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CAN OUR CIVILIZATION SURVIVE?*

THE GOLD STANDARD AS "GOVERNOR" FOR A DYNAMICALLY STABLE GROWING ECONOMY

During only seven decades prior to World War II an undreamed of increase in production of the things desired by humans occurred in western industrial nations. For example, in the United States, although the population multiplied less than four times:

a. The freight ton-miles carried by railroads and trucks multiplied about 220 times;

b. Hot rolled iron and steel products multiplied 56 times;

c. Wholesale and retail trade multiplied more than 20 times.

These figures give a general idea of the physical volume of things that flooded through the Nation's markets on a rapidly increasing scale in only seven decades. Purchases of raw materials, factory sales, wholesale trade, and retail sales all involved transfers of money. From where did the money come for the vast multitude of business transactions? Barter among producers of the flood of merchandise obviously was not practicable. Only the availability of money in some form could have facilitated the distribution of things to the managers, laborers, and investors who were entitled to a share.

Immediately after the Civil War if any banker had been told that he and his successors would have the task of providing the money required for such an expansion of production and trade during the next few decades, he might well have thrown up his hands in despair. Few professional money men could have provided a solution to the problem. A typical comment might have been:

"The total money available in the form of gold coins, including that in the hands of the public as well as in bank vaults is only 400 million dollars. New gold production in the entire world, even if it all came to the United States, would not be enough."

Such a banker could not have known in 1865 that the Nation's monetary gold stock would multiply 10 times by 1940, but even that increase in the money supply was not enough. By 1940, total currency in circulation plus private checking accounts, the purchasing media in use, had increased 55 times in order to meet the requirements for transactions in the Nation's markets. Perhaps there was not a man alive in 1865 who could have imagined how this would occur. None of the economists' textbooks published in the United States or abroad described how such a financial miracle might happen nor did any economists dream that the flood of things produced would reach such startling proportions.

Nothing like this had occurred before in the known history of earlier civilizations. There was no precedent to guide the bankers, no plan prepared by some government agency to cope with the situation.

EVOLUTION OF COMMERCIAL BANKING

By a process of trial and error the practice of sound commercial banking gradually evolved. By the end of the 19th century, all leading industrial nations had adopted the gold standard. In England the evolution of sound commercial banking became well advanced early in the 19th century. Progress in the United States was slower, but the basic principle of sound commercial banking was so well recognized before World War I that it was embodied in the Federal Reserve Act of 1913.

The development of sound commercial banking can be traced from the famous Bullion Report of 1820 in England to the creation of the Federal Reserve System in the United States nearly a century later. However, for the purposes of this discussion the situation that existed early in the present century will be described.

The vastly increased production of the industrial age passed through manufacturers' shipping rooms to wholesalers, then to retail stores. At each stage of the distribution process the things produced were stored, temporarily, while buyers placed their orders. In effect, the manufacturers' shipping rooms, wholesalers' warehouses, and retailers' shelves were like baggage check rooms where things were stored until buyers who had claim checks demanded the things available.

The monetary unit then was gold. In the United States the unit was about one-twentieth of an ounce of pure gold in an alloy nine-tenths fine and it was named the "dollar." This was the accounting unit then used. Dollars in the form of coins or paper claims to gold were the claim checks that entitled buyers to claim their shares of things produced.

Most buyers used paper currency or checking accounts for purchases in the Nation's markets. These purchasing media were in effect claim checks for the things offered by manufacturers, wholesalers, and retailers. The total of such purchasing media in use, although denominated in dollars and referred to as so many dollars, evidently did not in large part represent gold dollars held by the banks.

* An address prepared by E. C. Harwood, Director Emeritus, American Institute for Economic Research, for delivery at the annual conference of NCMR at New Orleans, November 2, 1978.

Only a small part could have represented actual gold dollars because the total purchasing media in use, about $10.5 billion in 1912, was 6 times the Nation's monetary gold stock, and by the 1920's the purchasing media in use had become nearly 10 times the gold stock.

How was it possible that the total of dollars in active use so greatly exceeded the actual gold dollars in the hands of the public and in the vaults of the banks?

Some of the purchasing media were created when gold was brought to the banking system. The banks did not borrow money to buy gold; they created paper currency to represent gold and gave the paper to the seller in exchange for the gold or they simply credited the seller's checking account (demand deposit) with the number of dollars that the gold constituted. Thus, part of the purchasing media actively in use represented gold.

During the evolution of commercial banking, the banks had learned that they also safely could issue purchasing media (currency or credits to checking accounts) to represent the gold-exchange values of things coming into the markets. Experience demonstrated that short-term self-liquidating loans could safely be made. When such loans were made, new purchasing media were created that, in effect, represented the gold-exchange values of things offered in the markets. Manufacturers' and merchants' notes were discounted and the proceeds were added to their bank accounts, a bookkeeping creation of purchasing media. Such purchasing media were used as claim checks are used, i.e., to claim the things available. Of course, when such purchasing-media claim checks were received by sellers, they used the purchasing media to repay their bank loans, which withdrew the claim checks from circulation.

Among the markets or baggage rooms were the banks themselves. They continuously stored and offered gold not only in exchange for the currency and checking accounts that had been created in exchange for gold delivered to the banks but also for any purchasing media in existence that was denominated in dollars. Any holder of purchasing media, regardless of whether it was created originally to represent gold or to represent other things available in the markets, always had a choice between demanding gold from the banks or demanding other things from the manufacturers and merchants.

THE GOLD WARNING SIGNAL

Availability of this choice facilitated preservation of a dynamic equilibrium. If the banks in one market area overestimated the gold-exchange values (the prices) of things being brought to markets and issued excess claim checks (purchasing media), prices of things other than gold in that market area would rise until prospective buyers perceived that better bargains were available elsewhere. Then, they would demand gold from the local banks and use it to buy in distant markets, or if they bought elsewhere with checks drawn on their checking accounts, the local banks would have to ship gold to the banks of the other market areas as checks were cleared.

An outflow of gold was a warning signal to any bank that it had created too much purchasing media thereby departing from the basic principle of sound commercial banking. Either the bankers concerned had overestimated the gold-exchange values of things moving into the local markets thereby encouraging some increases in prices above the equilibrium level, or purchasing media had been created and issued to represent things *not* being offered in the markets.

For example, creating purchasing media by adding to a manufacturer's account the proceeds of discounting his note secured by bills of lading evidencing the shipment of automobiles to dealers is a sound commercial loan. The new purchasing media thus created, when distributed by the manufacturers to employees as wages, to suppliers in payment for raw materials, and to investors as dividends were used by them to buy in markets that had received additional things to be offered for sale, the automobiles. Things having a gold-exchange value equal to the additional purchasing media were in the baggage rooms (retail stores) ready to be claimed by purchasers.

The fact that few of those who received wages or dividends from the automobile manufacturer chose to buy new automobiles did not destroy the equilibrium, because other potential buyers were receiving purchasing media that represented the gold-exchange values of innumerable other things in the baggage rooms or markets. When markets were free and prices were not controlled, discrepancies attributable to an unwillingness to buy at quoted prices soon were remedied by special sales or by more lasting price reductions that signalled to the distributor or manufacturer that the public's demand differed from that expected. By the time any would-be "planners" learned about some minor disequilibrium, the situation usually was well along toward being remedied by the flexible functioning of free markets. Business-cycle corrections were of short duration as long as major departures from sound commercial banking were avoided.

THE PROCESS OF INFLATING

Sometimes bankers disregarded the basic principle of sound commercial banking by acquiring more investments than were justified by the savings brought to the banks. When acquiring such excess investments, the banks credited the borrowing sellers' accounts, thereby making available for circulation claim checks that did *not* represent things flowing into the markets or baggage rooms for sale but that could be used like all other purchasing media to buy things in the markets.

For example, a borrower might wish to buy an automobile. If the bank loaned to him savings recently deposited by others, the borrower thus obtained the use of purchasing media or claim checks that represented things, including cars, in the market. When he bought a new car, equilibrium was maintained.

However, if the bank already had invested or loaned all the savings deposited with it and created new purchasing media or claim checks to lend to the prospective car buyer, an excess of money chasing things in the markets resulted. Prices would rise. The resulting disequilibrium at times encouraged manufacturers to overexpand, and a typical business-cycle boom would be experienced.

During World War I, the basic principle of sound commercial banking was disregarded in another way. The banking system created checking accounts for the Government in exchange for Government bonds that were held by the banks rather than offered in the markets. As the new purchasing media or claim checks were used to buy things in the markets, things already represented by other purchasing media in use, demand exceeded supply at the original gold-exchange values. This was inflating, and of course prices rose.

During the 1920's, similar inflating occurred by means of the overexpansion of private debt. The gold-exchange-standard experiment then under way facilitated nearly simultaneous inflating in most industrial nations by double-counting gold reserves. When the credit bubble finally burst, the aftermath was world-wide deflation and depression.

Before World War II, the Keynesian notion that perpetual prosperity could be sustained by perpetual inflating was applied, continued through World War II, and thereafter was applied on an increasing scale. The basic principle of sound commercial banking was forgotten. Perpetual inflating became the new way of life.

As the currencies of several leading nations deteriorated, that is, as prices generally rose at increasing rates, gold was demanded from the banking systems. After the gold held by U.S. banks had decreased to only 40 percent of the amount held shortly after World War II, the pretense that the dollar still was as good as gold was abandoned in 1971.

No longer was gold by weight the accounting unit of all leading industrial nations. The "governor" of modern banking that had made possible dynamic equilibrium was abandoned. The depreciating paper currencies provided no standard of value.

From then on, lacking both a warning signal in the form of an outflow of gold and any definite restraint on the expansion of purchasing media, bankers based commercial loans on current inflated prices and made other loans and investments at similarly inflated prices. All increases in wages and other prices were validated by more and more increases of purchasing media by the central banks and the other commercial banks. Thus all the leading industrial nations became trapped in an inflation spiral of ever-increasing wages and other prices, in other words, depreciating currencies. For this situation there is no certain end short of complete depreciation of the currencies no longer used to effect exchanges.

From time to time during a prolonged inflationary spiral temporary setbacks occur. Overspeculation in various aspects of the economy, such as construction in major cities or excess tanker construction or excess lending to incompetent debtors, such as some of the less developed nations, may be followed by recessions or even more severe depressions. Nevertheless, in the absence of the gold governor or any other sound basis for judging comparative exchange values, the inflationary spiral continues as long as the central banks create more inflationary purchasing media to finance government deficits and excessive private borrowings.

CONSEQUENCES OF INFLATING

The consequences of prolonged inflating are all too visible. Everywhere and at all times for which there is any record, inflating has been the great destroyer of social order. Gradually nearly every segment becomes a warring faction. Even school teachers find that they must unionize and strike or become economically submerged. Factory workers fight for higher wages only to discover that a higher tax bracket and more rapidly rising prices have foiled their efforts. Unscrupulous adventurers seeking a "fast buck" rise to the positions of power in business and banking. Few statesmen can hope to be reelected to public office; only the shifty politicians who promise more and more to major pressure groups win elections. Businessmen change their inventory policies from FIFO (first in, first out) to LIFO (last in, first out) only to discover that they should change again to NIFO (next in, first out) if they are to avoid dissipating their capital. Inflating is an assured self-destruct mechanism.

That Western civilization as the older among us once knew it already is retrogressing seems evident. The number of births in the United States reached a peak in 1957. Since then, although the number of women reaching childbearing age has increased 65 percent, the number of births has decreased nearly one-third. A comparable but much less extreme situation occurred during the depression years of the 1930's. To some extent this apparently reflects seriously adverse economic conditions for young families, largely attributable to inflating. Serious crimes against persons per 1,000 of population during the past 20 years have more than tripled; murders have nearly quadrupled; serious crimes against property owners have multiplied nearly seven times. These facts strongly suggest deterioration or retrogression rather than progressive advance of a civilization.

Does this imply that the present civilization, like all earlier ones, must decline? Is there no reason for hope that the experience of mankind will be different this time? Are your grandchildren or at latest their grandchildren, doomed to still another dark age when the new barbarians will take over perhaps for several centuries?

From whence might come the new barbarians? We have seen the rising tide of terrorists hijacking planes, others shooting down a civilian plane in Rhodesia and murdering surviving occupants, the genocidal totalitarianism in Cambodia; and, looking at the situation here at home, we find looters rampage in New York City when the lights go out. By unsound economic policies we are creating barbarians in our midst. On the pretext of protecting those who labor we deny to millions of young people a foothold on the ladder of success. Instead of acquiring on-the-job training while learning useful work habits, for millions the minimum wage is an eleventh commandment, "Thou shalt not work." And among the relatively poor of our great cities we foster for youth a drug-and-crime culture, while we teach their parents that if enough gang together to exert political clout, they have a right to have transferred to them what fellow citizens have produced. Thus, some new barbarians support themselves in idleness or gamble at the races, the casinos, and in the numbers game. I wonder how many states operating lotteries would profit by them if welfare checks were not so freely available, if charity went to those who needed it instead of to the pressure groups incited to demand what they want by political action.

DIFFERENCES IN PRESENT CIVILIZATION

An observer might conclude, unless he has rose-tinted glasses, that this civilization already is in decline and that its fall is as certain as any future event can be. But there are grounds for optimism instead of pessimism. At least we know that the present civilization is different in two signifîcnt respects from any that ever existed earlier.

One of those differences is the vast increase in the productivity of human beings. In the first part of this discussion I described the unprecedented and amazing increase in the production of things that men desired. However impressive that has been, it is only the superficial consequence of one significant difference between the present civilization and all those that preceded it. I call that consequence superficial because, if one focuses attention only on material gain, he may overlook how it came about.

To summarize in one sentence: The great advance in the ability of mankind to provide more for all was attributable to increased Freedom, Liberty, and Justice, which are inseparable aspects of the same beneficial situation that fosters the utmost humans can do for themselves and their fellows.

COMMON LAW

More than eight centuries ago, on an island off the western coast of continental Europe, a strange new development in social order gradually evolved. This was the Common Law. As one judicial decision after another explored and affirmed the rights of persons to be secure in their persons and in their possessions, humans in that social order attained a degree of liberty that assured to individual initiative and competence their reward.

Magna Charta was one landmark in that evolutionary development of social order, termination of Star Chamber proceedings was another, but perhaps the most significant of all was the Constitution of the United States. Belatedly made a part of that document were the first ten amendments, the Bill of Rights, developed gradually during the centuries-long evolution of the Common Law.

Freedom, Liberty, and Justice, as more nearly attained in the United States than elsewhere in the world, account for the incredibly great advance of our Nation from the status of a pygmy among giants to the giant among pygmies in the entire world within the short span of less than two centuries. Thus, we can be confident that freedom, liberty, and justice for each individual, to a degree never before experienced in the known history of the world, has been a significant difference in the present civilization compared with those long dead and gone.

Unfortunately, in our growing concern about some undesirable aspects of the current civilization, we have turned to authoritarian solutions for social problems. We seem to have lost faith in the compass that guided our advance, name it as you choose, Freedom, Liberty, or Justice. Instead of exploring the further implications of justice for remedying adverse developments in social order, we have sought to change undesired consequences of injustice by bull-in-the-china-shop procedures. Instead of continuing to regard government bureaucracy as the inevitable enemy of human progress, we have delegated to government more and more responsibilities for which politicians and government employees are perhaps the least qualified. This is the road to ruin.

Fortunately, the second great difference between the present and earlier civilizations may help us to solve our social problems. For the first time in the known history of mankind, useful procedures of inquiry have been described so well that future students can be taught how to function far more effectively in studying the problems of men in society. This advance was achieved in large part by American philosophers during the last 150 years, and may be the most significant achievement of our civilization, even the one of greatest potential value to mankind since the invention of the wheel.*

WHAT CAN BE DONE?

If there were a magician who could redirect the course of human developments by waving a jewel-encrusted wand, perhaps the most helpful thing he could do would be to shift us backward in time to the point where we diverged from the path toward more freedom, liberty, and justice. And in order that we might not lose our way a second time, the magician should inculcate in our college and university graduates an ability to apply useful procedures of inquiry. Then, the future well-being of our descendants, if not absolutely assured, probably would have a better chance.

Lacking the magician and his wand, what can we do? I can see no other way to proceed with hope of success than to begin now to teach our youth the significance of the evolution of Common Law toward Freedom, Liberty, and Justice in social order. Every student in a college or university should be entitled to this enlightenment. And, as rapidly as is possible, all who are inclined to inquire into our social problems should become skilled in useful procedures of inquiry.

Now it will be obvious that these suggestions will not provide a universal panacea for all the ills of every social order. We ask today, "Why can't Johnny read?" He cannot read when he enters high school, when he enters college he has to take a remedial reading course before he can study effectively, and after he leaves college all too many Johnnys (and Janes) never read anything serious again. There are plenty of other problems also that may be helped to some extent, but not necessarily solved, by the prescription I have offered.

My final point is that the two suggestions are believed to be essential to the long-run survival of the present civilization. How long will it be before significant results are obtained? At least a quarter century, a generation, perhaps much longer, but assuredly the desired results never will be attained unless we begin.

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* Rollo Handy and E. C. Harwood, *Useful Procedures of Inquiry*, Behavioral Research Council, Great Barrington, Massachusetts 01230 ($12.50).

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