INTERNATIONAL TRADE COURSE

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Sound Money versus Inflation

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INTRODUCTION

Few statements on the money question are as clear and concise as this contribution from Dr. J. E. Holloway. Therein is the argument for sound money, based upon free convertibility, not merely into gold but into gold coin. The importance of sound money in the sphere of international trade, as well as that of internal trade, is clearly shown.

Sound money, like free trade, while in itself not a remedy for the unjust distribution of wealth, is nevertheless part of the pattern of freedom, and is indispensable to a just and free society.

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The text which follows was originally published in the South African journal *Optima* (to whom acknowledgments are made) under the title "Monetary Reform or Revolution." It has been slightly condensed and cross-heads added. On pages 11 and 12 will be found short extracts from the writings of two other authors on the subject of inflation.

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Sound Money versus Inflation

By J. E. Holloway, D.Sc.

The theory of real or honest money is exceedingly simple. It postulates simply that the value of the material of which a given unit of money (say, £1 or $1) is made must be exactly equal to the nominal value of that unit. Therefore £1 must contain exactly £1 worth of monetary material.

At the time when the bulk of the financing of world trade depended on the reliability of London, and for a long time before that, the British Treasury was so puristic in its regard for the maintenance of the honesty of British money that it paid the minting charges itself. The minting was, in fact, a process of stamping on a disc of gold a Government certificate that that disc was made of gold, eleven-twelfths fine, and weighed 123.27447 grams, subject to the allowable "currency remedies." The cost of the minting was borne by the Treasury, so that the value of the money material coincided exactly with the face value.

It follows from this definition that gold is not the only material of which honest money can be made. For centuries this rôle was played by silver. As, however, the material of which money is made is itself subject to changes in value, gold is far and away the best material for honest money. Gold—*provided it is allowed to influence the prices of commodities, an essential qualification*—is more stable in value over both short and long periods than anything else known and this pre-eminence is due chiefly to the difficulty of winning gold and to the smallness of the annual production in relation to the existing reservoir. It is also due to other qualities which gold possesses above silver and other types of monetary material. Any text-book on money will explain these other qualities clearly and in simple language.

It also follows that paper possesses hardly any of the qualities necessary for honest money. I am not here referring to paper as "representing money" or "money of account": of that more later. Paper money by itself, possessing value simply by Government *ukase*, gives the public, who have to store their savings in it, no protection whatever. There is hardly a case on record where paper money, other than "representative" paper money, has not depreciated in course of time. In other words, *inconvertible* paper money is the worst and most dishonest money.

If paper is used as a representative money—that is as representing real or honest money—it should be interchangeable at the will of its holder into real money. If this condition is present, paper money can serve very well as "money of account." It has certain definite advantages, *provided this safeguard is present.* Once this safeguard is removed and the money of account usurps the rôle of real money, it quickly becomes money of less and less account, until it finally becomes money of no account.

This process is taking place before our eyes to-day. The public call it a "rise in the cost of living." The public can see from week to week the process of money of account becoming money of less account. Yet it does nothing about it. All over the world goods and services are being taken away from their subjects by governments in return for such unhonoured promises to pay—I.O.U.'s—and the public tamely submit.

Colossal Fraud

It is enlightening to trace the process by which nations came to accept tamely the most colossal fraud of all time.

The generation which commenced to take notice of public affairs when the first World War broke out, had grown up under a regime of honest money. They knew that it simplified all wealth-producing processes, that it made mankind better off because it made man's activities more economical. That generation had known that dishonesty spread out over a wide field is an anti-economic force. They had even been brought up on the a-moral maxim: "Honesty is the best policy." They knew that inconvertible paper money was dishonest; that it dulled the edge of husbandry; that it always depreciated; that it had always been the source of social upheaval. They saw in a short period the once proud German mark disappear into thin air; the franc, the lira and many others depreciated to a shadow of their former selves. And yet it was this generation which took refuge in universal inconvertibility!

The explanation of this paradox lies in the changes in the method of waging war.

The wars, even the great wars, of past ages were fought with armies of "champions." The bulk of the population stayed at home. "Business as usual" was not only the motto: it was the

fact. A small army of "champions" was sent out to fight the cause of the nation when it became involved in a war. Armies of volunteers, supplemented from time to time by mercenaries and by press-gang methods, supplied all the man-power that was needed. The productive activities went on with little disturbance, except in the actual and usually limited area of active operations. Generally speaking, a country at war could largely provide the sinews of war by the continued operation of its normal productive activities.

"Forage on the Country"

The war between the States in North America was the beginning of modern war, war between citizen armies, war on a scale that could no longer be carried on without introducing violent changes into the productive activities of the belligerents. The famous order given by General Sherman that his army should "forage liberally on the country" presaged a vast new development. Now Sherman used this order about the country of his enemies. Modern armies, however, "forage liberally," and have no option but to forage liberally on the productive activities of their own countries. The vast increase in destructiveness of modern weapons of war and vast cost of producing them, have changed the entire economic structure of the world.

When the first World War broke out, Britain, unlike Continental belligerents, was still obsessed by the idea that the war could be fought with an army of champions. "Business as usual" was the motto. "We shall get enough volunteers to man the fighting forces" was the popular belief and the slogan of the politicians.

By 1916 it was clear that neither the motto nor the slogan fitted the facts. Conscription was introduced even in the country that had, up to then, taken keen pride in being the land of the free.

Inexorable necessity had created a situation that every Briton two years earlier would have regarded as impossible. What neither governments nor the public—whether in Britain or on the Continent—nor even the vast majority of thinkers had yet seen, was that the new conditions had shattered not only the right of the citizen to decide whether or not he would volunteer to fight, but also the relationships of citizens with each other in regard to personal property.

It seems curious to-day that the idea ever took root that it was proper to conscript a man's person, his very life, for the defence of the State, but that it was improper to conscript the material means with which he defended the State.

The conscript soldier of the first World War therefore gave his personal services in defence of his country, frequently passing through hell in doing so, and in millions of cases paying the supreme penalty.

To supply the weapons, the material means with which he defended the country, he had to pay a levy on his meagre earnings to those who remained in civilian employment. Those things had, in so far as taxation could not supply the means of payment, to be "borrowed" from the latter, and interest had to be paid on war loans. These loans were, it is true, a burden on the whole community. Those who did not fight had also to contribute. But while the majority of the civilians were in a position to invest in war loans—in fact, their earning power was increased because of the absence from civilian employment of the conscripts—the soldiers were, as a rule, not in this position.

When the war ended, therefore, the soldiers, on balance, owed the civilians money for the weapons with which they had defended the civilians.

A Subtle Process

This is how the theory of conscripting armies and borrowing for their weapons would have worked out. But, in fact, it did not do so completely. A new factor intervened. For this, the destruction of the monetary mechanism was responsible. In effect, governments, quietly and without making a fuss about the matter, introduced a method of conscripting wealth. They did not call it that. To have done so would have caused a furore. All they did was to deprive the citizen of the right to receive final payment—payment in honest money—for the goods and services they took from him. They forced the citizen to take "promises to pay," but they absolved themselves from the obligation of paying on demand. They could always take more and more goods for more and more promises, and so *ad infinitum*.

The generation that grew up in the era of honest money did not, however, forget all. When the war was over, they set about the task of reconstructing the system that had served them and their ancestors so well.

In reconstructing the system, they made one cardinal mistake. It is easy to be wise after the event. Very few thinkers on the subject, however, were wise enough to see the far-reaching, structural change that had been introduced into economic relationships between different classes of citizens by the actual conscription of wealth, which depreciation of money had brought about.

Those Promises to Pay

The reason for this is that people were still arguing on the assumption that governments had "borrowed" the money and would, in time, repay it, or continue to pay interest on it. In fact, most governments were continuing to "pay interest on the national debt." This further helped to obscure the real position that, just as the conscripts who had fallen were no more, the material wealth destroyed or consumed by the process of military operations was gone for ever. If the persons who had "lent" this now non-existent wealth to the government demanded repayment, and that at a price in real money which existed in a previous era, they were, in fact, laying an impossible mortgage on all other classes, and not least, on the men who had borne the heat and burden of the war.

The cardinal question to be decided after a war is how much the astronomical promises to pay are worth in terms of real or honest money.

Now, in considering this cardinal question, attention must be given to the relationship between the volume of the money of account (or promises to pay) and the volume of final payment, *i.e.*, gold.

During a war, the promises to pay fall thick as autumn leaves in Vallombrosa. During a war, the production of gold is generally reduced, because productive resources are, wherever possible, switched over to the production of the requirements of war.

It would, therefore, seem clear to the meanest intelligence that the value of gold must rise in terms of paper money.

The Pound of Flesh

But let us look at the reverse side of the picture. If, in fact, as Britain and South Africa and other countries decided in 1925, the relationship between the two must remain the same as it was in 1914, certain startling consequences follow.

The first is that the actual conscription of wealth by which governments matched the conscription of men, must be put into reverse. The persons who "lent" money to the government (in many cases money derived from war-time profiteering) must be repaid at full value to the last pound of flesh.

Where must this flesh come from?

The lenders are also taxpayers. To the extent that the money to pay the interest on John Smith's holding of war loan can be obtained by taxing John Smith, the debit and the credit entries on the books of the Treasury wipe each other out. True, you still have to pay the Treasury officials who laboriously calculate and pay out interest to John Smith; you still have to pay the stockbrokers and their staff who do the work of "making a price" for the war loan; you still have to pay the Income Tax officials who calculate what John Smith has to pay, and the accountants and auditors (and now and again the lawyers and the judges who have to decide whether the income tax is just and fair). All this is an extra burden on the community, for officials and stockbrokers and accountants must live.

Enslavement of Producers

But the lenders are not the only taxpayers. The soldiers who survived the war, the civilian workers who never earned enough to leave a surplus to invest in war loans, the young men and women who were in their cradle when the war was being fought, all have to contribute to the service of the national debt as well as to the other services of the government.

If, then, the war-time conscription of wealth has to be put into reverse, if money is to be sacred when human life is not, there is clearly a transfer of funds to the lenders of wealth from those who have still to earn it. If, therefore, the final payment—payment in real or honest money—has to be made in terms of the relationship that existed between real money and money of account before a great war destroyed a vast amount of wealth, and before money of account was increased to astronomical proportions, the earners will be permanently enslaved to the holders.

Two Alternatives

It is obvious that no human community will bear such a burden. To escape from it, the community is, therefore, faced by a choice between two alternatives.

The first alternative is that of never resorting to final payment. The second alternative is that, before it has recourse to final payment, it goes through the preliminary business precaution of settling the size of the bill. It then wipes out the bankruptcy caused by war, and starts producing again, without the weight of a millstone round its neck.

"Debauch the Currency"

If the former is chosen, the inevitable continuing depreciation of money must be accepted. The pound, the dollar, the franc, the lira, the peso, the gulden and what will you, will depreciate "till none is left." Now and again a savage depression will halt the process. Now and again a government will be both wise enough and strong enough to put on the brakes; but not for long. The cost of living will go on increasing; labour disturbances will be the order of the day; these will be more

frequent, more prolonged, more savage, and more destructive of the productive resources of the community than ever before. The process of wiping out the provident classes of the community will grow apace. There will be no room for private saving. Communism is the inevitable end of this march.

Lenin is reported to have said: "If you want to wipe out capitalism, debauch the currency." He was right. But his dictum goes much further. "If you want to wipe out individual liberty debauch the currency." That is the inevitable end of the first alternative.

Wipe out the Barriers

The second alternative is the only one that offers any hope for a free society to survive. The mere determination of the size of the bill is but a preliminary. It has to be followed by monetary reconstruction on a sound basis, to enable the community to devote its energies to production, instead of dissipating them in endless quarrels about the way in which the rising cost of living has to be met.

The first problem of monetary reform is to find out what our money of account is worth. That can only be determined in terms of real value. The best real value that mankind has evolved, as a monetary measurement, is the measure of gold.

What are the paper promises to pay, which the citizens hold, worth in terms of gold? Nobody knows. Limited free markets, harried by governmental restrictions and isolated from each other by barriers and prohibitions, all give different results from each other at one time, and different results inside the same market at different times. The only way of finding the answer to this all-important question for monetary reform is to wipe out the barriers between them. The only way is to have a real free market for gold in the principal trading countries of the world—freedom for the citizens to buy, sell, import, export or hold gold as he sees fit.

Result of Freeing the Exchanges

This is only a first step. It will determine the size of national debts in real terms. It will determine what currencies are worth in terms of each other, and replace the present absurd system by which their value is "pegged" according to the notions of a limited number of authoritarian bureaucrats and maintained (more or less inefficiently) by a vast army of officials, supported at the cost of the workers of the world.

It is not sufficient that this right of the citizen to demand final payment, at whatever figure his claims are now worth, should be re-established. It should thereafter be maintained . . . . .

The Citizen's Potent Weapon

As soon as the citizen can freely exercise the right of demanding final, or real payment for his goods and services, *governments will be careful not to issue more than they can redeem on demand*. If, alternatively, they over-issue, the citizens can force them back inside the limits of safety quite easily by demanding payments in gold. The securing of the right to demand gold is, therefore, a potent weapon against inflation—against a rise in the cost of living caused by monetary manipulation.

This is, in fact, the only weapon now available sufficiently powerful to put an end to the present inflation and the many evils which follow from it. It is often said that a rise in the price of gold will cause more inflation. It is important to analyse this statement critically.

It must be admitted that if the price of gold is increased, *and governments retain the right to inflate the currency* the statement is true. But the qualification is essential.

It is, indeed, very significant that this objection to the increase in the price of gold comes mostly from monetary authoritarians. A few others sometimes fall into the trap of using the same argument because they do not appreciate the importance of the qualification. The monetary authoritarians should be the last to advance this as an argument against increasing the price of gold. For is it not a cardinal tenet of their faith that they can manage money.

Failure of the Money "Managers"

It is, of course, quite clear from the present universal inflation that they have failed to manage money in such a way as to keep even a modest control over prices. If now they argue that a higher price for gold will cause more inflation it is tantamount to a confession that they will use the broader gold base for the creation of even more inflation.

It is, however, an essential condition of sound monetary reform that governments should be deprived of the right to inflate the currency. This can be done in two stages, namely:—

(1) the restoration of the right of the citizen to buy, sell, import, export or hold gold without let or hindrance from the government. (This does not preclude the enactment of safeguards against theft, or illicit gold buying);

(2) the restoration, once the true value of gold in terms of paper money has been established, of convertibility of paper money into gold, again at the will of the citizen and not of the government.

Let us suppose, however, that the authoritarian bureaucrats have their way and spend the extra money that they get by a revaluation of the gold stock (if any) held in the national treasury. This will certainly cause further incipient inflation. But if, as any sound monetary reform must postulate, the citizen regains the right to demand gold, such action by the monetary authorities will immediately cause a drain of gold away from the national treasury. The monetary authoritarians will, therefore, be brought to heel very quickly.

Convertibility and Stability

It is perfectly true that, until the price of gold in a free market becomes reasonably stable, a government cannot restore convertibility. Convertibility assumes a definite figure at which the unit of money of account can be converted into gold. That figure cannot be fixed until the price of gold has been determined by the arbitrament of a free market, the only agency that can now determine it. There would, therefore, be an interval during which dealings in gold would be free but the right of the citizen to demand gold for paper could not yet be exercised. But no government, intent on monetary reform, would render itself more vulnerable to a demand for gold at such time as the right to demand it is restored, by inflating its currency during this interval.

Once the change-over to convertibility has been achieved, a powerful safeguard for the maintenance of a stable monetary system will enter into force. If, in such circumstances, a government does tend to live beyond its means, pressure will immediately be exerted on it, by an efflux of gold, to return to safer limits. Pressure, so exerted, will be of a mildly deflationary nature. Just as a gyroscopic compass corrects a vessel's deviation from its course as soon as this deviation becomes significant, just so will a movement of gold, either abroad or into private hoards, correct deviations from sound monetary policy.

Inflation and Deflation

One of the great evils of inconvertible currency is that such dangerous deviations can go unchecked for a long time without either corrective forces being set up, or the community even being aware that it is drifting into danger. This, then, gives rise in time to capital flight, and when the disease has advanced far enough to demand governmental interference, recourse must be had to such drastic remedies as import and exchange controls, rationing, price fixation, and self-defeating cost-of-living allowances. These inherent evils of inconvertible money will always be with us until the citizen's right to final payment on demand is restored.

The present highly fictitious prosperity is being kept up by wars and rumours of wars, by re-armament and stock piling. These latter, again, are kept going by the process of pumping ever more and more promises to pay into circulation. What will happen when this process can no longer be continued? Clearly, only war or a depression of a magnitude that will create a disruptive revolution. Joseph Stalin and his associates must be laughing in their fists at the aptness with which the totalitarian bureaucrats in the national treasuries of freedom-loving countries have become pupils of Lenin: "Debauch the currency."

Final Challenge

Two great wars have taught us that, if the relationship between real money and money of account has been disrupted by the abolition of the safeguards for honest money, there is only one way out: to write down depreciated money to its correct value in terms of real money. To attempt, as we have done before, to write up depreciated money to the value of real money, is to disrupt the whole community.

Once this adjustment has been completed, there is no reason why real money should not exercise the salutary influence that it has exercised during the periods of great progress and prosperity in the world's history.

If gold is not correctly priced it will, in time, work havoc with any monetary mechanism, whether this mechanism be the gold standard or a managed currency.

The theory of the monetary authoritarians is that they can control gold. They have tried. They have been armed with the great powers of control that governments hold over the gold in their treasuries and central banks. They have given an interpretation to the Articles of Agreement of the International Monetary Fund that would, if it had been advanced at Bretton Woods, have prevented the Fund from ever being born. They have had the benevolent support of the greatest gold producers, South Africa and Canada, which have refrained from using the powers specially reserved to gold producers.

And yet the monetary authoritarians have failed to keep incarcerated even the gold that was held by treasuries and central banks before the Fund's gold policy of 1947 was formulated. The Fund is now (*i.e.*, August, 1951) struggling with the problem of the losing fight that official hoarders are waging against private hoarders.

They are trying, in truly authoritarian fashion, to introduce ever more prohibitions and restrictions in order to turn the odds in their favour—this from an organisation created to eliminate foreign exchange restrictions, which hamper the growth of world trade!

Against them are fighting millions of humble individuals, who care nothing for their theories, but who realise vividly that the possession of gold is a safeguard of human liberty.

Can the monetary system of the authoritarians survive a challenge based on this ground? And if it can, is it a victory for mankind—or for authoritarianism and ultimate Communism?

THE MIRAGE OF INFLATION

By Henry Hazlitt

The following is from Henry Hazlitt's book, "Economics in One Lesson." Mr. Hazlitt has been journalist and editor for more than thirty years, specializing in both economics and literature. He has been literary editor of "The New York Sun" and "The Nation," editor of "The American Mercury," an editorial writer for "The New York Herald," and financial writer for "The New York Evening Post."

Inflation throws a veil of illusion over every economic process. It confuses and deceives almost everyone, including even those who suffer by it. We are all accustomed to measuring our income and wealth in terms of money. The mental habit is so strong that even professional economists and statisticians cannot consistently break it. It is not easy to see relationships always in terms of real goods and real welfare. Who among us does not feel richer and prouder when he is told that our national income has doubled (in terms of dollars, of course) compared with some pre-inflationary period? Even the clerk who used to get $25 a week and now gets $35 thinks that he must be in some way better off, though it costs him twice as much to live as it did when he was getting $25. He is of course not blind to the rise in the cost of living. But neither is he as fully aware of his real position as he would have been if his cost of living had not changed and if his money salary had been *reduced* to give him the same reduced purchasing power that he now has, in spite of his salary increase, because of higher prices. Inflation is the auto-suggestion, the hypnotism, the anesthetic, that has dulled the pain of the operation for him. Inflation is the opium of the people.

Take but one example, the belief that public works necessarily create new jobs. If the money was raised by taxation, then for every dollar that the government spent on public works one less dollar was spent by the taxpayers to meet their own wants, and for every public job created one private job was destroyed.

But suppose the public works are not paid for from the proceeds of taxation? Suppose they are paid for by deficit financing—that is, from the proceeds of government borrowing or from resort to the printing press? Then the result just described does not seem to take place. The public works seem to be created out of "new" purchasing power. You cannot say that the purchasing power has been taken away from the taxpayers. For the moment the nation seems to have got something for nothing!

THE WATERED PUNCH

By Dr. F. A. Harper

Dr. Harper is the author of many books and articles and is a member of the staff of the Foundation for Economic Education. The following is from his booklet "Inflation."

Inflation means too much money. The way to prevent inflation, then, is to close down the money factory. It is just that simple. All the complicated gibberish one hears and reads about inflation simply blocks an understanding of the essentials of the problem—though it may impress the ignorant, or hide the negligence of those who are responsible for inflation by making the task of preventing inflation seem hopelessly complicated.

Counterfeit money affects what you can get for your money in the market much like water affects the punch at a bring-your-own party. Each in attendance is to be allowed to dip into the punch bowl in proportion to the quantity of ingredients he has brought and dumped into it. All bring some pure ingredient wanted in the mixture.

Now suppose that one person brings water, and dumps it in. This dilutes the punch, but the person who does it is permitted to drink of the mixture the same as those who are being cheated. He gets something for nothing, and the rest get nothing for something by an equal amount. If everyone were to do the same as he has done, it would be perfectly clear what the adding of water does to the taste of the punch. So it is with counterfeit money, *whether done privately or by the government.*

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