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The President
The White House
Washington, D.C. 20500

Dear Mr. President:

Most economists are in one of four major groups. For the last three decades, Keynesian economists have dominated the field and have been the principal advisers to governments and central banks. They have relied on what may be called secular revelation and related older procedures as their methods of inquiry. Based on their theories they have urged perpetual inflating to perpetuate prosperity.

Some economists are "monetarists" or "Friedmanites." They also advocate continual expansion of the domestic money supply at some definite rate without limit or restriction by international money-credit developments.

A third group are the classical economists who rely on procedures of inquiry developed about 2,000 years ago but now largely superseded.

A fourth group rely on modern scientific procedures of inquiry developed during the present century. Much of the work of the National Bureau of Economic Research that was done under the guidance of Dr. Wesley C. Mitchell until his death (but not more recently) reflected application of these procedures of inquiry. The work of American Institute for Economic Research during the past 40 years also reflects application of these procedures.

The group of 21 economists selected for your "Summit" conference includes 12 Keynesian economists (most of them educated at or connected with Harvard). Of the 21, nearly all of them have had advisory or administrative experience in the Government where they have been, in varying degrees, the architects of the economic disaster now confronting Western civilization. These include some "Friedmanites."

Dr. Greenspan, of your Council of Economic Advisers, is perhaps the only classical economist you will be consulting.

Of the modern economic scientists developed at the National Bureau and at American Institute for Economic Research the list of 21 includes none. The latter in particular for the past forty years has been publishing *Research Reports* in which economic developments have been analyzed and the present economic turmoil has been predicted.

Would it not be wise to consult some of the modern economic scientists in the field of economics?

Sincerely,
E. C. Harwood
E. C. Harwood
Director Emeritus

September 3, 1974

RESTORING ECONOMIC ORDER

That the United States and most other leading industrial nations are confronted with serious economic disorder is clearly apparent. Perhaps the most alarming symptom is the increasingly rapid decline in the buying power of currencies, that is, the accelerating upward trend of most prices. Maladjustments among the nations engaged in international trade on a large scale are reflected in chaotic fluctuations of exchange rates. Interest rates so high as to inhibit important aspects of economic activity are still another symptom of the widespread economic disorder.

Many observers have focused their attention on one or another aspect of the maladjustments and have urged action designed to alleviate the particular distortion that seems to them most important. Few appear to understand that the existing economic disorder is exceedingly complex and has developed to the present acute stage during several recent decades.

The last great contraction of business activity, from 1929 to 1932, was followed by several attempts to alleviate the symptoms of economic disorder. As was predicted in Institute publications at the time, such actions prolonged the depression and inhibited lasting recovery for nearly a decade. In the present instance, if similarly unwise actions are to be avoided there must be more general understanding of how the economic distortions occurred in the 1920's and of the fact that similar and far greater distortions have developed since World War II. In view of the complexity of the problem we do not hope that any single and easy remedy will be found for present difficulties, but an understanding of the principal mistakes that account for present troubles may facilitate avoiding errors such of those of the 1930's, which would make a bad situation much worse.

THE ART OF COMMERCIAL BANKING

That the economic disorder today includes a near breakdown of the money-credit system will be questioned by few experienced observers. How has this come about?

More than two centuries ago the industrial revolution began to increase production enormously and at the same time to foster specialization to such an extent that more and more people became dependent on the rapid proliferation of organized markets. These two developments vastly multiplied the transactions in markets of all types and correspondingly increased the required amount of purchasing media, i.e., currency and checking accounts.

The flow of things to organized markets expanded at a rate unprecedented in the history of mankind. A procedure was required that would enable all entitled to a share of things produced to claim their respective portions. Obviously, the claim checks or purchasing media had to be distributed to employees and stockholders of businesses, to suppliers of raw materials, and to others entitled to claim things available in the markets. Moreover, the claim checks or purchasing media issued to represent the value of things in the markets had to be removed from circulation as things were sold.

No ready-made solution to this problem existed. No one is known to have invented or devised a system. The solution was found, after much painful trial and error, in the evolution of commercial banking as a gradually acquired art rather than as a scientific discovery.

Prior to World War I, the evolution of commercial banking had reached a stage such that:

a. All the leading industrial nations used gold by weight as their accounting or monetary units; and,

b. The art of commercial banking had evolved through the period of the unsound Scottish banks in great Britain and the "wildcat" banks in the United States to the stage of advance that subsequently prevailed in England for several decades and finally was embodied in the Federal Reserve Act in the United States. In this stage of development, a basic principle of commercial banking became widely understood and applied. This principle is that currency and demand deposits or checking accounts should be created only to represent gold and other things being offered in a nation's markets. The principle was applied by issuing gold certificates or other purchasing media for the gold held by the banking system (which was always offered in the markets by the redemption process) and by creating new demand deposits or other purchasing media only by discounting short-term notes and bills representing the values of things en route to or offered in the markets. As things were sold, the proceeds of sales were used to repay short-term borrowing, thereby removing purchasing media from circulation until new supplies of things were offered. This principle was embodied in the provisions of the Federal Reserve Act by permitting the Federal Reserve banks to hold only gold and such short-term commercial paper.

The extent to which the inflating during the past few decades has been attributable to monetizing government debt and the extent to which inflating has reflected unsound commercial banking are clearly shown in the chart Sources of Purchasing Media. Monetizing government debt is accomplished when the Federal Reserve banks acquire government securities by creating deposits in the form of U.S. or other checking accounts in exchange for the securities. Roughly half of the inflationary purchasing media in use was created by monetizing government debt and half was created by monetizing excessive private debt. Therefore, stopping deficit spending by government will not restore sound money-credit conditions. Also essential is the restoration of sound commercial banking.

A sound money-credit system requires two aspects of vital importance:

1. The accounting unit (or unit of money) must be some real thing that is relatively stable in exchange value over long periods of time, several decades at least. Only such an accounting unit can serve the needs of a modern industrial society. Never in the history of mankind when such an accounting unit has been abandoned has social order been maintained.

2. During the more recent cultural development of industrial societies in the 18th and 19th centuries, sound commercial banking evolved as a means of meeting the need for a vastly enlarged amount of purchasing media to facilitate the tremendously increased number of exchanges characteristic of industrial specialization and mass production. To summarize:

a. Sound commercial banking provided purchasing media (bank notes or currency, and checking accounts, sometimes called demand deposits) to represent gold held by the banking system (but continually offered in exchange for currency and demand deposits) and to represent other things being offered in the markets.

b. By the process of commercial lending, the banks created *temporary* purchasing media to represent things other than gold being offered in the markets. For example, a manufacturer who had shipped things to market could arrange for his bank to credit his account with the value of the things shipped, so that he could distribute the purchasing media thus created to those who had participated in processing the things sent to market. Thus all who participated in processing things for exchange could have temporary purchasing media with which they could claim any things (including gold) available in the markets.

c. After a manufacturer had deposited the proceeds of sales he then could have the bank debit his account for the amount involved, thereby removing from circulation the purchasing media created originally to represent things being offered in the markets. This summary description omits many complex details, but the basic principle is clear: Purchasing media were created and placed in circulation only to represent gold and other things available to be claimed in the markets (including the banks where gold could be claimed); and, as things were purchased in the markets, the purchasing media were removed from circulation by repaying bank loans, that is by having the banks debit the demand deposits (reduce the checking accounts) of those who had borrowed originally but who subsequently received the proceeds of sales in the markets.

Prior to World War I, relatively close adherence to the basic principle of sound commercial banking resulted in stable prices for nearly a century and in rapid economic development. Among the leading nations all currencies were freely interchangeable according to their respective gold weights. The seemingly endless complications reflected in floating exchanges, competitive devaluations, speculative flights from currencies, and inflating simply did not exist. Only in some places such as the United States during and immediately after the Civil War was the basic principle of sound commercial banking disregarded. Except in such instances, cyclical fluctuations of business activity were contained within a narrow range and for brief periods, reflecting minor departures from sound commercial banking.

Beginning with World War I, first in Europe and later in the United States, the basic principle of sound commercial banking was disregarded. So extreme was the departure from that principle that the great boom of the 1920's occurred, fostered by prolonged inflating aided by the gold-exchange standard (whereby gold was counted twice—once as the reserve of one central bank and again as the reserve of another that held the paper currency of the first country). The Great Depression was the inevitable aftermath of the great inflating.

During the 1930's, the years of the Great Depression, the economic notions of John Maynard Keynes became widely accepted as the remedy for depression difficulties. The "new" economic ideas (actually very old, but new to many ignorant of history) became virtually a new economic "religion" with fanatic followers in all the leading universities of Western civilization. Dr. Keynes' ideas were embodied in the charter of the International Monetary Fund, created in 1945-46. It became a great engine of inflation, and thus has functioned for nearly three decades.

Beginning in World War II and continuing until 1974, the process of inflating was repeated on an increasing scale. The central banks of leading nations created purchasing media to finance government deficits as well as to represent dollars and pounds added to their reserves, and the commercial banks simply disregarded the basic principle of sound commercial banking; in fact that principle seems almost to have been forgotten. Now the consequences confront us in the form of innumerable economic distortions, vast debts much of which will never be paid, and general economic disorder.

Many people seem not to realize that the symptoms of economic disorder reflect misapplication of real economic resources. For example:

1. Far more office space in New York City, and in many other cities, has been provided than will be needed for perhaps 10 to 20 years. In the meantime, numerous owners will become bankrupt and many leading institutions will suffer serious losses.

2. In Florida and in some other localities, hundreds of millions of dollars have been frozen in new condominium apartments that may not be genuine economic assets for years. In the meantime, creditors will lose large sums and the labor formerly employed in such construction must find other jobs or be unemployed.

3. Billions of dollars' worth of real wealth went "down the drain" in Vietnam. There is no way of recovering it and converting it to the capital equipment that it perhaps would have become if wisely invested.

4. More than a *trillion* dollars' worth of real wealth has been "embezzled" from savers and holders of life insurance by the subtle processes of inflating. There is no easy means by which this dissipated wealth can be recovered.

If stable money, a meaningful accounting unit for the short and long term were restored, free markets could function to expedite the restoration of economic order.

How To Begin

We do not see how anyone can devise a plan that will restore economic order within a short period of time. If there is some magic formula that could be embodied in new legislation thereby remedying the situation quickly, we do not know about it nor do we believe that anyone else does. Until many months have elapsed, we shall not even know the nature and full extent of the economic distortions that must be corrected and of the economic losses to be experienced. Many if not most of those distortions will have been partially or fully corrected by the subtle influences of competitive markets even before we recognize that the distortions exist.

Nevertheless, a beginning can be made that will form the foundation for economic order. We can take some action that we can be sure will tend to alleviate rather than exacerbate the problems.

The first step should be to coin gold in unit weights (not as dollars) and to restore the freedom to contract in terms of gold or its equivalent as is expressly provided and implied in the Constitution of the United States. No new and complicated legislation would be required. Free minting of coins and stamping of gold bars should be undertaken forthwith by the Government. Gold coins should be minted by the Government as an assurance of uniformity for citizens not in a position to judge the merits of coins made by various manufacturers. Gold bars might be manufactured by others as well as the Government if they choose to do so. They might not so choose if the Government bars were stamped with the weight and fineness free of charge.

Most important in this connection is that both coins and bars should have stamped on them their weight and fineness or the weight of pure gold (.999 fine). In order to be up to date in conformance with the metric system, the weight of pure gold should be indicated in grams to four or five decimal places. Coins containing five, ten, and twenty grams of pure gold might be the best for general use. *No indication of dollar amounts should be shown on the coins or bars.*

American citizens then would have available a new accounting unit, one gram of gold .999 fine, for such use as they might choose. (Such units might be designated metric gold (MG) or MAU, M for metric and AU for either accounting unit or as the chemical symbol for gold.) Banks might at first accept such items for storage, giving appropriate receipts. Almost surely, some banks soon would accept deposits denominated in MAU while continuing to accept other deposits denominated in dollars, just as many banks now accept deposits denominated in currencies other than their own. No doubt, some corporations would issue bonds denominated in MAU, especially when they discovered how much lower their interest-rate obligation might be. During a recent conference in London, representatives of insurance companies and pension funds, when asked what interest rates would induce them to buy such securities, replied 3 or 4 percent. Even government agencies, federal, state, and municipal, might experiment with obligations denominated in MAU.

At some future time, when other actions taken had resulted in a relatively stable exchange relationship between paper dollars and MAU, the dollar could, in effect, be superseded by legislation making one MAU (a gram of gold) the statutory equivalent in all contracts to a specified number of dollars, perhaps 7 or some other number, depending on the level at which relative stability of exchange, dollars for gold, existed.

Of course, there would be no relative stability of the paper dollar until not only inflating was stopped but also deflating had restored sound commercial banking. Until clearly evident progress toward this end was being made, the paper dollar would continue to decrease in exchange value for gold and other things (with possible intermissions during the temporary aftermaths of speculative flights from one currency or another into gold).

How to Restore Sound Commercial Banking?

Inasmuch as sound commercial banking has become a "lost art," its restoration within a few years probably will not be easy. The first step would be to separate commercial banking from other forms of banking. This does *not* imply that a bank must be split apart so that one new corporation will be a commercial bank, another corporation a bank for the collection and investment of savings, and another corporation a trust company. Any multi-purpose bank could continue to exist provided the commercial department is internally separated from other functions with appropriate separate accounting procedures. Assets and liabilities should be segregated by appropriate types for the different functions.

In particular, investment-type assets should be limited in amount to the savings-type liabilities. Investment-type assets include securities such as Government, municipal, and corporate bonds, mortgages, term loans, installment loans, and in fact all assets other than cash that do *not* represent (directly or indirectly) things *currently* being offered in the markets.

The assets that would balance demand deposits (checking accounts) and paper currency (including some in the form of warehouse receipts for gold) would be *only* gold and short-term self-liquidating commercial loans. Although the bankruptcies and debt liquidation during a depression help to restore the balance described, when and if the steps suggested are taken, more liquidation of earlier inflationary lending probably will be required. This is what occurred, and had to occur, from 1929 to 1932 in order to restore the banks still in existence to a sound condition.

A substantial part of the excess investment-type assets in the American banking system can be removed by substituting for Government securities in the Federal Reserve banks the "profit" on gold that will result when a relatively stable relationship between paper dollars and gold exists, perhaps in three to five years. This would facilitate the restoration of sound commercial banking without continuing the liquidation of debt to the extent that was necessary in 1929 to 1932.

Many serious economic problems will remain. Some of them were created in vain efforts to cope with the Great Depression of the 1930's. Others have prevailed for a longer period. Practically all have been both accentuated and obscured by the inflating during the past three decades. We see no hope that these problems will even be recognized, to say nothing of being appropriately solved, until sound and stable money-credit conditions are restored.

While that is being done, a next constructive step should be to foster the maximum effficiency of free markets. Many past efforts to remedy economic disorder by legislation that interferes with the functioning of free markets must be modified if their efficiency is to be restored.

Unfortunately, even some economists seem to be unaware of the remarkable efficiency of free markets. In recent years, many economists have become intrigued with computer models, which now are widely used in attempts to predict future economic activity. However, the limitations of computers, in comparison with the functioning of free markets, are so great that many predictions prove to be erroneous.

Complex as the large modern computers are, they nevertheless are simplistic in comparison with the actual functioning of free markets in a modern industrial society. Only relatively simple programs can be fed into any computer, and the number of variables is small in comparison with the multitude of variables that characterize any modern society. Every individual in each of his many transactions with others is another potential variable more or less capable of adjusting to changing circumstances.

Perhaps the greatest usefulness of free markets is that they foster innumerable adjustments long before the changing circumstances are reflected in statistics available to would-be managers of an economy, in government or elsewhere. Government intervention to remedy problems that arise, therefore, almost invariably fails or makes a bad matter worse (or appears at first to solve it, but in the long makes it worse or gives rise elsewhere to even worse side-effects). This situation has been epitomized in the assertion, "the best remedy for high prices is high prices". Government intervention to force the price of anything down encourages demand and discourages supply, thereby accentuating the basic discrepancy that accounts for high prices. In a similar manner, the best remedy for low prices is low prices, which encourage demand and induce the least efficient producers to produce other things. Government intervention in free markets tends to perpetuate and increase economic distortions; not to solve problems, but to institutionalize them.

A summary of the needed changes in the extent of government interventions would be beyond the scope of this discussion. However, a few questions are pertinent.

1. Aside from considerations of justice and the constitutionality of denying persons the right to work unless they can earn some specified amount, does the minimum wage force unemployment on millions who are in their formative years when they should be acquiring good work habits and skills and put them on the streets where education to become the barbarians of Western Civilization is too readily available?

2. How can restrictions on the earnings of retired persons be justified when every additional service or item of wealth produced adds to the total to be divided, especially when things produced or services are offered in the markets where they are, in effect, demand for the other things the producer wants?

3. Has Government regulation been an important factor in hamstringing most American railroads?

4. Has unwise regulation of the Nation's gas producers unnecessarily hampered the development of new sources?

5. Are the Government, some economists, and many other citizens laboring under a great delusion when they imagine that the correct answers to innumerable problems already are known, that politicians are capable of acting wisely to solve the problems, and that politically selected solutions will not make a bad matter worse?

6. Especially for the economists who have participated in designing the great disaster now confronting the Nation, with all the confident planning and fine tuning, is the mess we have today the goal you were aiming at?

Many more questions should be asked and the answers sought. Probably we shall not even recognize many of the interferences with free markets until the money illusion fostered by inflating is ended after the restoration of sound money.

This emphasizes that restoring economic and social order should begin with the money-credit aspect. A useful accounting unit is the sine qua non for a modern industrial society.

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