

Central Banks, Gold, & Decline of the Dollar

by Robert Batemarco

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Are business cycles, inflation and currency depreciation inevitable facts of life? Are they part of the very laws of nature? Or do their origins stem from the actions of man? If so, are they discoverable by economic science? And, if economics can teach us their origins, can it also teach how to avoid them?

The particular need which all money, even fiat money which we now use, serves is to facilitate exchange. People accept money, even if it is not backed by a single grain of precious metal, because they know other people will accept it in exchange for goods and services.

But people accept the U.S. dollar today in exchange for much less than they used to. Since 1933, the U.S. dollar has lost 92 percent of its domestic purchasing power.¹ Even at its “moderate” 1994 inflation rate of 2.7 percent, the dollar will lose another half of its purchasing power by 2022. In international markets,

the dollar has, since 1969, depreciated 65 percent against the Deutsche Mark, 74 percent against the Swiss franc, and 76 percent against the yen.²

Many economists claim that this is the price we pay for “full employment.” If so, I’d like to ask who among you thinks we’ve gotten our money’s worth? We’ve experienced eleven recessions³ since the advent of inflation as the normal state of affairs in 1933, with the unemployment rate reaching 10.8 percent as recently as 1982. Clearly, the “demise of the business cycle” — a forecast made during every boom since the 1920s — is a mirage.

Other things being equal, if the quantity of anything is increased, the value per unit in the eyes of its users will go down. The quantity of U.S. money has increased year in and year out every year since 1933. The narrow M1 measure of the quantity of U.S. money (basically currency in circulation and balances in checking accounts) stood at \$19.9 billion in 1933. By 1940, it had doubled to \$39.7 billion. It surpassed \$100 billion in 1946, \$200 billion in 1969 (and 1946-1969 was considered a noninflationary period), \$400 billion in 1980, \$800 billion in 1990, and

today it stands at almost \$1.2 trillion. That is over 60 times what it was in 1933.

For all practical purposes, the quantity of money is determined by the Federal Reserve System, our central bank. Its increase should come as no surprise. The Federal Reserve was created to make the quantity of money “flexible.” The theory was that the quantity of money should be able to go up and down with the “needs of *business*.”

Under the Fed, “the demands of *government* funding and refunding . . . unequivocally have set the pattern for American money management.”⁴ Right from the start, the Fed’s supposed “independence” was compromised whenever the Treasury asserted its need for funds. In World War I, this was done indirectly as the Fed loaned reserves to banks at a lower discount rate to buy war bonds. In 1933, President Roosevelt ordered the Fed to buy up to \$1 billion of Treasury bills and to maintain them in its portfolio in order to keep bond prices from falling. From 1936 to 1951, the Fed was required to maintain the yields on Treasury bills at 0.375 percent and bonds at 2.5 percent. Thereafter, the Fed was required to maintain “an

orderly market” for Treasury issues.⁵ Today, the Federal Reserve System owns nearly 8 percent of all U.S. Treasury debt outstanding.⁶

The Fed granted access to unprecedented resources to the federal government by creating money to “finance” (i.e., to monetize) government’s debt. It also served as a cartellization device, making it unnecessary for banks to compete with each other by restricting their expansion of credit. Before the emergence of the Fed, a bank which expanded credit more rapidly than other banks would soon find those other banks presenting their notes or deposits for redemption. It would have to redeem these liabilities from its reserves. To safeguard their reserve holdings was one of the foremost problems which occupied the mind of bankers. The Fed, by serving as the member banks’ *banker*, a central source of reserves and lender of last resort, made this task much easier. When the Fed created new reserves, all banks could expand together.

And expand they did. Before the Fed opened its doors in November 1914, the average reserve requirement of banks was 21.1 percent.⁷ This meant that at most, the private banking system could create \$3.74 of new money through loans for every \$1 of gold reserves it held. Under the Fed, banks could count deposits with the Fed as reserves. The Fed, in turn, needed 35 percent gold backing against those deposits. This increased the available reserve base almost threefold. In addition, the Fed reduced member bank reserve requirements to 11.6 percent in 1914 and to 9.8 percent in 1917.⁸ At that point, \$1 in gold reserves had the potential of supporting an additional \$28 of loans.

Note that at this time, gold still played a role in our monetary system. Gold coins circulated, albeit rarely, and banknotes (now almost all issued by the Federal Reserve) and deposits were redeemable in *gold*. Gold set a limit on the extent of credit expansion, and once that limit was reached, further expansion had to cease, at least in theory. But limits were never what central banking was about. In practice, whenever gold threatened to limit credit expansion, the government changed the rules.

Cutting off the last vestige of gold convertibility in 1971 rendered the dollar a pure fiat currency. The fate of the new paper money was determined by the whim of the people running the Fed.

The average person looks to central banks to maintain full employment and the value of the dollar. However, the historical record makes clear that a sound dollar was never the Fed’s intention. Nor has the goal of full employment done more than provide them with a plausible excuse to inflate the currency. The Fed has certainly not covered itself with glory in achieving either goal. Should this leave us in despair? Only if there is no alternative to central banking with fiat money and fractional reserves. History, however, does provide us with an alternative which has worked in the past and can work in the future. That alternative is gold.

There is nothing about money that makes it so unique that the market could not provide it just as it provides other goods. Historically, the market *did* provide money. An economy without money, a barter economy, is grossly inefficient because of the difficulty of finding a trading partner who will accept what you have and who also has exactly what you want. There must be what economists call a

“double coincidence of wants.” The difficulty of finding suitable partners led traders to seek out commodities for which they could trade which were more marketable in the sense that more people were willing to accept them. Clearly, perishable, bulky items of uneven quality would never do. Precious metals, however, combined durability, homogeneity, and high value in small quantity. These qualities led to wide acceptance. Once people became aware of the extreme marketability of the precious metals, they could take care of the rest without any government help. Gold and silver went from being “highly marketable” to being universally “accepted in exchange” — i.e., they became “money.”

If we desire a money that will maintain its value, we must have a money that cannot be created at will. This is the real key to the suitability of gold as money. Since 1492 there has never been a year in which the growth of the world gold stock increased by more than five percent in a single year. In this century, the average has been about two percent.⁹ Thus with gold money, the degrees of inflation that have plagued us in the twentieth century would not have occurred. Under the classic gold standard, even when only a fractional reserve was held by the banks, prices in the United States were as low in 1933 as they had been 100 years earlier. In Great Britain, which remained on the gold standard until the outbreak of World War I, prices in 1914 on the average were less than half of what they were a century earlier.¹⁰

Traditionally, the gold standard was not limited to one or two countries; it was an international system. With gold as money, one need not constantly be concerned with exchange rate fluctuations. Indeed, the

very notion of an exchange rate is different under a gold standard than under a fiat money regime. Under fiat money, exchange rates are prices of the different national currencies in terms of one another. Under a gold standard, exchange rates are not prices at all. They are more akin to conversion units, like 12 inches per foot, since under an international gold standard, every national currency unit would represent a specific weight of the same substance, i.e., gold. As such, their relationships would be immutable. This constancy of exchange rates eliminates exchange rate risk and the need to employ real resources to hedge such risk. Under such a system, trade between people in different countries should be no more difficult than trade among people of the several states of the United States today. It is no accident that the closest the world has come to the ideal of international “free trade” occurred during the heyday of the international gold standard.

It is common to speak of the “collapse” of the gold standard, with the implication that it did not work. In fact, *governments abandoned the gold standard because it worked precisely as it was supposed to: it prevented governments and their central banks from surreptitiously diverting wealth from its rightful owners to themselves.* The commitment to maintain gold convertibility restrains credit creation, which leads to gold outflows and threatens convertibility. If government were unable to issue fiat money created by their central banks, they would not have had the means to embark on the welfare state, and it is even possible that the citizens of the United States and Europe might have been spared the horrors of the first World War. If those same governments and central banks had stood by their promises to maintain convert-

ibility of their currencies into gold, the catastrophic post-World War I inflations would not have ensued.

In recent years, some countries have suffered so much from central banks run amok, that they have decided to dispense with those legalized counterfeiters. Yet they have not returned to the gold standard. The expedient they are using is the currency board. Argentina, Estonia, and Lithuania have all recently instituted currency boards after suffering hyperinflations. A currency board issues notes and coins backed 100 percent by some foreign currency. The board guarantees full convertibility between its currency and the foreign currency it uses as its reserves. Unlike central banks, currency boards cannot act as lenders of last resort nor can they create inflation, although they can import the inflation of the currency they hold in reserve. Typically, this is well below the level of inflation which caused countries to resort to a currency board in the first place. In over 150 years of experience with currency boards in over 70 countries, not a single currency board has failed to maintain full convertibility.¹¹

While currency boards may be a step in the right direction for countries in the throes of central-bank-induced monetary chaos, what keeps such countries from returning to gold? For one thing, they have been taught by at least two generations of economists that the gold standard is impractical. Let’s examine three of the most common objections in turn:

1. *Gold is too costly.* Those who allude to the high cost of gold have in mind the resource costs of mining it. They are certainly correct in saying that more resources are expended to produce a dollar’s worth of gold than to produce a fiat (paper) dollar.

The cost of the former at the margin is very close to a dollar, while the cost of the latter is under a cent. The flaw in this argument is that the concept of cost they employ is too narrow.

The correct economic concept is that of “opportunity cost”, defined as the value of one’s best sacrificed alternative. Viewed from this perspective, the cost of fiat money is actually much greater than that of gold. The cost of fiat money is not merely the expense of printing new dollar bills. It also includes the cost of resources people use to protect themselves from the consequences of the inevitable inflation which fiat money makes possible, as well as the wasted capital entailed by the erroneous signals emitted under inflationary circumstances. The cost of digging gold out of the ground is comparatively minuscule.¹²

2. *Gold supplies will not increase at the rate necessary to meet the needs of an expanding economy.* With flexible prices and wages, any given amount of money is enough to accomplish money’s task of facilitating exchange. Having the gold standard in place in the United States did not prevent industrial production from rising 534 percent from 1878 to 1913.¹³ Thus it is a mistake to think that an increase in the quantity of money must be increased to assure economic development. Moreover, an increase in the quantity of money is not tantamount to an increase in wealth. For instance, if new paper or fiat money is introduced into the economy, prices will be affected as the new money reaches individuals who use it to outbid others for the existing stocks of sport jackets, groceries, houses, computers, automobiles, or whatever. But the monetary increase itself does not bring more goods and services into existence.

3. *A gold standard would be*

too deflationary to maintain full employment. In the relationship of a gold standard to full employment, the gold partisans have both theory and history on their side. The absolute “level” of prices does not drive production and employment decisions. Rather the differences between prices of specific inputs and outputs, better known as profit margins, are keys to these decisions. It is central bank creation of fiat money which alters these margins in ways that ultimately send workers to the unemployment line. Historically, the gradual price declines of the nineteenth century made way for the biggest boom in job creation the world’s ever seen.

The practical issues involved in actually returning to a gold standard are complex. But one of the most common objections, determining the proper valuation of gold, is fairly minor. After all, the market values gold every day. Any gold price other than that set by the market is by definition arbitrary. If we were to repeal legal tender laws, laws which today require the public to accept paper Federal Reserve Notes in payment of all debts, and permit banks to accept deposits denominated in ounces of gold, a parallel gold-based monetary system would soon arise and operate side-by-side with the Federal Reserve’s fiat money.¹⁴

A more difficult problem than that would be how to get the gold the government seized in 1934 back into the hands of the public. But even that surely can’t be more difficult than returning the businesses seized by the Communists in Eastern Europe to their rightful owners. If the Czech Republic can do that, we should be able to get government-held gold back into circulation.

In all likelihood, the biggest problem gold proponents face is

that people simply aren’t ready to go back to gold. Most people aren’t aware of the extent of our monetary disarray and many of those who are don’t understand its source. Two generations of Americans have known nothing but unbacked paper as money; few realize that there is an alternative. In contrast, when the United States restored gold convertibility in 1879 and when Britain did so in 1821 and 1926, gold money was still seen as the norm. That is no longer the case.

It might take a hyper-inflationary disaster to shake people’s faith in fiat money. Let’s hope not. In addition to the horrendous costs of such a “learning experience,” it’s not even a sure thing that it would lead us back to gold. Recent hyper-inflations in places as disparate as Russia and Bolivia have not done so.

The desire to get something for nothing dies hard. Governments use central banks with the unlimited power to issue fiat money as their way to get some-

thing for nothing. By “sharing” some of that loot with us, those governments have convinced us that we too are getting something for nothing. Until we either wise up to the fact that governments can’t give us something for nothing or, better yet, when we realize the moral folly of taking government handouts when offered, we will continue to get money as base as our desires.

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I doubt that 20th Century warfare is possible without a credit-based monetary system. Historically, without credit, the only way a nation could normally fund a foreign war of aggression would be based on whatever wealth was accumulated in their government’s treasury. To initiate a foreign war (with all the attendant logistical costs of trans-



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port, feeding, arming, and paying the soldiers, etc.) would require a government to have a huge treasury.

But how would the government accumulate all that money except by taxing its own people? If government took enough money from its own people to fund a foreign war, two things would happen: 1) while the taxes were imposed and accumulated, they nation's own economy would be impoverished; and 2) the overtaxed, impoverished people would be unwilling to fight for their government -- i.e., their loyalty and morale would be so poor, they'd probably retreat or surrender rather than fight in the foreign war. The net result of overtaxing it's own people would be a loss of the economic strength and public support that's absolutely necessary to initiate and win a foreign war.

Further, while imposing a tax sufficient to fund a foreign war, a government would necessarily accumulate a lot of gold in its treasury before the war was actually declared. However, all that money in the government treasury would create a strong incentive for some other foreign government to initiate a war in order to steal the accumulated gold as plunder.

Since the local populace would be demoralized by high taxes, the local government could not count on their support to fend off an invasion. This public discontent would provide another incentive for a brash foreigner (or perhaps a domestic revolutionary or political rival) to attempt to overthrow the existing government. Result? By raising taxes, a government might precipitate its own destruction. Therefore, war might be less likely in a gold-based monetary system

On the other hand, if government could fund foreign wars with credit, it would not need to overtax and impoverish its

people before the war and thereby lose their loyalty and fighting spirit. Instead, leaders like Lyndon Johnson could promote our ability to have "guns and butter" and lead most folks to assume the proposed war would be economically painless. All government would have to do is print more money, spread patriotic propaganda about "fighting for democracy", and march a bunch of trusting, foolish kids overseas to lose legs, ingest Agent Orange, be left behind as POW's, or perhaps jeopardize their souls by killing "enemy" soldiers for reasons as lame as the 1960's "Domino Theory". If our kids were wounded, killed, or captured -- tough. The important thing was the war was initiated, more money was borrowed, and the American People were further indebted (some say "enslaved"). All this, through the modern miracle of credit-based warfare -- fight now, pay later!

The truth is probably this: You could not have one "world war" (let alone two) without first creating a credit-based money system. Korea, Viet Nam, Agent Orange, posttraumatic stress syndrome, POWs, Gulf War Illness -- without a debt-based, unlimited credit money system none of these would be likely, and the lives lost or shattered in those conflicts would've probably lived longer and more fully.

And it's probably not only the United States that's guilty of credit-based warfare; I'd bet that the post WWII global expansion of "Evil-Empire Communism" was funded by a generous line of credit from one or more banking systems. Without credit, how else could it have happened?

Why that credit may have been provided to the Soviet Union is debatable. But if those reasons persist and the USSR is gone, how would the powers that be create a new threat to the Western World? By providing

enormous credit to a potential adversary. What potential adversary remains besides Red China? Is the international banking community providing credit to China?

¹ Arsen J. Darnay, editor, *Economic Indicator Hand-book* (Detroit, London: Gale Research Inc., 1992), p.232 and *Survey of Current Business*, vol.75, Feb. 1995, p. C-5.

² *The Wall Street Journal*, Apr. 7, 1995, & *The Economic Report of the President, 1995*.

³ As measured by the National Bureau of Economic Research.

⁴ Robert Shapiro, "Politics and the Federal Reserve," *The Public Interest*, winter 1982, p.123.

⁵ Shapiro, pp.126-127.

⁶ *Federal Reserve Bulletin*, February 1995, p. A30.

⁷ Murray N. Rothbard, "The Federal Reserve as a Cartellization Device: The Early Years, 1913-1930," in Barry N. Siegel, editor, *Money in Crisis* (Cambridge: Ballinger Publishing Company, 1984), p.107.

⁸ Rothbard, pp.105-106.

⁹ Richard M. Salsman, *Gold and Liberty* (Great Barrington, Mass.: American Institute for Economic Research, 1995), p.26.

¹⁰ Michael David Bordo, "The Classical Gold standard: Some Lessons for Today," *Federal Reserve Bank of St. Louis Review*, May 1981, pp. 8-9.

¹¹ Steve H. Hanke, "Critics Err-Mexico Still Needs a Currency Board," *The Wall Street Journal*, February 22, 1995.

¹² For a fuller treatment of this issue, see Roger Garrison, "The Cost of a Gold Standard," in Llewellyn H. Rockwell, Jr., editor, *The Gold Standard: An Austrian Perspective* (Lexington Books, 1985), pp.61-79.

¹³ Alan Reynolds, "Gold and Economic Boom," in Siegel, p.256.

¹⁴ Hans Sennholz, *Money and Freedom* (Spring Mills, Pa.: Libertarian Press, 1985), pp.81-83.