UNDERSTANDING THE MONEY MUDDLE
And How It Affects You

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Contents

I. THE TWENTIETH CENTURY GREAT DELUSION ................................. 1
   The Inflating Delusion .............................................. 1
   Laymen Can Understand ........................................... 1
   The Underlying Promise .......................................... 1
   Deceived by the Authorities ....................................... 2
   New Deception or New Hope? ....................................... 3
   Is Disaster Inevitable? ............................................ 4
   Your Responsibility ............................................... 5

II. STEPS IN THE DOLLAR'S DEGRADATION ................................. 6
   Currency Redeemable in Gold ..................................... 6
   Loosening the Ties .................................................. 6
   Removal of the Final Barrier ..................................... 7
   The Dollar is Not a Dollar ......................................... 7

III. SYMPTOMS AND CONSEQUENCES TO DATE ............................... 8
   Not So Obvious Consequences ..................................... 8
   Destroying Organized Society ..................................... 9
   Wage and Price Controls ........................................... 9
   The Damage Done by Controls ..................................... 10
   Devaluations and Floating ......................................... 11

IV. THE END OF TRADITIONAL PRACTICES .................................. 12
   Unreliable Accounting ............................................. 12
   Capricious Government ............................................ 13
   High Odds Against Success ....................................... 13

V. WHAT TO EXPECT ....................................................... 15
   Widespread Speculating ........................................... 15
   The Burden of Debt ................................................ 15
   More Controls ....................................................... 17
   Depression or a Flight from Currency? ........................... 17

VI. A POSSIBLE SOLUTION .................................................. 19
   Evolution of a Sound System ...................................... 19
   A Modest Beginning ................................................ 20

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I.

THE TWENTIETH CENTURY GREAT DELUSION

HUMANS have been the gullible victims of their own delusions ever since they achieved verbal facility as they ascended the evolutionary scale. Long before humans could write, they used the spoken word, and apparently from the time when language became part of the developing human culture, the verbal sophisticates have aided the gullible in acquiring every imaginable kind of self-delusion.

The vast range of human delusions will not be described here. Sorcerers, medicine men, witch doctors, oracles, advocates of human sacrifice to the gods, leaders of the Crusades (including the Children’s Crusades), and a multitude of others have helped to inculcate delusions in the human race.

THE INFLATING DELUSION

The Great Delusion of this twentieth century is the mistaken belief that inflating can somehow create orderly and sustainable economic growth. The delusion is not new. It has been nurtured through the ages by kings, princes, and oligarchs, whose coin-clipping defrauded their subjects while enriching the royal coffers.

But in the twentieth century the Great Inflating Delusion received the blessing of Lord Keynes who, as advisor to governments and teacher to teachers in the universities, became the most persuasive purveyor of monetary illusions since John Law. Lord Keynes’ disciples now include many, perhaps by far the most, of the academic economists as well as many others serving central banks, governments, and innumerable businesses.

The Keynesian theories became a secular “revelation”—as influential in our day as, in olden times, were various religious revelations that influenced millions of impassioned people. Inflating as a way of life today is as widespread and powerful a delusion as were the Crusades or the Dutch tulip mania. Inflating is perhaps the most pernicious development in Western civilization.

Inflating is the name applied in this bulletin to the process of issuing excessive amounts of currency and checking accounts (purchasing media) in relation to the things offered in the markets and available to be purchased. From one point of view, things processed and sent to the Nation’s markets are like the baggage placed in a baggage check room ready to be claimed by those who have baggage checks. When purchasing media in the hands of purchasers correspond in value with the things offered for sale, the flow of such things moves smoothly through the markets without serious price distortions.

However, when purchasing media in excess of those needed to represent things offered in the markets are created and issued, demand can exceed supply at the earlier prices. If inflating is relatively great in extent and is long continued, serious adverse consequences follow. Some of these are described in Chapter III.

In effect, the process of inflating is similar to counterfeiting. The excess purchasing media usually are created by the banking system in cooperation with the Government, in order that the excess (or counterfeit) purchasing media might be more readily accepted by the public.

LAYMEN CAN UNDERSTAND

During the past 4 decades the number of books, articles, speeches, and shorter assertions by economists, editorial writers, bankers, and politicians on the subject of money has reached fantastic proportions. We have read and analyzed much of this material. We doubt that the human race has produced in any other field of endeavor within a comparable period of time such a vast accumulation of conflicting, contradictory, and confusing material, much of it incoherent and inconsistent. For anyone attempting to find a useful description of what has happened and what the situation is today, the search cannot be compared with separating wheat from chaff, nor of finding the proverbial needle in a haystack. The task would be more like finding a few particular grains of sand that had been scattered in the Sahara Desert.

We cannot recommend that readers undertake to study all of the material for themselves. Nevertheless, we believe that the average serious reader who is not a trained economist can hope to obtain an understanding of the underlying principles involved and of the trend of developments. We offer the following in support of our belief.

First we should note that even the trained economists disagree markedly, so much so that some, and perhaps nearly all, must be seriously in error. Clearly, training as an economist even to the Ph.D. level provides no assurance of competence in this field of inquiry. How can the layman know what to believe when the experts so markedly disagree?

We suggest that one requirement for anyone who would understand the “money muddle” is to have been born with or to have acquired what may be called an inner compass or guiding star. Any reader who has become convinced that cheating one’s fellows is not a satisfactory basis for orderly social relationships should find little difficulty in understanding one of the basic principles of sound money.

The point we shall make in this connection is not intended primarily to be a moral one in the usual sense of moral. One of the ten commandments is, “Thou shalt not steal,” and many readers would accept that as appropriate guidance for the moral basis for behavior. However, we shall discuss the matter from the viewpoint of what has proved to be useful over the centuries in preserving and advancing social order. At the same time, we have no objection to the views of others who choose to rest their case on the basis of what they regard as moral law.

THE UNDERLYING PROMISE

In a modern industrial society, good order is preserved in part by means of a vast web of interweaving promises, expressed and implied. These are the promises men live by in this modern age.

A few examples will suffice to reveal the pervasiveness of such promises. The wage or salary earner advances to the employer the fruits of his labor for a week or a month in the expectation that the employer will carry out his promise to pay the agreed upon weekly or monthly wage. Manufacturers, wholesalers, and retailers create a vast web of mutual promises to accept or make deliveries and to pay on explicitly specified or customary
terms. Other promises link insurance companies and policyholders, issuers of bonds and the purchasers, and a multitude of other participants in financial transactions.

The whole structure of modern industrial and commercial society rests on promises, on loans made and credit granted in the expectation of future payment, and on other contracts that promise one thing for another.

The essential feature for efficient functioning of this system of promises is that the promises almost invariably be 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 trillion-dollar life insurance and pension plans, the sanctity of contract may well have been the greatest single influence in the economic progress of the United States and other advanced nations. A modern nation in which economic promises ceased to be kept on a wide scale 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 surely must impair the efficiency with which that system produces and distributes wealth.

In almost all economic promises the money aspect is dominant, because a stable monetary unit is necessary for their effective and satisfactory fulfillment. Inflating, however, through the resulting depreciation in buying power of the currency, breaks faith with those who considered the currency a thing of stable value. When carried far enough, inflating inevitably has led to devaluations of the currency. Devaluation is 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 commodity, 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 has abrogated such promises of its currency. For example, until recently all Federal Reserve notes contained the inscription, “The United States of America will pay to the bearer on demand (so many) dollars.” This promise to pay dollars on demand was a contract to pay gold, because each dollar then was defined by law as 1/35th of an ounce of pure gold. How-

DECEIVED BY THE AUTHORITIES

In nearly every modern nation the money managers are the administration in power and the central bankers. Several decades ago, some of the central bankers were largely independent of political control and could act as they deemed wise in order to assure their capacity to “make good” their promises and the related promises on each nation’s currency. However, the monetary policies adopted by most leading nations during and since the great world wars of this century have so altered the situation that now most central bankers are the willing, or sometimes unwilling, collaborators of the politicians in power.

Perhaps the most insidious but effective influence leading to the abandonment of sound commercial banking, as it was becoming more widely known prior to World War I, was the miseducation of most economists, bankers, and businessmen in recent decades. Lord Keynes, like John Law of Mississippi Bubble fame more than 2 centuries ago, was a man who, if he ever had an inner compass or guiding star, lost it early in life. As has been true of many perpetual-motion mongers, his facility with words was phenomenal, and he acquired a devoted following among economists. By far the majority of the institutions of higher economic education in Western civilization have become diploma mills grinding out students indoctrinated with the notions of Lord Keynes, if they learn any economics at all.

To summarize, the unwarranted Keynesian notions include:

1. Requiring money managers (either governments or banks) to “make good” on their promises to provide some definite quantity and quality of real wealth on demand is anachronistic; thus gold, the principal item of wealth that had been found most useful in forcing governments and bankers to keep their promises, is a “barbarous relic.”

2. By inflating a nation’s supply of purchasing media, prosperity can be restored virtually at will, and maintained indefinitely.

3. Lincoln’s dictum, “You can fool some of the people all of the time and you can fool all of the people some of the time, but you cannot fool all of the people all of the time,” should be changed to, “If you are clever enough, you can fool all of the people all of the time, because we live only in the short run and in the long run we are all dead.”

Politicians are among the principal beneficiaries of inflating, because they can “buy” votes with promises to spend without taxing. Monetizing the deficits with the aid of the central bank is the process of inflating that has been most used in modern times. In earlier times, the less subtle practice of “clipping coins” accomplished the same purpose.

During the past 4 decades, the political and monetary authorities of the leading industrialized nations have applied Lord Keynes’ prescription to inflate almost continuously in an effort to restore and maintain prosperity. Simpler notions of responsibility and integrity have all but disappeared, as far as the world’s money managers are concerned. Clearly, they have no intention of “making good” on their expressed and implied promises to pay real wealth equivalent to that received. If this seems like harsh criticism of men who work in imposing marble halls and whose protestations of concern about money-credit matters have filled space in the press for many years, so be it. The ordinary intelligent man should simply look at the consequences of monetary policy and judge for himself.

From time to time, the political money managers and their banker collaborators deplore the consequences of inflating. This has become commonplace in the United States
during recent years. However, few that we are aware of have urged an end to inflating; by far the most recommend only a lessening in the rate of it. From their actions, it is obvious that their purpose is not to stop the embezzling but to maintain the confidence of those who are the victims so that trust in paper money and bankers’ promises will not vanish, leaving the embezzlers with nothing to steal. In short, they conspire to continue the process indefinitely, and they need unwary victims to do so.

One European central banker has candidly said, “Fraud is a poor foundation for a money-credit system.” Of course he was right. Nevertheless, the political money managers, aided and abetted by their central bankers, intend to continue defrauding citizens of their savings and life insurance. History provides a long and clear record of such procedures, but the money managers of Western civilization reveal no awareness that they are destroying the foundation of social order.

Nearly every nation today in Western civilization has become a politicians’ paradise in a bankers’ heaven. What could be more “heavenly” for a banker than government guarantees of his deposit liabilities, while at the same time he is relieved of making good on his implied promise to repay on demand the equivalent of the real wealth he had received?

But a politicians’ paradise in bankers’ heaven is for most citizens not a heaven but a hell providing tortures not dreamed of in Dante’s Inferno. Those tortures, described as the consequences of prolonged inflating, tend to destroy organized society. Anyone who reads newspapers knows about the appalling evidence of increasing social disorder and economic disintegration.

How long the fraudulent process of inflating can be continued without collapse of the system is not ascertainable — perhaps a few decades or a few more years. But the ultimate result is predictable if inflating continues. One should not be deluded about that!

**NEW DECEPTION OR NEW HOPE?**

After many instances of implementing policy changes that were largely palliatives for stopping ongoing “runs” against the dollar in foreign-exchange markets, the Federal Reserve Board (the U.S. central banking authority) announced on October 6, 1979 a new set of policies ostensibly intended to stem the erosion of confidence in the paper dollar. The loss of confidence was reflected in a sharp increase in the price of gold from about $300 in late August 1979 to nearly $400 in late September (see Chart 1). Eleven months earlier, on November 1, 1978, U.S. officials also had announced a rescue plan for the dollar, after a summer of turmoil for the dollar when the price of gold rose from about $180 per ounce in late June to roughly $240 an ounce in late October. That plan succeeded in reversing the downward trend in the value of the dollar for a few months. However, because that plan treated the symptoms of inflating and not inflating itself, the widespread move out of the dollar and into gold and other currencies resumed in the spring and accelerated in the summer.

The October plan was significantly different from earlier ones. Obvious palliatives such as larger “swap” agreements, larger Treasury gold sales, and the use of SDR balances were absent. Instead, the Fed, for the first time in decades, chose to focus primarily on the sources of inflationary purchasing media, namely, past Fed policies provided the banking system with too many dollars of reserves that subsequently were used to create too much purchasing media in relation to available goods. The chief of the three new Fed actions, in the words of the Fed, were:

“A change in the method used to conduct monetary policy to support the objective of containing growth in the monetary aggregates over the remainder of this year within the ranges previously adopted by the Federal Reserve. These ranges are consistent with moderate growth in the aggregates over the months ahead. This action involves placing greater emphasis in day-to-day operations on the supply of bank reserves and less emphasis on confining short-term fluctuations in the Federal funds rate.”

This change in focus was highly significant, but not because it revealed that Fed officials finally learned about the sources of inflationary purchasing media. We are confident that they understood the inflating process for some time. Its significance was that, having drawn full attention to the key monetary series such as Federal
Table 1
GROWTH RATES OF SELECTED MONETARY SERIES
(Seasonally adjusted, compound annual rates of change)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal Reserve credit*</td>
<td>10.0</td>
<td>7.8</td>
<td>11.3</td>
<td>7.1</td>
</tr>
<tr>
<td>Member bank reserves*</td>
<td>7.0</td>
<td>1.2</td>
<td>9.6</td>
<td>4.9</td>
</tr>
<tr>
<td>Monetary base*</td>
<td>9.3</td>
<td>6.5</td>
<td>11.1</td>
<td>6.8</td>
</tr>
<tr>
<td>M-1B money stock</td>
<td>8.9</td>
<td>7.2</td>
<td>10.9</td>
<td>1.5</td>
</tr>
</tbody>
</table>

* Adjusted for reserve requirement ratio changes by Federal Reserve

Table 2
PRICE CHANGES AND BUDGET DEFICITS

<table>
<thead>
<tr>
<th>Year</th>
<th>CPI*</th>
<th>PPI*</th>
<th>Deficit†</th>
</tr>
</thead>
<tbody>
<tr>
<td>1971</td>
<td>3.4</td>
<td>3.2</td>
<td>23.0</td>
</tr>
<tr>
<td>1972</td>
<td>3.4</td>
<td>3.8</td>
<td>23.4</td>
</tr>
<tr>
<td>1973</td>
<td>8.8</td>
<td>11.8</td>
<td>14.8</td>
</tr>
<tr>
<td>1974</td>
<td>12.2</td>
<td>18.3</td>
<td>4.7</td>
</tr>
<tr>
<td>1975</td>
<td>7.0</td>
<td>6.6</td>
<td>45.2</td>
</tr>
<tr>
<td>1976</td>
<td>4.8</td>
<td>3.3</td>
<td>66.4</td>
</tr>
<tr>
<td>1977</td>
<td>6.8</td>
<td>6.6</td>
<td>45.0</td>
</tr>
<tr>
<td>1978</td>
<td>9.0</td>
<td>9.2</td>
<td>48.8</td>
</tr>
<tr>
<td>1979</td>
<td>13.3</td>
<td>12.5</td>
<td>27.7</td>
</tr>
<tr>
<td>1980</td>
<td>13.7</td>
<td>13.8</td>
<td>60.9</td>
</tr>
</tbody>
</table>

* Rates of change December to December for Consumer Price Index – All Urban (CPI) and Producer Price Index for Finished Goods (PPI), except 1980 is annualized rate of change for January through July, not seasonally adjusted for CPI, seasonally adjusted for PPI.

Reserve credit, member bank reserves, the monetary base, the money stock measures, etc., the Fed in fact would have to practice less expansion or their failure would be immediately evident and would promote a new "run" on the dollar.

As Table 1 reveals, Federal Reserve authorities did appear at first to put into practice the new policy they announced on October 6, 1979. From September of that year until May 1980, the rates of growth in key monetary series were lower than immediately before the new operating strategy was disclosed, say from May 1979 to September 1979. In following these developments in our weekly publication, Research Reports, we warned against attributing too much significance to this small slowing over a brief duration, as many analysts had been doing. It was clear to us there were many earlier instances when Fed officials, in order to stop waning confidence in the paper dollar, temporarily followed less easy (notice that we did not say restrictive) policy, only to abandon such “restraint” when economic activity seemed to begin to falter. An earlier instance of a temporarily less easy policy occurred from October 1978 to May 1979, which was subsequent to the November 1, 1978 “rescue” package mentioned earlier.

From the data in the right-hand column of the table, one can see that from May 1980 through August (the most recent data available) the growth rates of the key monetary series were back to the previous high rates from which monetary officials promised a slowing. The price of gold, which had risen sharply in December 1979 and January 1980, when Russia invaded Afghanistan and threatened to bring war to the Middle East, is on its accelerating growth path again, after dropping markedly when war appeared to be less imminent than was thought in January 1980. In effect, the gold-market participants are telling U.S. monetary officials, “We don’t believe that you will stop inflating or even slow it significantly.” Considering the most recent evidence, together with the many past broken promises of Federal Reserve authorities, that conclusion is eminently reasonable. An end to inflating is not on the horizon, at least not now.

IS DISASTER INEVITABLE?

Perhaps the heretofore invariable trend of developments will not be repeated. At this time, in the United States at least, an important aspect of the situation differs greatly from prior inflations here or elsewhere in the world. For the first time in the history of the human race, by far the most (perhaps 80 percent) of the families in a nation own large amounts of life insurance and of savings fixed in dollar amount, such as U.S. Savings Bonds, savings deposits, etc.

Mankind’s earlier experiences might not be repeated in the present instance, because those who are losing as a result of the continued inflating constitute a large portion of the Nation’s voters. If they so choose, they can at some indefinite future time elect a President and enough Congressmen who have pledged to restore sound money-credit conditions and who will carry out such promises. During recent years, growing numbers of politicians have been vocal in their opposition to more inflating, but few have pledged to act accordingly and few now are so acting in spite of much verbal “shadow-boxing” with the problem. Nevertheless, one cannot deny the possibility that different leadership will come forth if the general public demands that inflating be ended.

The election in 1976 of Jimmy Carter over Gerald Ford, the more economically conservative candidate, indicated that the majority of voters still were deluded with the notion that the Government could provide them with good economic times simply by spending more and/or taxing less.

Progress toward lower rates of price increases that was made during the 1973-75 recession was reversed after 1976, and Federal budget deficits remained unusually large for a period of peace and economic expansion. (See Table 2.) A number of analysts have asserted that the 1973-75 recession did not degenerate into a total collapse of the economy only because the Government incurred a huge budget deficit that quickly cycled saved purchasing media back into the spending stream, enabling highly indebted business firms and consumers to meet their financial obligations.

One might be inclined to congratulate U.S. officials for the wisdom to initiate those policies and prevent worse hardship. However, the inflationary policies that helped end the recession also prevented the correction of many economic distortions fostered during the preceding period of inflating. The unsound practices employed during Jimmy Carter’s term in office thus were placed on top of an already weakened foundation, and the adverse effects on the economy were more severe.

Now the Nation is approaching another Presidential election, with the economy apparently coming out of a recession, with prices shooting upward, and with the paper dollar suspect around the world. Again the American voter has a chance to express his or her attitude toward the policy of spending-inflating-embezzling.

The 1980 Democratic platform does not call for an end to “inflation,” simply for a fight against it, but only if the fight is painless:

“In using monetary policy to fight inflation, the
Government should be sensitive to the special needs of areas of our economy most affected by high interest rates. The Federal Reserve should take particular care to make certain that it is aware of the concerns of labor, agriculture, housing, consumers and small business in its decision-making process.”

Republicans reveal a much more realistic understanding of “inflation” and the need to stop it:

“Inflation is too much money chasing too few goods. Much can be done to increase the growth of real output. But ultimately price stability requires a non-inflationary rate of growth of the money supply in line with the real growth of the economy. If the supply of dollars rapidly outstrips the quantity of goods, year in, year out, inflation is inevitable.

“Ultimately, inflation is a decline in the value of the dollar, the monetary standard, in terms of the goods it can buy. Until the decade of the 1970s, monetary policy was automatically linked to the overriding objective of maintaining a stable dollar value. The severing of the dollar’s link with real commodities in the 1960s and 1970s, in order to pursue economic goals other than dollar stability, has unleashed hyper-inflationary forces at home and monetary disorder abroad, without bringing any of the desired economic benefits. One of the most urgent tasks in the period ahead will be the restoration of a dependable monetary standard—that is, an end to inflation.”

The reference to the “severing of the dollar’s link with real commodities” and to “restoration of a dependable monetary standard” hints at the possibility of again making the U.S. monetary unit some weight of gold rather than the paper no-thing that it now is. Reportedly, some of Governor Reagan’s economic advisers urged an explicit endorsement of the aim to restore the dollar as a unit of gold. The absence of such a statement raises doubt about the usefulness of Republican views toward money, but their position on this matter of utmost importance is not as deficient as that of the Democrats.

More important for the outlook for inflating than the specific party platform positions and the probability of their being implemented if their respective candidates are elected, is the attitude of the voting public that the election results will reveal. The election of Ronald Reagan would not be a guarantee that the role of Government will be substantially reduced, that inflating will end, and that a sound monetary and economic system will be restored. However, the re-election of President Carter would almost ensure the opposite, for it would be a signal to the politicians that the American public still has not recognized or rejected the spending-inflating-embezzling practice that has been followed for nearly 5 decades and has been so successful in enhancing the power of politicians. Without that sign from voters, politicians assuredly will continue their reckless (and economy wrecking) spending and inflating.

YOUR RESPONSIBILITY

To reverse the economic retrogression of the United States, every responsible individual should gain an understanding of what constitutes sound policies and to share that understanding with as many of his family and friends as possible. By so doing, those concerned with their own future and with that of their family at least will be expending their energy for a useful purpose. With enough such effort, future election results might send to the seats of political power more individuals committed to the adoption of sound policies.

Armed with an understanding of the “money muddle,” one also is in a better position to preserve his own wealth. Doing so is desirable from more points of view than simply that of wanting to keep what one has earned, although we do not want to disparage that motive.

Inflating can be continued only as long as substantial real wealth can be “embezzled” from savers. Only the transfer of real wealth from some members of society to others in the group makes possible continuation of the process, with “business” more or less as usual. When the real wealth of savers and life insurance holders has been dissipated, continued inflating must be reflected in rapidly spiraling prices, what is called “runaway inflation,” and the economic collapse to severe depression that follows the final discrediting of a nation’s currency. Such developments usually have set the stage for dictatorship in fact if not in form.

Therefore, by keeping as much of one’s wealth in forms that prevent its embezzlement through inflating, one denies to the perpetrators of inflating an enlarged pool of wealth that can be stolen and thus hastens the end to inflating. If the end ultimately is total economic collapse, the wise individual will have preserved as much of his wealth as practicable, and he will be in a financial position to contribute to the preservation of political freedom and economic rehabilitation. These would not be inconsequential benefits.

Inflating may end in the United States if and when savers and holders of life insurance, the great majority of American families, insist on a return to sound money-credit conditions. There is little reason as yet to believe that such a revolt by the victims soon will occur. In the meantime, their real wealth now is being “embezzled” at faster and faster rates. An end to inflating, even if not clearly in sight, inevitably will come. By reading on, you might be better equipped to cope with this situation.
II.

STEPS IN THE DOLLAR’S DEGRADATION

ESSENTIAL to an understanding of the implications of current monetary events is an understanding of the developments accounting for the prolonged degradation of the dollar during the past half-century or more.

Economic activity consists of processing (including distributing) things and providing services, which involve a multitude of exchange transactions in a modern industrial nation. Even before economic activity became highly specialized or industrialized, humans recognized that the direct exchange of things (barter) was inefficient; consequently, the use of media of exchange developed. This removed the constraints to economic expansion associated with barter.

However, for an exchange medium to function efficiently, it must be acceptable to virtually all of the participants in the markets. To the extent that it is not acceptable, exchanges become more difficult and economic activity is obstructed. Although thousands of things at different times in history and different places in the world have been used as media of exchange for various periods of time, only one has a record of never having become unacceptable. That is gold.*

CURRENCY REDEEMABLE IN GOLD

An enviable record such as this did not go unnoticed by government officials, and gold long has been an acceptable means of payment among nations. Before the Federal Reserve System, which functions as the central bank of the United States, was established by the Federal Reserve Act on December 23, 1913, much of the Nation’s currency in use was in the form of gold certificates. These were redeemable in gold on demand at the U.S. Treasury. The advantages of continuing to tie the Nation’s currency to gold were widely recognized and were reflected in provisions of that Act.

Federal Reserve notes, which later were to become the principal paper currency of the Nation, also were made redeemable in gold on demand. The Federal Reserve banks were required to maintain reserves in gold of not less than 40 percent of the amount of their notes in circulation.

Furthermore, the balance of such notes was to be secured by the pledge of “... notes, drafts, bills of exchange arising out of actual commercial transactions...” that were rediscounted by those banks. Such notes, drafts, and bills of exchange were short-term, self-liquidating promissory notes reflecting the movement of things produced to the markets for sale. When held by the central bank, these instruments represented a claim on outstanding purchasing media. Repayment of the loans represented by such instruments involved the removal from circulation of an equal amount of purchasing media that the borrowers had acquired as things were sold. This arrangement was intended to promote dynamic balance between the dollar-value of gold and other products offered in the markets, on the one hand, and the amount of purchasing media available to bid for the gold and other products.

The gold provisions both enhanced the domestic and international acceptability of the purchasing media and established an upper limit to the amount of Federal Reserve notes that could be issued, given the stock of gold held by the central bank. Within that upper limit, the provision requiring backing by rediscounted trade paper provided a means by which the volume of paper currency could expand and contract in accordance with the sustainable needs of business and agriculture.

Purchasing media comprised checking accounts in commercial banks as well as paper currency. However, with checking accounts redeemable in currency and currency redeemable in gold, total purchasing media reflected the limitations of the aforementioned provisions of the original Federal Reserve Act.

Since August 15, 1971 there has been no effective limitation on the volume of purchasing media that the monetary officials of the United States can create. How did the situation come to this? A brief chronology of the events involved follows.

LOOSENING THE TIES

Opinion varied widely after the crash of 1929 and during the ensuing depression as to what should be done to return prosperity to the economy. Some observers saw the events of the 1930’s as the predictable consequence of the overextension of credit and “easy money” policies of the banking system during the 1920’s. Others expressed the view that the depression was not a corrective event but was the product of an inherently defective free-market system that could be corrected by inflating the supply of purchasing media and thus raising prices. A high price level was equated with prosperity by those who held this view.

Eventually, the proponents of inflating gained sufficient influence to obtain passage of some of the legislation that they supported. The Glass-Steagall Act of February 1932 permitted, among other things, Federal Reserve banks to pledge as security for their notes in circulation, U.S. Government securities in addition to rediscounted commercial paper. Thereby, the association between the issuance of purchasing media and the genuine needs of business and agriculture for it was removed.

Monetary officials were freed to put into circulation whatever amount of currency they deemed appropriate, regardless of the needs of businesses and agriculture as reflected in trade paper discounted by commercial banks. The U.S. monetary system thereby was returned to the Government-debt-secured currency of the old national banking system. The Federal Government could not issue currency directly, but it could issue debt securities that were bought in the open market by the Federal Reserve banks and then used as “backing” for Federal Reserve deposits and notes placed in circulation.

Although the Glass-Steagall Act offered opportunities for monetary and Government officials to debauch the Nation’s currency, all holders of such currency and owners of checking account balances still retained an ultimate veto power of official actions by being able to demand gold for currency. This veto power was not to be held for long.

Soon after taking office, President Franklin D. Roosevelt issued a proclamation (on March 6, 1933) that all U.S. banking institutions observe a bank holiday from March 6, 1933 to March 9, 1933, inclusive. During that period banks were not to permit the “... withdrawal or transfer in any manner or by any device whatsoever, of

* A detailed discussion of the monetary role of gold is presented in our Economic Education Bulletin “Why Gold?,” 28 pages, $2.
any gold or silver coin or bullion or currency or [to] take any other action which might facilitate the hoarding thereof . . . . " Federal Reserve banks were included in these restrictions.

A subsequent Presidential proclamation on March 9, 1933 extended the provisions of the March 6 proclamation " . . . until further proclamation by the President." The Emergency Banking Act of March 9, 1933 "approved and confirmed" the President's March 6 proclamation and further provided that "during time of war or during any other period of national emergency declared by the President, the President may . . . prohibit . . . [the] export, hoarding, melting, or earmarking of gold or silver coin or currency, by any person within the United States or any place subject to the jurisdiction thereof . . . ."

By virtue of that authority, President Roosevelt on April 5, 1933 decreed that all individuals, partnerships, and corporations deliver to the Federal Reserve System on or before May 1, 1933 all gold coin, gold bullion, and gold certificates owned by them. A few exceptions were granted, including gold earmarked for official foreign institutions.

The Presidential proclamations mentioned above not only eliminated official domestic redeemability of the Nation's currency but also, by prohibiting gold ownership, prevented even unofficial redeemability that would be possible if residents were free to exchange currency for gold at whatever rate they could obtain in the open market. (This universal historical means of protection from unsound monetary practices was denied to Americans until December 31, 1974.)

REMOVAL OF THE FINAL BARRIER

An external check on U.S. authorities remained to be removed: the convertibility feature of U.S. dollar claims held by foreign official monetary institutions. Although foreign private holders of dollar claims could not present them to the U.S. Treasury for gold, they could present them to their central banks for domestic purchasing media, and the central banks could present them to the U.S. Treasury for gold.

Continued and more rapid inflating during the late 1960's was accompanied by the accumulation of large amounts of dollar claims by foreign central banks. During that period, the U.S. monetary stock of gold decreased to $10.4 billion at the end of July 1971 from $15.0 billion at the end of February 1965.

Because of the strategic importance of an adequate stock of gold for military and other emergency purposes, aside from that for monetary purposes, U.S. authorities were faced with a serious dilemma: If they continued to inflate, the calls on the remaining gold stock would increase further. However, inasmuch as the level of business activity was considered by Government officials to be too low, and these officials believed that inflating was necessary for expanding such activity, they believed they could not stop or slow inflating. Indeed, they apparently assumed that they had to increase inflating. On August 15, 1971, as part of his New Economic Policy, President Nixon totally suspended convertibility of U.S. dollar claims into gold.

THE DOLLAR IS NOT A DOLLAR

When President Nixon nullified the U.S. promise to pay dollars for dollar claims, the U.S. monetary unit was changed from gold to a no-thing. Obviously, the two monetary units are vastly different, in spite of their having the same name. A brief history of the "dollar" may aid readers to understand the crucial difference and why today's dollar does not serve well the role of money.

The U.S. Congress authorized the minting of gold coins on April 1, 1792, with a dollar specified as 24.75 grains of "pure" gold. This established a "price" for gold of $19.39 per troy ounce (480 grains per troy ounce divided by 24.75 grains per dollar equals 19.39 dollars per troy ounce). In 1834 the gold content of the ten dollar coin produced by the U.S. Mint, the "eagle," was reduced from 247.5 grains to 232 grains of pure gold, establishing one dollar as 23.20 grains and a gold "price" of $20.67 per ounce. In 1900 the Gold Standard Act clearly specified "That the dollar consisting of twenty-five and eight-tenths grains of gold nine-tenths fine . . . shall be the standard unit of value." ("Pure" gold of 23.2 grains equals 25.8 grains of nine-tenths fine gold.) Thus was confirmed what had been in practical effect for the preceding century, except for small variations and brief interruptions. Let us designate the 23.2 grains-of-gold dollar as "dollar number one," or "D-1." We invite readers to note that D-1 was 23.2 grains of pure gold. D-1 was not convertible or redeemable in that many grains of gold; it was that many grains of gold. However, persons who held U.S. currency (or demand deposit claims on U.S. banks, which immediately were convertible into currency) could in fact take those claims for D-1 dollars to the banks and get D-1 dollars, that is, 23.2 grains of pure gold (in coin form) for each dollar claim.

In 1934 President Roosevelt devalued the dollar from 23.2 grains to 13.71 grains of pure gold, a devaluation of 41 percent. This raised the "price" from $20.67 per troy ounce to $35.00 per ounce. Obviously this was a different monetary unit than D-1. In recognition of this difference we designate the lighter gold dollar as "dollar number two," or "D-2." D-2 still was an amount of gold, but Americans who held claims to D-2 (U.S. currency and demand deposits) could not utilize those claims because President Roosevelt had declared that Americans could not hold gold in the United States. (As one of his later acts, President Eisenhower extended that prohibition to holdings by American citizens outside the United States.) Foreign official institutions, however, still could present their D-2 claims for actual D-2's, that is, gold at the exchange ratio of 13.71 grains of pure gold per dollar claim. The U.S. monetary unit, or standard of value, still was gold.

On August 15, 1971 President Nixon declared that the U.S. Treasury no longer would meet its promise to pay D-2 dollars, that is, gold, in exchange for dollar claims when foreign official institutions presented dollar claims for payment. In 1973, Congress created "dollar number three," or "D-3," which ostensibly was 12.63 grains of pure gold. In 1974, "D-4" was created. It is 11.37 grains of gold, according to Congress. However, D-3 and D-4 are imaginary in that no actual dollars (gold coins of the specified weights) ever were coined nor was gold made available to anyone in those ratios to the paper currency labeled "dollars."

By 1971, nearly all of the paper currency in circulation consisted of Federal Reserve Notes in various denominations. A demand "note" ordinarily is evidence of a promise to pay or to deliver something on demand. For many years this was indicated by a printed statement on the paper currency to the effect that the U.S. Treasury would deliver the indicated number of dollars (amount of gold) on demand in exchange for the paper claims to the dollars.

As new paper currency was printed after 1971, the promise to pay was deleted from the Federal Reserve Notes. Although still designated as a "note," which ordi-
arily implies a promise to pay something on demand or at some designated future time, the Federal Reserve Notes now issued not only do not represent any thing (as did gold certificates or silver certificates) but also they do not promise any thing. They do not even purport to be any thing other than identical pieces of paper printed with varying numbers. Such a piece of paper currency is a nothing having exchange value as a physical substance. Moreover, it does not even purport to be a claim on any thing. D-4 clearly does not have a meaningful connection to gold, or to D-1 dollars. Today’s dollar is totally a fiat currency.

From a monetary system founded on the universal acceptability and long-term exchange-value stability of gold, the U.S. dollar has come to be based only on Government fiat, with no limitation on the amount of purchasing media that may be created other than the whims of the political and monetary authorities.

Therefore, those who place their confidence in the future value of paper dollars, are placing their confidence in the wisdom and commitment of politicians to stop the inflating that they have been fostering for more than 40 years. That is miserably misplaced confidence!

III.

SYMPTOMS AND CONSEQUENCES TO DATE

PROLONGED inflating, like counterfeiting, cannot occur without signs of its having taken place. The repeated abandonment of external restraints on the dollar-creating opportunities of monetary authorities was described in the preceding chapter. Those events were symptoms of the inflating disease. The fact that authorities intermittently sought to free themselves to inflate further was accurately described by us since our founding in 1934 as a sign that authorities intended not to restore sound monetary conditions. Wise men would not have wanted to be without the guides of external restraints, and men seeking the removal of such restraints were not wise enough to be trusted with the free reign they sought.

Many other symptoms of inflating also were evident to astute observers during the decades preceding the 1970’s. Balance of payments deficits were large and continual since the early 1950’s. The U.S. monetary gold stock dwindled considerably during the late 1950’s and into the 1960’s. The general level of prices and wages began to rise alarmingly in the late 1950’s, although by comparison with such increases now the increases then were small. Deficits became entrenched in the Government’s budget practices in the early 1960’s and began their inexorable increase to the $40 billion to $60 billion range now common. Government officials increasingly “jawboned” businessmen to restrain price increases during the 1960’s, and they further sought first voluntary then mandatory restrictions on the outflow of capital from the United States. The gold pool was formed in 1961 to defend the international value of the dollar; it worked for a while, but in 1968 the “two-tier” market for gold succeeded the pool arrangement when more and more dollars were exchanged for gold. And throughout the 1960’s, public and private debt was incurred at rates that clearly were unsustainable in the long run if inflating were terminated. These were some of the early signs that inflating would produce major problems, and these problems have become obvious since the 1970’s.

NOT SO OBVIOUS CONSEQUENCES

Inflating is a great destroyer, but the destructive process is subtle. Consequently, numerous detrimental results of inflating are wrongly attributed to other causes. Of course this diverts public indignation toward inappropriate targets, while the profligate politicians merrily continue their pernicious policies. In this section we briefly describe some of the consequences of inflating often not recognized as such.

At first, for a decade or two, salaries of the Nation’s teachers at all levels lagged far behind the rise in the cost of living. Few persons of ability who had families to support could afford to join or remain in the teaching profession. Mediocrities, or worse, filled the vacancies and, as they acquired tenure, achieved seniority. Such individuals lack understanding of and devotion to what might have been their cultural heritage. Too few have any understanding of the principles of fair dealing embodied in, for example, Robert’s Rules of Order for organized social groups. Too many college faculties, judged by their group actions, are not equipped either by character or understanding to inspire, teach, or lead the Nation’s youth. (There are exceptions that too often are a minority in their respective college faculties.)

The widening of the so-called “generation gap” well may be related to inflating. In the absence of sound teaching and good leadership at colleges and universities, young people know too little about the profound achievements within their culture. But they are not blind. Even if in particular instances their own families are not among those riding the crest of the inflationary affluence, they may be dimly aware of the topsy-turvy social situation. Few probably could write a satisfactory essay describing the source of their disenchantment with the social order, but they are only the more frustrated in their idealism as a result of their lack of understanding.

Also to be mentioned here is the growing hatred between the receivers and payers of government transfer programs. Upon the introduction of such programs years ago, the majority of needy evidently accepted the help with appreciation and a determination to use the programs as little as necessary. However, as transfer programs increased both in number and amounts, generations of families became “hooked” on welfare and grew to hate the system that made them such. Moreover, such help seemed to be provided quite painlessly through deficit financing (made easier to finance by inflating); indeed, economists and politicians convinced the public that such deficits were good for the economy and for them. Coincident with the growing hatred of the recipients and with their own increasing difficulty of “making ends meet,” widening enmity among taxpayers developed for welfare recipients. Thus, the socially divisive effects of mandatory transfer programs have replaced the socially salutary effects of voluntary giving and helping.

The cost of the necessities of life has increased more during the past few decades than has the spendable income after taxes of a large proportion of the families in the Nation. One should remember that more than half of the Nation’s employed earn less than the average wage.
The very large incomes of relatively few shift the average income to a level reached only by a minority rather than a majority. Therefore, a majority (no one knows exactly how great) of the families in the United States have experienced a loss of buying power that has deprived increasing numbers of the modest surplus over bare necessities they once enjoyed.

In this situation, no wonder that employees who never before thought of organizing join a union, the better to fight for their livelihood. No wonder values become distorted. With no relatively stable basis for judging exchange values, each employee (if he is to survive) must no longer think in terms of past worth, as he may once have judged his compensation, but must focus on the desperate scramble to get more, and more, and more. Ever-increasing intermecine strife rather than a continuing effort to give more value in order to receive more becomes the rule rather than the exception.

Financial rewards during a prolonged period of inflating tend to gravitate toward the speculator, the smart guy after a “fast buck,” the promoter whose scruples are few and not too well developed, all, in short, who are more interested in getting something for nothing rather than in serving others as they would in turn be served. This consequence extends down to the lowest paid of those who are working for a living. This subtle corruption affects far more than those relative few who in such circumstances get a job that might be unobtainable in ordinary times. Laxness and inefficiency tend to become pervasive even among those who ordinarily would be honest and conscientious. Quality of products and services deteriorates, while prices rise.

Innumerable businesses also have been brought to the verge of ruin as taxes have taken the depreciation charges hidden in reported profits swollen by inadequate depreciation charges, and as the promise of “good times” misled many businessmen to overexpand their facilities and overuse debt.

Perhaps the most obvious of the numerous adverse consequences of continued inflating has been the loss by savers and holders of life insurance of more than $3.0 trillion (in dollars of current purchasing power) since 1939. During 1979 the rate of loss attributable to a depreciating dollar was approximately $525 billion, or 1.3 times the amount of gross private investment in the United States during 1979.

Some of the consequences of inflating can be illustrated as similar to the effects of driving a horizontal wedge through any social group. Pushed down by the lower face of the wedge are:

1. all retired and other elderly persons dependent on savings, pensions, and the proceeds of life insurance;
2. all salaried individuals and others whose relatively fixed incomes lag behind the rise in prices;
3. all owners of businesses whose depreciation charges based on earlier lower costs are inadequate for the replacement of worn-out plant and equipment because of higher prices;
4. millions of individuals who own real estate rental properties and who must use their depreciation funds to live on, thereby depleting their capital instead of maintaining or replacing their modest properties; and
5. all tenants of rental properties such as those described in 4, above, who find their segments of cities undergoing seemingly inexplicable deterioration.

Lifted by the upper face of the wedge to new wealth and power are:

1. some businessmen who for a time at least are the recipients of large incomes as their companies report large “windfall” profits;
2. holders of monopoly privileges linked in one way or another to the rise in prices;
3. organized labor to the extent that its leaders finally diagnose what is going on and extract wage increases large enough to exceed the rising cost of living;
4. politicians who, in effect, can buy votes with the inflationary purchasing media without levying additional taxes because the banking system monetizes Government deficits; and
5. the bankers and other money managers who deal in ever-increasing sums but have been relieved of their most important responsibility (i.e., to meet their liabilities with the same real wealth they acquired as assets) and thus find themselves in a bankers’ heaven that also is the politicians’ paradise.

DESTROYING ORGANIZED SOCIETY

A complete catalog of the consequences of prolonged inflating would require a large volume, but the consequences already described provide some warrant for our attributing to increasing inflating the power to destroy organized society.

Civilization can advance as long as most men cooperate voluntarily by seeking to serve others as they, themselves, would be served by exchanges of honest values in competitive markets. But when large scale “embezzlement” is the order of the day, when the victims are pushed down in the economic scale and the beneficiaries of inflating reap huge, undeserved rewards, the social groups gradually change in vital ways.

To the seats of power in political offices, in the banking houses, and in businesses generally a new type of individual works his way. The cynical promisor of “goodies” replaces the statesman; the daring speculator with other people’s money replaces the conservative banker (he does not call his activities speculation, of course, but what else is excessive lending long-term and borrowing short-term?); and the “wheeler-dealer” replaces the prudent man of business. What happens lower down the scale already has been mentioned.

In thousands of subtle ways, each hardly discernible at the time but increasingly apparent with time, the “promises men live by” are falsified. In desperation the more nearly destitute victims of prolonged inflating revolt against “the system.” Rioting becomes an accepted form of protest and even looting is not seriously opposed by those civil servants, the police, who already have deteriorated in quality of personnel because salaries have lagged behind in the inflationary progression (thereby limiting recruitment of more able personnel) and whose efforts to maintain law and order have been overwhelmed by a rising tide of crime.

This is not make-believe or “theorizing.” A hard look around reveals that this is what is going on and has been going on in these United States. Contrary to what many have said, the source of many of today’s problems is understandable.

WAGE AND PRICE CONTROLS

Hardship associated with rapidly rising prices has elicited the common response by politicians of attempting to restrict them by voluntary wage-price controls at first and later, when the first had proven futile, mandatory controls. The imposition of a wage and price control program was another feature of President Nixon’s desperate economic policies of August 1971.
That these controls were more effective in fostering the development of shortages of certain goods and commodities than in eliminating the underlying upward trend of wages and prices is too well known to need confirmation in this discussion. Many analysts have concluded that the double-digit rates of price increases during 1974 were attributable in large part to those controls.

However, Government officials usually attempt to suppress the adverse effects of inflating by imposing controls on various aspects of economic activity. Because there is no present indication that inflating will be stopped in the foreseeable future, increased Government interference in one form or another probably will continue to disrupt the free-market mechanism and restrict individual freedom of action for an indefinite future period.

In our 1976 edition of this bulletin we asserted: “The probability that wage-price controls again will be imposed increased substantially with the election of Jimmy Carter to the Presidency. When confronted during the Presidential campaign with the question that might not be planned policies to stimulate the economy also stimulate accelerating price rises, Mr. Carter asserted that he hoped a program of voluntary wage and price restrictions would prevent that. That such voluntary programs of the early 1960’s were failures and that the mandatory programs of the early 1970’s also failed seemed not to deter the Carter economic advisors. One of them indicated that they would not be ‘swayed by experience’ and suggested that the next effort would be designed and administered effectively.”

In October 1978, President Carter announced an anti-inflation program, the heart of which was “voluntary wage and price guidelines” for workers to hold their wage demands to 7 percent more than a year earlier and for firms to hold price increases to “0.5 percentage point below their average annual rate of price increase during 1976-77.” Of course there were exceptions for special circumstances, and these increased in number as time passed. So many were the exceptions that, as this is being written nearly 2 years later, the program is widely recognized to have produced none of the desired results. Surely it did not slow the rate of price increases, as the data in Table 2 reveal. But many of those who innocently abided by the guidelines must surely feel more resentful of the Government and newly dedicated to “getting theirs” from now on. Moreover, those who were intimidated to hold to the guidelines also became victims of them, and insofar as they held to the guidelines, economic distortions were promoted in their sectors in relation to other sectors.

In spite of all previous evidence plainly indicating the deleterious effects of controls, when price increases approached mid-teen levels in early 1980, many analysts again recommended their imposition—for a time only, of course. Otto Eckstein, a member of the President’s Council of Economic Advisors under President Johnson and now president of a major economic consulting firm, testified before the House Budget Committee that although mandatory controls in the past had failed to achieve their purpose, they nevertheless deserved serious consideration. Barry Bosworth, an economist who directed President Carter’s Council on Wage and Price Stability for a number of years, offered his opinion that voluntary controls were not working and mandatory controls therefore were necessary. The March 3, 1980 issue of Business Week stated: “The editors of Business Week have rethought this magazine’s long-standing opposition to wage-price controls. We have concluded that a six-month freeze on wages and prices—if made part of a comprehensive attack that focuses primarily on eliminating the basic causes of inflation—would give dramatic, credible evidence that the country at long last has become serious about curing this pernicious economic disease.”

Finally, Henry Kaufman, a well known Wall Street economist and partner in Salomon Brothers, endorsed mandatory controls in a New York Times interview: “[A] temporary wage and price freeze or a simple mandatory controls program would be of some marginal transition help.” Public opinion polls repeatedly indicated that a majority of the American public supported wage and price controls. A New York Times/CBS News poll, conducted in mid-January, found that 65 percent of adult Americans were willing to “have the Government enforce limits on both wage and price increases.”

Comprehensive wage-price controls were not imposed, but credit controls were implemented in mid-March, the first instance of such restrictions during peacetime. At President Carter’s request, the Federal Reserve Board applied the equivalent of reserve requirements (which immobilize funds) on specified types of credit extended by various creditors, savings and loan associations, credit unions, finance companies, and retailers and other credit card issuers. In addition to other restraints, the Fed “requested” banks to limit the growth rate of loans to a range of 6 percent to 9 percent during 1980.

Consistent with their past uncanny skill to take stiff action at exactly the wrong time (remember President Ford’s WIN campaign in the autumn of 1974, just before economic activity plummeted?), the mid-March credit restraints took effect just about the time that economic activity was beginning a sharp cyclical contraction. The data were not available at the time, but it later showed that a marked decline had begun in February. To their credit, Federal Reserve officials lifted these restrictions in stages during the subsequent few months, but the economic damage had been done, with no apparent effect on prices. And another precedent for Government meddling was thereby established.

THE DAMAGE DONE BY CONTROLS

All efforts to limit wages and prices through externally imposed controls deal with symptoms, not the problem itself; consequently, they are bound to fail. Even worse, they introduce more distortions, further hamstringing sound economic activity and sustainable growth.

The free-market system provides increasing rewards for increased output. Under this system, a proficient worker who processes an increasing volume of things can expect to be rewarded by a commensurately higher wage with a minimal time lag. A wage freeze or arbitrary limitation of wage increases interrupts this sequence. Consequently, the worker’s incentive will be diminished and his productivity probably will decrease. This deterioration will affect the quality of things that he produces as well as the quantity. His productivity decrease may well be so great that even his present wage is not warranted. Employee dissatisfaction insofar as they held to the guidelines, economic distortions were promoted in their sectors in relation to other sectors.

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most efficient use. A price freeze or price controls imposed by government interrupts this sequence. A shortage of the desired thing will occur, and quality might deteriorate because the processor’s initiative is frustrated by the retarded upward trend of profits. Black markets develop in which prices charged are far higher than if the processor had expanded output. Importantly, disrespect for the law (society’s means of self-limitation) is a principal characteristic of black markets, and flouting the law becomes a fashionable game of wits in which the most cunning members of society benefit most. This reverses social standards, and moral disintegration is a predictable result.

Thus, the free market involves freedom to receive reward in proportion to the effectiveness with which a processor serves others. The reward is automatic, impersonal and accurate. The application of price controls involves the transfer of millions of market evaluations to the political sector for “decision.” The accurate measurement of market evaluation thus is replaced by inaccurate political guesswork, delays, conflicting judgments, discrimination, and inequities. Satisfaction is reduced as the market becomes less automatic, less personal, and less accurate. Particularly important, personal freedom is relinquished, and license is granted to a small centralized group to make sweeping allocational judgments with neither an effective checkrein nor effective measurement standards.

No one should accept the notion that price and wage controls, in any of the disguised forms by which they may be “sold” to the public, will remedy the problems of inflating. This assertion applies also to recently proposed wage-price policies of manipulating the tax structure of businesses and workers to either penalize or reward, respectively, those businesses and employees that fail to meet or that reach bureaucratic-established wage-price limitations. Proponents of these schemes claim that the tax-based income policies would avoid the allocational problems of traditional wage-price controls because they would not interfere with market-determined relative price and wage changes. That is nonsense. The plans would mistreat those whose, say, wage contracts would be adjusted after the effective date of the plan.

Substitution of bureaucratic decision-making for that of market forces inevitably introduces distortions that later require correction. These distortions may not be apparent for some time, but all experience with controls suggests that distortions eventually follow, as the night follows day.

DEVALUATIONS AND FLOATING

Reputation of the U.S. obligation to redeem dollar claims in gold effectively immobilized the monetary gold reserves of all the free-world countries in August 1971.

On December 18, 1971, the finance ministers of the leading industrial nations (the so-called Group of Ten) met in Washington and agreed to fix new parities among their currencies. Features of this “Smithsonian Agreement” included a widening of the permissible fluctuations of these currencies from plus or minus 1 percent of par value to plus or minus 2½ percent and a devaluation of the U.S. dollar from $35 to $38 per ounce of gold. However, the dollar remained inconvertible into gold at that “price,” and the world’s gold reserves remained immobilized. Without use of these reserves, the central bankers faced insurmountable difficulties in maintaining the agreed parities, even with the wider “band” of permitted fluctuations. Within a matter of months, several countries had imposed restrictions on the free transfer of funds, including (for the first time) restrictions on the inflow of funds by countries with relatively “strong” currencies, such as Germany and Switzerland.

In June 1972, the exchange rate of the pound was “floated,” i.e., allowed to exceed the fluctuation permitted by the Smithsonian Agreement. Within a year, many other countries, including Switzerland, Italy, Japan, and Germany, also “floated” their currencies.

In spite of these actions, some foreign central banks continued to buy huge amounts of U.S. fiat dollars in attempts to keep the value of their currencies from appreciating markedly in relation to the dollar. On February 13, 1973, the United States announced another devaluation of the dollar to $42.22 per ounce of gold from the Smithsonian $38 per ounce. That “price” was meaningless, however, since the dollar remained inconvertible.

By March 1973, some member-countries of the European Community formed a joint float (the “snake”). Under this arrangement the exchange value of the currencies of the participating countries were maintained within 4½ percent of each other, but they floated in relation to the dollar and other nonsnake currencies. “Floating” became generalized by the summer of 1973, and currency rates have fluctuated widely since then, as Chart 2 reveals.

Nevertheless, floating exchange rates have not been “clean,” that is, countries have in fact intervened in foreign-exchange markets by buying and selling other currencies in order to influence the exchange rates of their own currencies. Indeed, the amount of currency support was far more than the total amount of official intervention under the former fixed-rate international monetary system in effect from 1944 until 1971. In spite of this massive intervention, the value of the U.S. dollar has dropped precipitously in terms of some currencies, espe-
pecially the Swiss franc, German mark, and the Japanese yen. In terms of these currencies, from August 1971 through August 1980, the dollar decreased in value 55 percent, 48 percent, and 35 percent, respectively.

Large fluctuations in exchange rates in a system of floating rates reflect international instability, just as large payments imbalances and flows of international reserves did in a system of fixed rates. There is no reason to believe that underlying economic relationships have changed so drastically during the past few decades that extreme volatility of international exchange rates, prices, and payments balances was inevitable. What have changed dramatically during the past few decades have been the monetary practices of central bankers and politicians, namely their predisposition to inflate, inflate, inflate.

Enormous injections of inflationary purchasing media probably were made during the years since World War II within all the major free-world countries. A substantial part of the total of these amounts of excess claims on things available for purchase can be concentrated in any single country by means of the foreign-exchange markets. When thus accumulated and directed, the excess purchasing media has overwhelmed the efforts of monetary officials to maintain a semblance of international monetary stability.

Inflating has left a legacy of both domestic and international instability. The increased risks of conducting international trade and investment in such an unstable environment most assuredly have retarded and will continue to restrain economic progress. This is another consequence of inflating that will affect Americans for years to come. One simply cannot expect advances in material well-being at the rates achieved earlier. Moreover, heightened volatility invites increased Government intervention, and such intervention restricts the freedom of Americans to act in their own best interests, as they see them.

Extensive controls on capital outflows have not been a part of U.S. history to date, but they well could be in the comparatively near future if the downward pressure on the U.S. dollar continues.

IV.

THE END OF TRADITIONAL PRACTICES

UNDER the best of conditions, successful operation of a business firm is no small accomplishment.

Long-term business success demands wise present and planned practices concerning employees, customers, money, equipment, production, inventory, sales, advertising, public relations, employee relations, union relations, taxes, capital expenditures, and on and on. Although such practices are difficult to achieve, businessmen with ability, integrity, and experience can be successful when they operate in a market setting relatively free of collusion and caprice.

In such an economic setting, traditional investments and methods of assessing them could be achieved with adequate success. This was the situation in the United States from the end of World War II until approximately the mid-1960's. No longer is the situation as it was then, and anyone who would hope to preserve his wealth should clearly realize this. Sound business operation in the United States today and in the foreseeable future is and will continue to be unusually difficult to achieve.

An unreliable monetary unit that is used to measure relative values and keep accounts, and government policies that are capricious and are arbitrary in their effect, if not intent, on business firms make a mockery of sound business judgment. A depreciating monetary unit and capricious government regulations foster speculative schemes rather than bona fide business ventures, because the expectation of adequate reward for long-term sound operation is destroyed in such an environment. In such a business setting, political influence, inside information, and good guesswork become the more important "skills" of the businessman. Who you know becomes more important than what you know.

UNRELIABLE ACCOUNTING

In normal accounting practice, assets, no matter how old, usually are recorded on the balance sheet at not more than their original prices. Upward change in value rarely is recognized until it is proved by the test of realization (as when sale turns goods into cash). Downward change tends to be recognized more readily, at least where the asset will be sold soon (as for inventory being reduced from cost to recoverable value in the event of obsolescence). Permanent assets (i.e., land) seldom are written down, or up, and assets with a limited life (i.e., buildings or machines) are revalued only in the sense that portions of their historical cost are written off (depreciated) annually.

Because of these conventions, the values of assets in the balance sheet become inconsistent with one another during periods of inflating. The prices of assets purchased earliest reflect dollars of relatively greater purchasing power, and the prices of assets purchased more recently reflect dollars of relatively less purchasing power. Thus, when assets of different vintages are added together—as for example in ascertaining the total value of the firm—the resultant totals are in dollars of mixed value in terms of purchasing power. This practice—which is routinely done in historical-cost accounting—makes no more sense than adding together apples and oranges. Not only does it misstate the value of each individual firm (with the bias tending toward understatement), it also renders nearly meaningless all interfirm comparisons based on assets.

Assets carried on the balance sheet at historical cost obviously provide misleading information about the real value of a firm's resources. This is of consequence to both managers and investors. Without a reliable monetary unit the measures commonly used to gauge performance, such as "book value," "rate of return," "assets per share," and "earnings on shareholders' equity" become distorted. Managers may be unable to discern which divisions of their firm are more profitable or what prices must be charged to maintain operating profitability. Investors and creditors do not have the necessary financial data to compare the performances of different industries and firms; consequently, deciding where to invest or on what terms to loan becomes more difficult and risky. The sure result of misinformation is inefficiency: the cost of capital may be too high or too low for individual enterprises; resources flow to and from inappropriate firms and industries.
Ultimately, the standard of living of society must suffer. Income statements based on historical costs are misleading to managers and investors in many of the same ways as are balance sheets based on historical costs. Without a stable monetary, or accounting, unit for recording revenues and expenses, accurate comparison of the performance of managers in their use of assets or groups of assets is virtually impossible. We already mentioned how resources thus easily can be misallocated. Unfortunately, the distortions that occur in income statements due to historical costing can damage a firm in an even more direct manner. The maintenance of operating capability of a firm (the ability to supply a fixed quantity of goods and services), requires the holding of optimum quantities of inventory, property and equipment. When income is chronically overstated, the operating capability of a firm may be directly eroded in either of two ways: (1) through payment of income taxes at effective rates far higher than maximum legislated rates and (2) through payments of dividends at levels unjustified by real earnings.

Some offset to the harmful effects of a depreciating monetary unit through inadequate costing of goods sold and depreciation charges has been achieved by some firms through gains on net monetary amounts owed. During a period of prolonged inflating (when most prices rise), there is an associated loss or gain of purchasing power from, respectively, owning a monetary asset or owing a monetary liability. For example, the holding of $100 for 1 year when general prices rise 12 percent per year involves a loss of $12 of purchasing power (measured in end-of-year dollars), that is, one would need 112 end-of-year dollars to have the purchasing power equivalent of 100 beginning-of-year dollars. Of course if cash loses value, so does a claim to cash (a receivable). Conversely, a monetary liability is associated with a gain of purchasing power, because the obligation incurred in beginning-of-period dollars will be paid off in “cheaper” end-of-period dollars. For corporations with large amounts of debt outstanding, the gain on net monetary assets sometimes exceeds income from continuing operations. For example, American Telephone & Telegraph Corporation (AT&T) had reported profits on a historical cost basis of $5.7 billion during 1979, but its gain on net monetary amounts owed was $6.8 billion during that year.

Although gains from net monetary items reduce the harm done to many firms from inadequate cost of goods sold and depreciation charges during a prolonged period of inflating, damage is done to the economy, nevertheless. We described earlier the probable inefficiencies from misinformation. Moreover, even when more nearly accurate information is obtained, as from inflation-adjusted financial data, managers are faced with uneconomic incentives. For example, many firms earn nearly as much or more from their debt as from continuing operations. The firms that prosper during an inflationary period thus are not necessarily the firms with the most efficient continuing operations. Funny-money manipulation becomes increasingly determinant of a firm’s profitability. Consequently, to the top managerial posts rise individuals especially skilled at those manipulations, not persons skilled at making their firms more productive of the things America wants and needs.

CAPRICIOUS GOVERNMENT

The plight of businessmen (and, in turn, investors who would buy U.S. common stocks) has been compounded by capricious government interference in the market. Laws and regulations that affect business have proliferated during recent years. These often are confusing, contradictory, discouraging, unpredictable, and sometimes counterproductive. Most regulations were initiated in response to some problem, whether real or imagined. Many, perhaps most, regulations have outlived their usefulness. However, little attempt has been made to eliminate such rules, although some talk about doing so often is reported. Instead, more regulations and rules are put into effect.

Consider, for example, Government laws of the late 1960’s and early 1970’s that forced firms to convert from coal-burning furnaces to oil-burning ones for the purpose of cleaning up the environment. Less than 10 years later, Government reversed its position, requiring conversion from oil to coal in order to reduce the Nation’s dependence on imported oil.

In the present business setting of unreliable business measures and often-changing laws and regulations, businessmen have learned that a seemingly prudent decision quickly and unpredictably can become totally unwise and a threat to the viability of their organizations. They also have learned that at the same time that the risks of doing business have increased, the potential reward for success has diminished. Clearly, these are not conditions that foster sound, sustainable economic growth. Instead, business fluctuations probably will become more volatile, and long-term economic growth probably will be retarded.

In this environment, how can businessmen and investors adequately assess a company’s actual performance and compare it with that of prior years or of other companies? How can equitable taxes be levied? How can capital be wisely allocated? The answer is, “There is no way.” Until a sound monetary unit is restored or until an alternative reliable accounting unit is adopted, business and investment decisions will involve an inordinate amount of guesswork and error. It’s a whole new “ball game.”

HIGH ODDS AGAINST SUCCESS

Every reader should understand some simple arithmetic that reveals the odds against business or investment success during prolonged inflating. Most Americans are so accustomed to thinking that “a dollar is a dollar” that they fail to see the combined consequences of taxes and the continued depreciation of their dollars. For example, if a person 30 years old is planning for his retirement he may be inclined to deposit his savings in a savings bank where the interest rate is 5 percent. We assume that he deposits $1,000 during the current year. Presumably, the tax rate applicable to his investment income will be at least 30 percent. Therefore, his after-tax return will be not 5 percent but 3.5 percent. In 30 years, compound interest at a net of 3.5 percent will increase the original $1,000 deposit to $2,807.

What the rate of increase in the cost of living will be in the future cannot be foreseen precisely, but indications are that it may not be much less than 10 percent annually. In 1979, it was nearly 14 percent in this country, and in Great Britain the rate recently has been about 20 percent. Even if the annual rate is “only” 10 percent, in 30 years the buying power of the dollar will have lost nearly 95 percent of its current value. At that value, the $2,807 accumulated after taxes would buy only $161 worth of goods at today’s prices. In other words, of the original $1,000 worth of buying power, $839 would have been lost in spite of accumulating at an after-tax compound interest rate of 3.5 percent.
Investment Income 5%

Indexes was bought in an equal amount on the last day of that period; and the average for the utility companies industrials increased from about 3 percent in 1975 to 11 percent for the transportation companies, decreases occurred in 2 of the 5 years. In the minority of instances

for the corporations comprising the three Dow-Jones stocks price indexes. These rates of return reflect the assumption that each stock in the respective indexes was bought in an equal amount on the last day of the preceding year, held through the year (all dividends received), then sold (with no transactions costs) on the last day of the indicated year. Note that the rates of return shown here are before-tax rates of return and do not capture the "tax creep" effect associated with rising nominal personal income.

Table 3 illustrates the before-tax annual rates of return on investments required to break even if we assume various annual rates of price increases and tax rates. Table 4 summarizes measures of returns in current-dollar and adjusted terms for the corporations comprising the three Dow-Jones stocks price indexes. These rates of return reflect the assumption that each stock in the respective indexes was bought in an equal amount on the last day of the preceding year, held through the year (all dividends received), then sold (with no transactions costs) on the last day of the indicated year. Note that the rates of return shown here are before-tax rates of return and therefore do not capture the "tax creep" effect associated with rising nominal personal income.

Plainly evident is the wide disparity between changes in nominal dividends and real dividends. For all three groupings the trend of the change in nominal dividends is upward: the average for the corporations comprising the industrials increased from about 3 percent in 1975 to 11 percent in 1979; the average for the transportation components from roughly 0 percent to 10 percent during that period; and the average for the utility companies from about 5 percent to 10 percent from 1975 to 1979. Of course these nominal percentage changes are the ones widely reported in the financial press and highly touted by the corporations as signs of their success. The record of percentage changes in real, or constant-dollar, percent changes in dividends indicates something else. For the industrial and utilities corporations, real dividends decreased during 3 of the 5 years, 1975 through 1979; for the transportation companies, decreases occurred in 2 of the 5 years. In the minority of instances

when real dividends were increased, none of the increases reached even 3 percent.

From an investor's viewpoint, increases in share prices comprise a return on invested funds as much as do dividends. The combined results of share price changes and dividend changes are reflected in the annual rates of return. The high nominal and real returns in 1975 and 1976 were attributable primarily to sharp increases in share prices during the early phase of cyclical expansion following the November 1973 to March 1975 recession. Once that rebound had passed, both the nominal and real returns fell markedly, with the real returns being negative during 3 of the 5 years, 1975 through 1979; for the transportation companies, decreases occurred in 2 of the 5 years. In the minority of instances

The results shown in Table 4 compared with the returns indicated in Table 3 as necessary for breaking even (no real return) make clear the odds against successful investment are quite large in a virulent inflationary environment such as that now prevailing in this Nation. Continuous inflating saps the wealth of all who save for future use, unless their savings are in a form that will preserve buying power.

### Table 3
**BEFORE-TAX ANNUAL RATES OF RETURN ON INVESTMENTS NEEDED TO BREAK EVEN**

<table>
<thead>
<tr>
<th>Tax Rate on Investment Income</th>
<th>Annual Rate of Price Increases</th>
</tr>
</thead>
<tbody>
<tr>
<td>5%</td>
<td>10%</td>
</tr>
<tr>
<td>20 percent</td>
<td>6.25%</td>
</tr>
<tr>
<td>30 percent</td>
<td>7.15%</td>
</tr>
<tr>
<td>40 percent</td>
<td>8.35%</td>
</tr>
<tr>
<td>50 percent</td>
<td>10.00%</td>
</tr>
<tr>
<td>60 percent</td>
<td>12.50%</td>
</tr>
<tr>
<td>70 percent</td>
<td>16.67%</td>
</tr>
</tbody>
</table>

### Table 4
**SELECTED NOMINAL AND "REAL" FINANCIAL DATA FOR THE DOW-JONES GROUPS OF FIRMS, 1975-79**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Industrials</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Stock Price Index* Nominal</td>
<td>840.8</td>
<td>976.9</td>
<td>818.8</td>
<td>807.9</td>
<td>836.1</td>
</tr>
<tr>
<td>Real</td>
<td>505.6</td>
<td>560.4</td>
<td>440.0</td>
<td>398.2</td>
<td>364.5</td>
</tr>
<tr>
<td>Percent Change in Dividends Nominal</td>
<td>+3.2%</td>
<td>+7.0%</td>
<td>+8.6%</td>
<td>+4.0%</td>
<td>+11.4%</td>
</tr>
<tr>
<td>Real</td>
<td>-3.5%</td>
<td>+2.1%</td>
<td>+1.8%</td>
<td>-4.6%</td>
<td>-1.5%</td>
</tr>
<tr>
<td>Annual Rates of Return Nominal</td>
<td>+42.7%</td>
<td>+22.9%</td>
<td>-13.1%</td>
<td>+0.6%</td>
<td>+14.5%</td>
</tr>
<tr>
<td>Real</td>
<td>+33.4%</td>
<td>+17.3%</td>
<td>-18.6%</td>
<td>-7.8%</td>
<td>+1.3%</td>
</tr>
<tr>
<td>Transportation</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Stock Price Index* Nominal</td>
<td>166.8</td>
<td>232.4</td>
<td>214.0</td>
<td>211.1</td>
<td>253.3</td>
</tr>
<tr>
<td>Real</td>
<td>100.3</td>
<td>133.4</td>
<td>115.0</td>
<td>104.1</td>
<td>110.2</td>
</tr>
<tr>
<td>Percent Change in Dividends Nominal</td>
<td>-0.8%</td>
<td>+5.3%</td>
<td>+9.6%</td>
<td>+10.3%</td>
<td>+10.0%</td>
</tr>
<tr>
<td>Real</td>
<td>-7.3%</td>
<td>+0.5%</td>
<td>+2.7%</td>
<td>+1.2%</td>
<td>-2.7%</td>
</tr>
<tr>
<td>Annual Rates of Return Nominal</td>
<td>+37.1%</td>
<td>+39.8%</td>
<td>-6.2%</td>
<td>+3.4%</td>
<td>+13.4%</td>
</tr>
<tr>
<td>Real</td>
<td>+28.2%</td>
<td>+33.4%</td>
<td>-12.1%</td>
<td>-5.2%</td>
<td>+0.9%</td>
</tr>
<tr>
<td>Utilities</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Stock Price Index* Nominal</td>
<td>81.6</td>
<td>105.3</td>
<td>111.4</td>
<td>99.4</td>
<td>108.2</td>
</tr>
<tr>
<td>Real</td>
<td>49.1</td>
<td>60.4</td>
<td>59.9</td>
<td>49.0</td>
<td>47.2</td>
</tr>
<tr>
<td>Percent Change in Dividends Nominal</td>
<td>+4.8%</td>
<td>+4.8%</td>
<td>+8.7%</td>
<td>+6.8%</td>
<td>+10.4%</td>
</tr>
<tr>
<td>Real</td>
<td>-2.0%</td>
<td>0.0%</td>
<td>+1.8%</td>
<td>-2.0%</td>
<td>-2.4%</td>
</tr>
<tr>
<td>Annual Rates of Return Nominal</td>
<td>+38.2%</td>
<td>+36.8%</td>
<td>+11.4%</td>
<td>-4.2%</td>
<td>+9.0%</td>
</tr>
<tr>
<td>Real</td>
<td>+29.2%</td>
<td>+30.5%</td>
<td>+4.3%</td>
<td>-12.1%</td>
<td>-4.5%</td>
</tr>
</tbody>
</table>

Note: "Real" reflects nominal amounts adjusted for general price increases as measured by the Consumer Price Index - Urban. "Real" stock price indexes reflect CPI values with 1967=100.

* End of year.
THE appetite of the State for power, primarily as embodied in your wealth however modest it may be, is insatiable. In spite of some short-term favorable trends from time to time (such as abating price increases during 1976 and 1977), no one should expect long-term trends to be reversed in the foreseeable future. In order to embezzle nearly all the wealth of citizens by continued inflating, the State will portray, in order to restore confidence in the paper dollar, every temporary improvement as evidence of a major reversal. When that no longer works, the State presumably will take increasingly drastic measures to keep your wealth accessible within the United States or to maintain such information and control that you can be forced to give up wealth at home or abroad in exchange for irredeemable and depreciating paper.

In the years ahead, as more and more citizens see their wealth gradually vanishing and become more aware of the social disorder already prevalent, increasing numbers will discover that only reasonable assurance is to be found in some hard money (gold and silver coins) at home and the same plus other appropriate investments abroad. Americans of past generations did not experience this and thus most Americans today do not understand it. But throughout Europe the need to put one’s wealth in forms and places inaccessible to currency depreciation and State seizure has occurred with substantial frequency. During recent years citizens of Great Britain, France, and Italy, to name a few nations, have been restricted in their external financial dealings. That Americans largely have been spared such policies in the past is no guarantee against the imposition of severe restraints in the future. Prolonged inflating was not a major U.S. problem in the past.

At some stage in the inflating process, most citizens will be faced with a disturbing dilemma. Should they continue to obey the developing rules designed as an economic straitjacket by an insatiable State, or should they disregard the rules much as prohibition was disregarded in order that they and their families may retain means essential for economic survival? For many, the choice will be difficult. Others will have planned in advance for this eventuality and thus will have minimized the agony of that time.

WIDESPREAD SPECULATING

During the late 1960’s, the worsening plight of the dollar in international money markets became more apparent as a consequence of prolonged inflating. Inflating, however, was not publicly recognized as the source of the dollar’s problems. Instead, officials blamed “international speculators,” and President Nixon’s policies of August 1971 were supposed to take control of the dollar away from speculators.

As for international speculation, the troubles of the dollar (which are of U.S. making and are attributable to prolonged inflating) have provided unusual opportunities for speculators to profit as they have shifted billions from one country to another, reaping a harvest of exchange-rate differentials first here, then there. But what had been a more or less sedate international gambling club now is a wide-open, rip-roaring gambling den. Major international financial interests have a field day, now that currencies have no ascertainable value and no ties to any definite value. The financial power big-money interests wield is sufficient to push up or down, for a time at least, the price of gold, prices of gold stocks, any currency in terms of another, and even, when they choose, to influence prices on the New York Stock Exchange as well as those on most other exchanges.

Instead of ensuring that “...the American dollar must never again be a hostage in the hands of international speculators,” when the dollar was made a no-thing, paper, unit, it put in the hands of international speculators not only the dollar but also the currencies and securities exchanges of virtually the entire free world. Wide fluctuations almost surely will occur with substantial frequency during the coming years. Expect them; plan for them.

“Hunting for wildly fluctuating markets does not mean, in our view, attempting to guess short-term swings in prices. Many analysts who, like us, have concluded that the traditional forms of long-term investing no longer have much chance of providing adequate returns, have recommended that short-term trading is the ‘only way to go.’ All of our research indicates there is no reliable method for consistently predicting short-term market price changes – for stocks, bonds, gold, other commodities, or anything else. Thus, in our opinion, short-term trading is nearly a sure way of going broke. Although traditional investment vehicles are inappropriate for long-term investing in an age of accelerating inflating, the purchase and holding of gold, through periods of price rises and declines, does seem to hold the promise of preserving the purchasing power of one’s wealth.

Nevertheless, the temptation to speculate through short-term trading is strong once the veil of money is lifted and one can see that investing in corporate America does not provide adequate real returns, as Table 4 shows. That temptation must be resisted by those who cannot afford the high risks of loss associated with short-term trading.

THE BURDEN OF DEBT

Unhampered by the constraint of having to redeem currency for something of intrinsic value, the banking authorities, prodded by the politicians, have fostered the granting of excessive loans to corporations and individuals. The potential rewards of huge borrowings during periods of inflating, which were discussed in Chapter IV, were not lost on shrewd businessmen. “Leveraging” is a much discussed topic in the Nation’s leading business schools these days, and in some firms, debt may even be regarded as a separate “profit center.” But debt, unlike equity, involves a legal commitment to a schedule of fixed repayments. As the amount of debt incurred increases, so does the size of each regular payment. During contractions of business activity, the manager who has gambled on a heavy debt load may find himself unable to meet his contractual obligations.

Thus an inherently unstable situation is promoted by prolonged inflating. Under current law, the businessman has two extremely powerful incentives to borrow heavily: (1) interest payments are deductible from revenue before taxes, which can reduce by nearly one-half the cost of
debts against equity; and (2) with a depreciating accounting unit and the requirement that income for tax purposes be computed using historical costs, borrowing long is an enticing means of recouping the losses that occur through understatement of cost of goods sold and depreciation. Unless inflating and/or tax laws change, business managers probably will adopt ever riskier financial structures, and the frequency of incidents such as the threatened Chrysler unit and the requirement that income for tax purposes be its obligations or the entire structure will collapse. Chart 3 shows the dramatic change in the ratio of debts of domestic nonfinancial borrowers to GNP since 1955.

Many private debtors probably would have severe difficulty meeting their obligations if nominal (paper-dollar) incomes were to decline for some time. However, in a paper-money economy, nominal incomes can be boosted by (1) increased Government spending to prop up various sectors of the economy, such as the construction, motor vehicle, and defense industries; (2) the Federal Reserve adopting a more expansionary monetary policy; and (3) Federal banking regulators easing capital or liquidity requirements so that more funds could be provided to threatened sectors, to home mortgage lenders by the Federal Home Loan Bank Board, for example.

After such actions, the banking system could continue to lend to businesses and individuals, which in turn would inject purchasing media into the economy, increasing paper-money incomes, and keeping borrowers afloat. This “spend out of recession” notion has not been discarded by the Congress or the administration, regardless of their rhetoric about fiscal prudence and monetary restraint. In the spring of 1980, Secretary of the Treasury G. William Miller assured the public that if a developing recession became severe, the Government would take appropriate action, implying, of course, increased spending. As to the attitude of Congress, the Joint Economic Committee’s 1980 Annual Economic Report focused on containing the role of Government, adopting policies providing incentives for long-run output and productivity increases, eschewing economic “fine-tuning” efforts, etc. Such views are most sensible and encouraging. Yet, the Committee’s commitment to its new views must be doubted when the Committee also stated that should a serious recession develop, “short-term countercyclical measures would be necessary.”

To alleviate a growing capital pinch in early 1980, Federal regulators eased reserve requirements for savings and loan associations and advanced dividend payment dates of the twelve regional Home Loan Banks so that more funds could be made available for the housing market. In addition, the Carter administration proposed plans for subsidizing mortgage rates for low-to-moderate income families. In the discussion stage among regulators is a proposal to allow “interstate bank acquisitions in emergency situations.” This proposed regulatory change would allow failing banks to be absorbed by financially strong ones located outside the failing banks’ home state. Federal regulators also are considering changing the powers of the Federal Deposit Insurance Corporation to enable that heretofore deposit guaranteeing agency to inject capital into problem banks.

In sum, the aforementioned examples illustrate that, with a paper-money system, Washington is ready and willing to take any steps required to forestall a liquidity squeeze on the banking sector that might produce deflating. The Federal Government obviously would act “decisively” during the infancy of an economic contraction more severe than those of 1973-75 and 1980. As long as Washington has this opinion and as long as debts can be repaid with paper dollars, the chance that an economic recession might escalate into a deflation-depression is small. A hyperinflation is much more probable.

Added to the huge total of domestic debts are hundreds of billions of outstanding debts of developing countries, and the amount of such debt continues to increase in spite of much evidence that the current amount is overburdensome. Among the many demands of the “Third World” countries is the demand that the developed countries (and principally the United States) and international organizations (funded principally by the United States) ease the burden of their debt by guaranteeing some of it and outright “forgiveness” of some of it. Surely these demands will heighten, and already much sympathy for the plight of developing countries has been expressed by U.S. officials. Needless to say, U.S. taxpayers and American victims of inflating will bear any burden U.S. officials lift from the leaders of developing countries. You will notice we said “leaders of developing countries.” This wording is intentional because funds going to “developing countries” mostly go into the pockets of the leaders (mostly dictators) not to the benefit of the people at large.

 Unrealized by many analysts is the vast debt being accumulated in the form of obligations to pay future retirement incomes. The Social Security Old Age Benefit scheme is the most conspicuous example. While population was increasing during recent decades, the number of employed greatly enlarged in relation to the number retired. Now that the rate of fertility has dropped below the replacement rate, a markedly different situation is beginning to develop. Social Security taxes already are a great burden on individuals and businesses. What they will become is commented on below. Moreover, most private pension plans are similarly situated. Many have not even funded their current pension payments, and the amounts required in the future will become astronomical. Already, the Railroad Pension plan is threatened with bankruptcy.

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**Chart 3**

**DEBTS OF DOMESTIC NONFINANCIAL SECTORS AS A PERCENT OF GNP**
Therefore, one of the most ominous of possible future developments is the huge and rapidly increasing need for money to fund the pension obligations of governments and business firms. In the United States, funding the Social Security scheme alone would total an estimated $2 to $4 trillion. Government will be forced to tax more and more to meet the obligations, and future retirees probably will receive smaller benefits. In the lifetimes of today's working population, Social Security benefits for the elderly will be from two to three times the tax rates for this purpose today, but already there is widespread clamor that the lower-income groups are being taxed beyond their ability to pay. If Government financially rescues large-scale private pension plans (already proposed), the Government's need for funds will become even greater. Moreover, businesses generally will find their own pension plans to be increasingly heavy burdens. All of these needs will constitute enormous political pressure to continue inflating at an accelerating rate.

MORE CONTROLS

When the symptoms of inflating become increasingly clear, political pressure for controlling the symptoms increases. Already evident are the disruptions of orderly social and economic relations. Gone are traditional economic value relationships. Now each group has learned that the only way of coping with ever-rising prices is to demand more and more and to force such demands by strikes or other "job action." The strong or strongly situated thus scramble against each other for financial benefits and the weak are trampled upon, pushed farther down into the poverty characterized by deteriorating slum housing and shrinking buying power of pensions. Government attempts to cope with the situation by price and wage controls, whether "voluntary" or otherwise, surely will do more harm than good, as always has been the result in the past.

Since 1971, controls over prices and wages in general or some prices and wages in particular have been imposed in the United States, Great Britain, and Canada. This is clear evidence that Western civilization is retrogressing. Less than a century ago the British Empire was the great exponent of free trade and free markets. The United States was nearly as staunch a supporter of economic freedom. Even in Europe, free movements of men and money across borders were benefits promoted by the gold standard. Today, after two world wars and 4 decades of inflating, retrogression has reached the stage where even many, perhaps most, economists find reasons for tariffs and other controls that an enlightened earlier generation strongly abhorred because that generation had learned the lessons of history. Education in economic matters has deteriorated to the point where the Keynesian secular revelations are accepted, while the repeated experience of mankind is rejected, as a guide to policy decisions.

In our time, one of the most powerful and despotic governments in the world has ruthlessly attempted to control prices completely. The experiment has continued without serious internal opposition for half a century in Russia. The situation there is summarized in the following extract from a report in the London Financial Times.

"Inflationary pressure has not in fact been eliminated. It simply takes the form of shortages and seller's markets instead of price rises . . . ."

"Concealed inflation takes several forms: gift bottles of vodka to shop managers to obtain scarce items, increased activities on the organized black markets, and reduction in quality at given prices . . . ."

"The casual visitor may not notice specific shortages until he sees a long queue; for bedspreads, say, or towels, or washing powder, or plastic bowls."

The destination of the American economy and of any other in Western civilization that adopts so-called income policies is clear. Black markets will become dominant, thereby providing greatly enlarged opportunities for the gangster element. Primarily those who defy the law will be able to prosper, a situation that must further tear apart the fabric of orderly, organized society.

DEPRESSION OR A FLIGHT FROM CURRENCY?

Many analysts, who recognize the enormous burden of debt outstanding and the seemingly inexorable trend toward more, predict that a 1930's-type depression with falling prices soon will occur. In our view they neglect critical differences between monetary and fiscal policies in the 1930's and now. The most significant of the differences is that the dollar in the early 1930's was an amount of gold and the dollar today is an irredeemable, fiat currency. In the early 1930's, holders of U.S. currency held, in fact, a claim on gold. U.S. currency consisted mostly of Federal Reserve notes, and the Federal Reserve banks were obligated to redeem in gold any notes presented to them for such redemption. To ensure that the Federal Reserve banks would be able to meet that obligation, they were required by law to maintain at least a 40 percent gold reserve against their outstanding notes. Obviously, monetary officials could not create gold; therefore, they were not free to issue unlimited amounts of currency.

Today's money managers are not so constrained. They can create as much irredeemable paper currency as the public might demand — and then some. Gold no longer is the public's early check on profligate money managers; the only external check on today's officials is the utter refusal of the public to use fiat currency as money. As such refusal builds among the public, it produces hyperinflation, not deflation.

As we mentioned earlier, should signs of an incipient deep recession become evident, almost certainly the Government would incur large deficits funded with enormous issues of Treasury securities monetized by the Federal Reserve and private commercial banks. In what amount? In whatever amount U.S. officials decide. Today's monetary system is devoid of external constraints on the actions of the money managers, and these leaders have not distinguished themselves by acts of self-restraint. To think they would neglect to use their unrestricted power to create purchasing media in the event of a developing severe recession is unreasonable. Today's money, today's banking system, and the attitudes of today's officials bear little resemblance to those of the early 1930's, and the consequences almost surely will be vastly different.

One might ask then, Is there no definite limit to the depreciating of currencies, to the magnifying of economic distortions? The answer is yes. There is a limit that is reached when the people of a nation no longer are willing to use as money their government's promises that "I owe you nothing." This is when a flight from the currency occurs. When such a situation will occur in one or more of the major nations of Western civilization is not ascertainable today. Perhaps it is as near as this year, or perhaps it is more distant, 2 or 3 decades in the uncertain future that lies ahead.

In any event, and regardless of whether the harsh economic aftermath of inflationary policies too long continued occurs in the near or distant future, the next few
decades will be markedly different from the first 2 following World War II and even from the tumultuous times of the past 10 years. The retrogression of Western civilization probably will continue, perhaps at an accelerating rate, until the lessons that should have been learned from history are taught again by bitter economic experience.

At the beginning of this year, the professional staff members of AIER and of American Investment Services, our wholly owned registered investment advisory, gave their educated guesses of the chances in 100 that various economic events will occur during the next few years. These possible events and the average probabilities assigned to them by AIER and AIS are shown in Table 5. Although deflation is not ruled out completely, it is considered to be only a small possibility, about the same as that for a restoration of stable prosperity within a few years. In our opinion, hyperinflation and a flight from currency within a few years is much more probable, but even that is not as probable as continuing prolonged inflating irregularly for perhaps a few more decades. Of course, our assessment of the chances for these various developments occurring may change in the light of new evidence, but obviously we are not expecting a fundamental change in U.S. policy in the near future.

Table 5

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<thead>
<tr>
<th>Developments</th>
<th>Chances in 100</th>
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</thead>
<tbody>
<tr>
<td>Drastic deflation and credit collapse within a few years.</td>
<td>7</td>
</tr>
<tr>
<td>Accelerating inflating followed by a flight from currency</td>
<td>26</td>
</tr>
<tr>
<td>within a few years.</td>
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</tr>
<tr>
<td>Prolonged inflating irregularly over possibly a few decades.</td>
<td>48</td>
</tr>
<tr>
<td>A resumption of the inflationary boom, but of shorter</td>
<td>14</td>
</tr>
<tr>
<td>duration than that of 1946 to 1965.</td>
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<tr>
<td>Restoration of stable prosperity within a few years.</td>
<td>5</td>
</tr>
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</table>
VI.
A POSSIBLE SOLUTION

In spite of the pervasive evil influence of long-continued inflating, by no means is it alone responsible for all the economic ills of Western civilization. The bungling of ever-growing government bureaucracies; special privileges of various kinds, including business and labor monopolies; prohibitions against employment for many who simply are not worth to employers the statutory minimum wage; government interventions in the form of wage, price, and other controls that prevent the free functioning of markets; unwise taxation that tends to kill the business "goose that lays golden eggs"; and various other maladjustments distort and retard the world's economies. However, inflating is so pervasive in its consequences that it, in effect, draws a veil over the economic scene concealing and distorting to such an extent that coping with other basic problems while inflating continues becomes virtually impossible. Restoring sound money-credit conditions would not be sufficient to assure the prosperity of an advancing civilization, but until such action is taken other important problems probably will not be accurately diagnosed, much less solved.

Inflating a nation's purchasing media (currency plus checking accounts) is not something new in the world. Within the span of recorded history, thousands of such instances have occurred.* Even in the relatively short period since World War II, hundreds of devaluations of currencies have been recorded. Since 1914 the French franc has lost 99.8 percent of its 1914 gold value. That period is about equal to the life expectancy of a newborn American. The dollar now has lost about 80 percent of its 1939 buying power. In other words, prices generally have increased by a multiple of five. Whenever any currency has lost as much of its buying power as the dollar now has, that currency has become virtually worthless in only a few more decades. There are no exceptions to this trend in the historical record. Based on the lessons of history alone, one would be justified in concluding that inflating and the resulting depreciation of the dollar surely would continue until, in the lifetime of most now living, the dollar would be practically worthless in relation to its pre-World War II value.

How might this trend be stopped or what might follow the final demise of the dollar are questions of utmost interest. No one knows the answers with certainty, but we are not without a guide pointing to a possible solution. That guide is the evolution of sound commercial banking as it once occurred.

EVOLUTION OF A SOUND SYSTEM

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.

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 purchasing media had to be distributed to employees and stockholders of businesses, to suppliers of raw materials, and to others entitled to claim (purchase) things available in the markets. Moreover, the 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:

1. All the leading industrial nations used gold by weight as their accounting or monetary units.
2. 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 discounted short-term commercial paper.

Ending the monetization of Government deficits would not ensure that inflating would end, although we cannot imagine an end to inflating in the absence of an end to Government deficits. Also essential to restoring a sound money-credit system is the rediscovery and practice of sound commercial banking.

A sound money-credit system would include 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 for a long-term reliable accounting unit. 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

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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.

Prior to World War I, relatively close adherence to the basic principle of sound commercial banking resulted in the maintenance of currency values for nearly a century and in rapid economic development. Among the leading nations all currencies then 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, albeit sometimes sharp, were contained within a narrow range and for brief periods.

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.

Beginning in World War II and continuing until the most recent recession, the process of inflating was repeated. 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 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 in equivalent real value, and general economic disorder.

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

A MODEST BEGINNING

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 that would remedy the situation quickly, we do not know about it, nor do we believe that anyone else does. We do not even know the nature and full extent of the economic distortions that must be corrected, or of the economic losses to be experienced. Some distortions will have been partially or fully corrected by the subtle influences of competitive markets even before they are widely recognized.

The more proposals we have studied for restoring a sound money-credit system, the more we believe that the task defies the abilities of the most knowledgeable individual or group of individuals. But that situation does not alarm us. Indeed, it is encouraging, because it forces the searchers for solutions to turn to the markets. There, all of the human talent is continuously working to find solutions to economic problems.

When this Nation's economy boomed after the Civil War until World War I, the markets developed a system to meet the need for effecting, in a noninflationary way, the astronomical increase in transactions that was a part of the growth process. The basic principle of sound commercial banking evolved in free markets. The gold-exchange values of things produced coming into the markets were briefly monetized, as though they were so much gold, by the commercial lending process, which involved automatically self-liquidating short-term loans. When the loans were made, the banks created corresponding credits to the checking accounts of the shippers, amounts not deducted from other checking accounts. In effect, this made the gold standard flexible enough so that the great unforeseen increase in production and even greater need for transactions "money" was accommodated. These newly created purchasing media were canceled by repayment of the loans as things were sold in the markets.

No economists invented the system. No governments created it. Human beings operating in free markets coped with a problem for which no solution previously had been provided. However, by the time the Federal Reserve Act was passed in 1913, the basic principle of sound commercial banking was so widely recognized and applied that it was embodied by specific wording in the Act.

In today's circumstances, hope that the present monetary problem can be solved by wise legislation in a short time seems to be perhaps the vainest hope imaginable. Clearly, what is needed is re-evolution of sound commercial banking, which includes a gold monetary unit. Such evolution would be encouraged if the United States government had been provided with a gold monetary unit. The price of such bonds, in paper dollars, would be determined by the free-market price of gold on the day of issue. A vast market for such bonds yielding only 1 to 3 percent, depending on maturity dates, probably would develop. Within a few decades, transactions specifying amounts of paper dollars, or no-things, probably would disappear as the contracts in terms of gold were perceived to be more advantageous.

The Federal Government could facilitate the evolution toward a sound monetary system and the termination of inflating by initiating the issuance of gold bonds with principal and interest payable in the new gold coins. The price of such bonds, in paper dollars, would be determined by the free-market price of gold on the day of issue. A vast market for such bonds yielding only 1 to 3 percent, depending on maturity dates, probably would develop. Within several years, the Government thus could refinance its debt and save much of the present $80 billion annual interest payments. If the resulting smaller total Federal expenditures with given revenues produced surpluses that were used to reduce the debt, the funds thereby made available to the capital markets would help finance the needed revitalization of industry.

No guarantee can be provided that a catastrophic flight from the paper currency could thus be avoided; the United States has gone far on the road to ruin. But if the worst does happen, an increasing supply of the new gold coinage would be available to provide a firm foundation for recovery from the debacle. The experience of Germany after 1923, and again after World War II, demonstrated the surprising rapidity of recovery that sound money and free markets can foster.
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