal Reserve Board deliberately forced a contraction of bank credit in order to eliminate the excessive amount of purchasing media that had been pumped into circulation during the inflationary expansion of World War I and for a short time thereafter. The deflation and readjustment lasted about a year, after which there was a rapid recovery in business activity and a period of general prosperity.

With gradual deflation, a longer time would be required to eliminate all inflationary purchasing media and reach an equilibrium between the remaining (noninflationary) purchasing media and prices and wages, but the traumatic events that are a feature of rapid deflation would not occur. The Nation would "outgrow" the inflationary condition as part of the savings of individuals, businesses, and perhaps of the Government were used to pay off inflationary bank loans and thereby cancel both the loans and the checking deposits that the loans had created. Although gradual deflation would be accompanied by decreasing prices, wages almost certainly would decline less or might even be sustained by greater productivity due to technological and other developments.

As prices declined, not only would the buying power of all purchasing media in circulation increase, but the cost of mining gold would decrease, with resulting stimulation of gold mining and restoration of gold mining in mines now closed. A larger amount of new gold entering the money-credit system would become a noninflationary addition to total purchasing media. As this development continued, it would retard and finally halt the decline in prices resulting from deflation. Too often the fact

is overlooked that inflation, by increasing costs, retards gold production; whereas deflation, by reducing costs, encourages gold production. Increased gold production due to deflation would partly offset the decrease in total purchasing media resulting from the elimination of that which was inflationary.

That a period of gradually declining prices can be a period also of great economic growth has been amply demonstrated in the past. For example, between 1875 and 1895 while prices decreased substantially, the Nation's productive capacity and output of goods and services increased at a very rapid rate. The often heard assertion that an economy cannot grow unless prices are rising has no basis in fact.

Whether a country that has determined to place its money-credit system on a sound basis should establish the full gold standard (thereby making its currency freely redeemable in gold) before or after it has achieved a considerable amount of deflation is an important question. Although the simple act of establishing that standard (the maintenance of which would require adherence to sound money-credit principles) probably would enhance confidence in the money-credit system, too early a resumption of gold redeemability for the currency might tempt those of lesser confidence, at home and abroad, to claim gold in large amounts. A sufficient length of time should be allowed, and a sufficient amount of deflation should be achieved, before instituting redeemability. If this is done, probably only small quantities of gold would be withdrawn, and possibly more gold would flow into the Treasury than flowed out. (This was the experience in the United States when redemption of the currency in gold was resumed in 1879. It was West Germany's experience after deflation and the restoration of a sound monetary system in 1948.)

If the Nation is to choose between devaluation and deflation, every citizen should understand what each of those alternatives involves. The experiences of this country and many others throughout the course of history have shown that devaluation almost always is followed by renewed inflation and further devaluation; the final outcome is virtually complete repudiation of the currency and governmental debt. Such a sequence of events in the United States probably would mark its end as a constitutional republic, except perhaps in name and empty form. Prolonged inflation with the aid of successive devaluations long has been recognized as a most effective destroyer of civilized society.

Deflation, on the other hand, leads to sound money-credit conditions that are conducive to a high level of business activity, the maximum use of human and material resources, and an optimum rate of economic growth. Unlike devaluation, deflation would support the buying power of the dollar and remove the many impediments to economic progress that inflation and the prospect of more inflating impose.

IX.

WHAT YOU CAN DO ABOUT THE GOLD PROBLEM

The U.S. gold situation is precariously weak, and the time within which it still may be strengthened is running out. Only by removing the primary causes of the long decline toward insolvency that the Nation has experienced can the correction be made and the Nation thereby be placed on the road to recovery from the consequences of its financial errors. Those causes have been the unsound fiscal policies of the Federal Government, and the unsound money-credit policies of the banking system. Together they have prolonged and increased a massive inflation of the Nation's purchasing media.

By preventing Americans from redeeming their currency in gold on demand, should they want to do so, the Government has tried for three decades to evade the discipline of the gold standard (which is basically the discipline of integrity that is involved in every kind of contract). Now events are demonstrating that once more in the history of depreciating currencies, when governments try to evade that discipline they succeed only in creating major problems that seemingly defy solution. We find no evidence that the present Administration, any more than others in recent decades, has any intention of adopting policies that would reverse the dangerous trend.

The Informed Balance-of-Power Minority

The all-important question today is, How is the Nation to solve its present financial problem? And a second important question is, How are you to safeguard your interests during the difficult times ahead?

Neither the Nation's financial problem nor your personal financial problem will be solved unless you and other interested citizens become well-informed about the developments that account for the present situation and are aware of the course of action that can remedy it. Perhaps most of the Nation's citizens cannot be induced to study the problem. An informed minority, however, even if only a few hundred thousand, could exert a decisive economic influence and, even at the polls, control the balance of political power.

The authorities may continue to temporize, but present indications are that they will be forced to choose between devaluation and deflation in the not-too-distant future. That decision will reveal whether or not the supposedly "responsible" members of the Federal Reserve Board

choose to be guided by their responsibility for the soundness of the dollar and whether or not the Administration leaders have the political courage to permit deflation. The decision also may reveal whether or not the Nation's independent balance-of-power minority have recognized the danger in the situation and have made their views known to those whose continued presence in legislative halls depends on their votes.

The future of the United States may depend on whether the American people will have the common sense to see that the advice of those economists who recommended the policies that have brought the Nation to the brink of financial disaster was bad advice. Whether they would then turn to the recommendations of economists who have continually opposed the "perpetual motion" ideas of the "creeping" inflationists we cannot yet know. But it is the American people themselves, or the better informed minority that may hold the balance of political power, who can demand and can get from their politically alert representatives in the Government a return to sound policies.

Sound Fiscal Policy

The first requisite of sound fiscal policy is a balanced budget. A government's budget may be out of balance from time to time, for part of a year or for an even longer period, and still not be harmful. But when deficits in large amounts are incurred almost continuously over a considerable period of time they result in inflation and impair confidence in the monetary unit, while, through the economic distortions that they cause, they keep the rate of economic growth at a low level.

This has been the experience of the United States. During the past 33 years, the Federal Government has had a surplus of receipts over expenditures only 6 times, and recurring deficits have increased the national debt from \$16 billion to \$308 billion. Because of the resulting inflation, the dollar today can purchase only 45 percent of what it could in 1940; and for several years the slow rate of national economic growth has been a continual cause of concern. Moreover, in recent years the dollar has been under such pressure in foreign exchange markets that its possible devaluation is a common subject of discussion.

A return to balanced budgets with Federal disbursements abroad limited to amounts that will permit a balance also in the country's international payments is obviously necessary. The Administration's proposal that a large reduction in taxes be made without a corresponding reduction of expenditures, while a large deficit is in prospect and the country's international financial position makes the dollar extremely vulnerable, would continue on the course that has brought the Nation to the brink of insolvency. Yet we are told that foreign short-term creditors are willing to see us do this without increasing their demand for gold.

Sound Money-Credit Policy

Sound fiscal policy, however, is only one part of the solution to the problem. The other is the adoption of a sound money-credit policy. The banking system shares with the Federal Government responsibility for the quality (and stability in value, at home and abroad) of the Nation's purchasing media. The policies of the Board of Governors of the Federal Reserve System, which are carried out through the 12 regional Federal Reserve banks, can cause an unwarranted expansion (inflation) of currency and checking deposits either when the Board and the Reserve Banks aid the Treasury in financing its deficits or when they act independently to inflate the supply of purchasing media. (During the 1920's, for example, the Government followed sound fiscal policies by continually running a surplus and reducing its debt; but the Federal Reserve banks inflated credit used for speculation on a vast scale, and the aftermath was one of the most severe depressions in U.S. economic history.)

Thus, if a sound financial situation is to be fully restored, the Federal Reserve authorities must be independent of inflationary Treasury influences and devoted to the kindred objectives of a stable money-credit system and a sound dollar. The Federal Reserve authorities can help to achieve and maintain these objectives by measures that discourage the monetizing of noncommercial debt, whether public or private, by the commercial banks. Sound banking will not be fully achieved in the United States, however, until the deposit-creating (debt-monetizing) ability of the commercial banks is restricted to short-term, self-liquidating (commercial) loans, so that all purchasing media in circulation represent either gold or other things en route to or being offered in the Nation's markets. But while better banking methods are being developed, much else of a more immediately important nature can be done to avert a possible flight from dollar claims and a run on the U.S. gold stock, thereby gaining time for a more thoroughgoing improvement of the money-credit system.

Interest Rates, Savings, Prices, and the Balance of Payments

The Federal Reserve authorities can help also by fostering a higher level of interest rates within the United States. In several ways this would have a favorable effect on the gold situation. It would immediately slow the outflow of U.S. investment funds abroad and attract more foreign investment funds to the United States, thus reducing the inclination of foreign holders of dollar claims to demand gold. A further effect would be the stimulation of saving by many individuals to whom the higher rate of return would make thrift more attractive. To the extent that the additional savings were invested they would accelerate economic growth,

and to the extent that they were used to pay off bank-held debt they would be deflationary. These developments would enrich and strengthen the national economy by enlarging the output of goods needed both at home and abroad while reducing costs of production and prices.

Because inflation is at the root of the Nation's worsening international financial situation, a gradual reduction in the excessive amount of purchasing media in use is necessary, if the situation is to be corrected. Because of the long inflationary rise in prices, many U.S. goods no longer can compete with foreign products. As prices decreased in the United States, due both to capital investment in cost-cutting technological improvements and to gradual deflation, a larger surplus in the country's international trade balance could be expected, with a correspondingly favorable effect on its overall balance of international payments.

In these observations is to be found an answer to the question, Why have foreign countries exchanged large amounts of their dollar claims for gold rather than used them to purchase U.S. goods and make investments within the United States? By obtaining gold they can buy the goods they want at lower prices in other countries and acquire investments in other countries at a rate of return that is higher than that obtainable for investments of comparable quality in the United States.

Some Specific Recommendations

1. In order to prevent a run on the dollar, the Government should reassure its foreign creditors that another devaluation will not occur. Already it has sought to reassure them with words, but mere words are not enough. Almost always, just before a devaluation, the government concerned issues a statement saying that it will not devalue. To make its words credible when it says "no devaluation," a government must also take certain actions.

2. As soon as possible Congress should enact suitable legislation that would require a return to the full gold standard, with redeemability of the currency for all holders of it after an interim period of perhaps several years, as may be deemed necessary.

3. Monetization of public debt and private noncommercial debt should be ended. Commercial banks gradually should decrease their investment-type assets (including mortgages and consumer loans) to an amount not more than the capital funds and savings or time deposits that justify the acquisition of such assets.

While accomplishing this liquidation of excessive investments, commercial banks should unhesitatingly enlarge their strictly commercial (short-term, automatically self-liquidating) loans as necessary to provide currency and checking account deposits representing things produced and en route to markets. Such purchasing media would be noninflationary.

Of course, in the absence of more inflation, and to some extent forced by gradual deflation, prices generally would decline. Thus, industries in the United States gradually could regain their competitive positions at home and abroad.

4. The Federal Government should spend much less than it collects in taxes and should steadily reduce its debt by a substantial amount each year. This would result in:

a. An immediate strengthening of confidence in Government securities, a better market for them, and a lower pattern of interest rates on such securities. The substantial savings in interest charges could be used to retire more debt.

b. The inflationary financing of Government deficits by commercial banks would be a thing of the past.

c. The better market for Government securities would facilitate demonetizing the debt previously monetized by commercial banks, because the banks could more readily sell such securities to private investors.

5. In order to lessen Government spending as well as to terminate an experiment that has been disastrous and costly, the spending of billions of dollars to take farm products off the market should be ended.

6. For all proposed Government spending, Congress should consider whether the funds it might spend could be left to better advantage in the hands of individuals and businesses in order to facilitate economic growth.

7. The Government should adopt an unbiased attitude toward labor problems and wage rates. During gradual deflation, with prices gradually declining, some of the labor force probably would have to accept moderate reductions in wage rates; but all wage and salary earners could expect a higher standard of living to result from lower prices. If labor and management would agree on formulas for those wage reductions that became necessary much strife would be avoided.

* * * * *

Many readers may be surprised at the assertion that in all probability the Nation's rate of economic growth would be increased greatly under conditions resulting from adoption of these recommendations, in much the same way as it was increased in the period following enactment of legislation that set the date (January 1, 1879) for the reestablishment of a redeemable currency. As shown in Chapter V, a 40-percent decline in prices was accompanied by the highest and best sustained rate of industrial growth in the Nation's history. However, such a large and extended decline in prices following a return to the full gold standard today is not to be expected. Under present gold mining conditions, the stimulation of gold production attributable to decreasing costs would

result in a rapidly increased gold output, with a consequent stabilization of prices as additional new gold entered the Nation's monetary system.

Within a few years, under sound money-credit conditions, the health and vigor of the American economy could be restored. This statement is not the expression of a visionary hope but is fully warranted by previous experience in the United States. It is supported too by the "miracle" of West Germany's industrial recovery and growth since World War II, which is attributable largely to the restoration of more nearly free markets and a sound currency freely exchangeable for gold. Further confirmation can be found in the examples of other European countries that in recent years experienced a marked increase in economic growth after having taken measures to protect their currencies from inflationary depreciation.

What Should Be Done if There Is a Run on the Gold Stock

As soon as official actions as well as words indicated that a return to sound policies was firmly intended, confidence in the dollar should quickly revive and the danger that now threatens the Treasury's gold stock should recede. If before this, however, for some reason or other, a run on the gold stock developed or were clearly imminent (perhaps because of a period of debate and uncertainty as to the policies that would prevail and that would determine the dollar's future value), certain practical, though presumably temporary, measures would be necessary to prevent the loss of most or all of the Nation's monetary gold. Because the gold stock is not only the Nation's monetary reserve but also its basic reserve for war and other emergencies, such a depletion of it should not be allowed, even though restrictions had to be placed on the payment of gold to the foreign governments and institutions that are entitled to it.

If a run on gold develops, the Treasury should continue to pay out gold on demand to its foreign creditors, but they should be informed that licenses for gold withdrawals (which would be the means by which the outflow could be controlled) would limit them to amounts that would not jeopardize the gold stock. The rate of gold outflow permitted, perhaps \$100 million per month or some such amount, should be no more than could be continued without danger during the period in which the Government might try to restore confidence in the dollar.

The foreign creditors should be informed also that their demand claims on gold would be honored in the order received. Those who wanted to withdraw gold would be required to convert interest-bearing investments (Treasury bills, savings and time deposits, and the like) into demand claims on dollars (i.e. into currency or demand deposits) and present those claims to the Treasury. Thus while waiting for pay-

ment, the foreign creditors would forfeit interest on the amount of gold they sought to claim. This would be the price they would have to pay for a place in the waiting line. Presumably it would reduce the amount of claims presented for payment.

As soon as sound measures replaced those that had caused the run on gold, these restrictions should be removed, of course. During the period of restriction the dollar probably would depreciate in foreign exchange markets; but with a return to sound monetary conditions and the removal of the restrictions, the dollar could be expected to appreciate to its full gold parity rate of exchange with other currencies.

Can Personal Interests Be Safeguarded?

The individual is limited in what he can do to protect himself against the hazards that are inherent in inflation, devaluation, and deflation. He cannot know with certainty which of these possible developments the future holds in store. He must face the possibility also of a continuation of the trend toward collectivism, whereby the Government takes an increasing measure of control over the economic life of all the people. In whatever ways the individual attempts to preserve the value of his earnings and savings against any of these contingencies, he must incur risks of a kind that would not have to be incurred under sound, and therefore stable, money-credit conditions.

In view of the diverse possible future developments and because an adequate scientific basis for assigning greater probability to one than another is lacking, there is not any adequate protection available that will insure the future purchasing power of all of one's accumulated savings. Concentration of a large portion of one's funds in domestic common stocks involves not only acceptance of an undesirably low rate of return but also the risk of severe losses in the event of deflation and depression. Those who invest most of their funds in bonds and liquid cash reserves might lose much of their purchasing power if more inflating or another devaluation of the dollar occurs. Shares of selected foreign gold mining companies and short-term bonds of countries that have demonstrated their determination to maintain a sound currency and to follow sound fiscal practices probably are the safest investments now available. However, such securities are not readily obtainable by the average investor of modest means; and they involve the risk, if foreign exchange restrictions or excessive taxes are imposed, that much or all of the income and principal might be unavailable to the investor when needed. For this reason we do not feel justified in recommending these investments for

²For a more comprehensive discussion of this question, see the Institute publications *What Would More Inflation Mean To You?* and *How to Invest Wisely*.

individuals who are dependent on their investment income to provide their living expenses and meet their other current needs.

Probably the best course that can be followed by the average investor today is to place 65 to 70 percent of his funds in fixed-income investments including some well-secured medium-grade bonds, and the remaining 30 to 35 percent in the common stocks of leading domestic corporations or closed-end investment companies. For individuals in modest circumstances, however, the point has now been reached where only a return to the gold standard and its discipline could assuredly protect their savings.

Summary

If suitable fiscal and monetary measures were taken to correct the present adverse gold situation, in which a flight from the dollar and a devaluation have become imminent dangers, the restoration of the full gold standard would quickly become feasible. Increasing confidence in the future of the dollar would make currency (promises to pay dollars) and interest-bearing claims on dollars preferable to the gold that secured them and that would be freely available, under the full gold standard, to any individual, citizen or foreigner, and to any institution that held U.S. currency. The adoption of sound fiscal and monetary policies would establish the conditions under which the full gold standard could exist and could operate to restrain departures from such policies while automatically regulating the supply of purchasing media within the country and the flow of funds between this and other countries.

Although the international financial situation of the United States has seriously deteriorated, and because of official adherence to unsound policies that situation is continually becoming worse, nevertheless it need not be regarded as hopeless. If sound policies along the lines suggested were adopted and maintained, the threat to the status of the dollar as a stable, trustworthy monetary unit, and the consequent threat to the financial standing and integrity of the United States in its relations with the rest of the world, would be ended.