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Embracing the Void: The Economic Effects of 40 Years of Fiat Currency. How have the retirement of the gold standard and the corresponding freedom of the central banks to print money affected domestic and worldwide economics?

**Introduction**

Beginning in the ancient world, money was developed as a means of transferring wealth. A wide variety of tradable commodities have been used, including salt, stones, shells, metals, diamonds, furs, livestock, blankets, and the list goes on and on. These types of money are known as commodity money because there is some sort of intrinsic value in the monetary unit. They are also typically fungible units with standard qualities. In other societies, fiat moneys have been used. Typically a fiat money has no intrinsic value, and is simply an agreed upon medium if exchange based on a sort of social contract of some kind. There have been many examples of hybrids of these types of money, but ultimately every monetary system is either commodity or fiat to one degree or another.

In the last 500 years or so, by and large most western societies have used precious metals as the medium of exchange, or they have created paper notes which were used in the place of precious metals, and were redeemable in certain weights of a precious metal. These notes were originally issued by those who stored the gold as a convenient means of claim. Eventually they evolved into a system of exchange, and governments regulated coinage and regulated the financial institutions who printed money to keep the players honest. Over time, these systems developed into three main categories of money and banking systems, free bank gold standard, central bank gold standard, and central bank fiat. The categories are oversimplified for the sake of this discussion.

In a free bank gold standard system, besides being subject to government regulations, banks operate truly independently, and issue notes against their gold reserves. Each bank’s survival is dependent on their notes being accepted at face value, and because any other bank in the system can refuse them if they suspect that the notes will not be honored by the bank, or redeem all of the notes they hold at once if they sense instability, the competing banks in the system serve as a check to keep each other honest. In a system such as this market forces set the cost of money. Proponents of this sort of system explain that it is honest, and that every player in it has an incentive to keep it honest. They further explain that it allows for individuals to make their own choices with as much accurate information as possible. Finally, they argue that it keeps the power of currency creation in the private sector, and well distributed, so that no one player or group of players can dominate the others for an extended period of time. Critics of this system complain that individual banks and players can game this system, and take control of an economy causing booms and busts. They also complain that commodities are not necessarily finite resources, and things like gold rushes can become very disruptive to an economy. Finally, they complain that without the ability of a central planner to introduce currency into the system at will, that those holding money can simply stop spending, putting the economy to a halt.

In a central bank gold standard system, the central bank holds the gold reserves, sets interest rates, and issues currency redeemable in gold to various independent banks, who then can borrow more from the central bank in the event that they become illiquid. This system can work fairly well if the central bank either acts responsibly, or if it doesn’t, the central banks of other nations (or the public at large) begin redeeming the central bank notes for gold. Proponents of this system feel that it is the ideal mix of the responsible limitation of a commodity measure of redemption along with the flexibility of governments or central banks to expand the money supply in times of crisis to provide for liquidity, stop wide spread panics in the event that one or several banks become insolvent, and allow for a modicum of central economic planning. Critics of this system complain that the centralization of currency creation removes accountability from the system, that a poorly managed central bank could bankrupt an economy, that the threat of widespread panics is overstated and that the proper place for economic policy to be decided is by the individual player.

In a central bank fiat system, the central bank prints money as though it is gold, continues to set interest rates, without any physical limitations whatsoever. It serves as the lender to each of its member banks, is free to print as much money as it wishes, with its only restraint being the public or international will to accept this currency. Fiat central banking systems can be successful if the central bank is well disciplined and avoids devaluing its currency by over issuing it. Unfortunately, history is full of examples of what happens when those agencies, whether public or private, are not disciplined in their issuance of fiat currency. The appeal that fiat currency has to government is that it allows a government to spend money that it doesn’t have and doesn’t have to borrow. History of the last several hundred year’s shows that many wars have been financed by the printing of fiat currencies. Proponents of this system say that all that matters is that economies keep moving, that economic activity of any kind is positive, and that so long as consumers (citizens and the world at large) believe in the value of the currency and its value does not drop precipitously, that money is doing its job, and society benefits from government being able to invest the surplus goodwill into valuable programs such as wealth transfers, warfare, etc. Critics of these regimes argue that fiat systems create mal-investment, as no one can really know what the future value of money is, that they amount to wealth transfer from those who cannot borrow directly from the central bank to those who get to borrow newly created money at a much lower cost, and that that fiat systems encourage corruption in financial and political processes, which will create continually increasing pressure to print more and more currency, which inevitably leads to hyperinflation, depression, and economic collapse.

Throughout history, the United States has employed all of these sorts of monetary systems, typically moving between free banking gold standard systems and central bank gold standard systems in times of peace and fiat systems in times of war. However, since 1971, the US has been on an entirely fiat system managed jointly by the Board of Governors of the Federal Reserve Bank and the U.S. Treasury. In addition to being the central bank of the United States, Federal Reserve Bank issued currency and United States Treasury Bills enjoy the status of being the primary reserve currency for the entire world, which gives the United States and its agencies unprecedented power as well as a huge market to expand newly printed currency into. In essence, in the minds of the consumer in most nations worldwide, the US Dollar has become gold, but is this a good thing for most people?

If you listen to the vast majority of wealthy people, Keynesian economists, and most people with power and an investment in the status quo, the answer is a resounding “yes.” The changes in the world over the last 40 years since the U.S. adopted a fiat currency have been phenomenal. Technology has exploded; we are now interconnected as never before. The Berlin Wall came down, China has adopted a sort of capitalism, we have more millionaires today in this country than ever before (though recently this reversed somewhat, and with inflation it is hard to say for sure what a millionaire is), and the government reports inflation at about 2-3%.

But there is an alternative view taken by an increasingly large minority. This minority says that a vast majority of the growth that has occurred since 1971 is an illusion, and comes at a great cost that includes corruption, erosion of self determination of peoples worldwide, never ending warfare, and the collapse of the middle class in the U.S. and abroad. If they are right, you would expect to see over the last 40 years increasing corruption in government and business, continual warfare, degradation of civil liberties, concentration of power in the U.S. and U.N. and other super governments, administrative agencies, concentrations of great wealth in the hands of an ever shrinking few, an ever increasing number of poor people, despite a war on poverty, and an ever growing prison population.

Ultimately, this research project seeks to explore what the real effects of the adoption of a fiat currency system have been for the United States and the world at large. While attempting to fully answer these questions is far more work than this course allows for and far more research is necessary, the initial work has been quite interesting, and suggests that there is at least a modicum of truth to the second position.

**Topic Analysis**

**Academic Disciplines:**

Military Science, Business, Economics, History, Law, Political Science, Sociology, Religion

**Library of Congress Subject Headings:**

AE – Encyclopedias

CB 478 – History of Civilization – Technology

CB481 - History of Civilization – War and Civilization

EB855-861 - Nixon Administration

HC79 – Economic History and Conditions – Special Topics

HD49-49.5 – Inflation

HD72-88 – Economic growth, development, planning

HD6977-7080 - Cost and standard of living

HG201-1496 - Money

HG1501-3550 - Banking

HG3810 – 4000 – Foreign exchange, international monetary system

**Key Word Terms:**

Bretton-Woods, Petro-dollar, Gold Standard, Federal Reserve, Central Banks, Globalism, Money, Monetary Policy

**Most Important Databases and Periodical Indexes**:

I found by far that ProQuest was the most helpful online research database for me. I believe that this topic is of insufficient interest to the academic community, and as such, what information is available is available on the websites of various organizations that advocate various positions. These websites were of second most importance to my research

**Experience identifying subject headings and key words:**

I had the most success starting with very general key words and then working my way into much more specific words. I also found that by paying close attention to the terms which surfaced in one source that I could use those words to dig up additional sources.

**Reference Sources**

**Organizations:**

*Board of Governors of the Federal Reserve System.* Board of Governors of the Federal Reserve System.

Web. 1 June, 2012. <http://www.federalreserve.gov/>

The Board of Governor of the Federal Reserve System is the face organization for the apex of current banking, both for the United States and for the world at large. Because they represent the status quo in what the world considers money (the U.S. dollar is by and large considered the reserve currency for the world), their position is one of presumed authority on all things monetary. They generally represent the point of view that economic policy should be dictated centrally. The intended audience for this website is the general public at large, as well as the banking and government communities. Their point of view is that there is absolutely nothing wrong with Fiat currency, that it is as real as any other thing, and that there is nothing wrong with the manipulation of currency to achieve policy goals. They express the bias of power. They have it, and they intend to keep it. This organization’s publications and statistics will be helpful in providing me with a fiat currency positive outlook. But I must keep on the lookout for bias in their data, as the Fed has much to defend. This site has quite a few useful articles and graphs.

*The Ludwig von Mises Institute.* The Ludwig Von Mises Institute. Web. 1 June, 2012. [www.mises.org](http://www.mises.org/)

The Ludwig von Mises Institute is an independent organization dedicated to the advancement of Austrian Economics and free market principles. It is composed of a large group of Economics scholars ranging from hobbyists to various lecturing PhDs. Their intended audience is the public at large, academics, government and business people. This organization is inclined to advocate what can be best described as an anarcho-capitalist view of economics and government in general, and to find fault with any centralized manipulation of the market. This organization’s point of view is useful to me because it is the pre-eminent voice for commodity based free market currency systems. Their analysis is generally well thought out, and given historical context. In contrast to the Fed website, the information presented on Mises.org is presented largely in the form of argument, rather than assumption. This organization’s website has great videos, articles, and courses.

**Statistics:**

Williams, John. *Shadow Government Statistics.* American Business Analytics & Research LLC. Web.

1 June, 2012. <http://www.shadowstats.com/>

The publisher and author of the 'shadow government statistics' website is Walter J. Williams, a Dartmouth trained consulting economist with several decades of industry experience. Mr. Williams’ premise is that the US Federal government has engaged in the reporting of slippery statistics over the last hundred years by changing their methods of collecting, collating, and reporting facts, and that ultimately most of these changes benefit the government itself. His point of view is that of an independent skeptic looking at economics numbers without focus on policy goals. He seeks to gain access to the raw data that the government uses to compile its reported statistics, analyze their methodology, and point out any inconsistencies. This organization’s statistical data is particularly valuable to me, because it gives me an alternative view of reality to the one which is espoused by the central economic planners in the Fed and the US government. By and large, Mr. Williams finds that like everything the analysis of data is fuzzy at the margins, and in general, you can count on government reported statistics to always have some basis in reality, but typically skewed to influence public opinion in favor of government policies. The charts on this organizations site are quite compelling. This information is useful to my topic because it provides alternative measures of economic performance by which to judge the efficacy of fiat currency over the last 40 years.

**Encyclopedias:**

Lawrence H. White, "Competing Money Supplies." *The Concise Encyclopedia of Economics.* 2008. Library

of Economics and Liberty. 20 May 2012.

http://www.econlib.org/library/Enc/CompetingMoneySupplies.html.

Lawrence H. White is the F.A. Hayek Professor of Economic History at the University of Missouri, St. Louis. Dr. White explores the existence of competition that is already thriving in money markets both at a micro and macro level, the history of competition, including free banking systems, and then discusses the recent trend of national governments monopolizing currency creation. He then discusses the alternative theories held by economists regarding various free banking monetary competition models, and discusses the various benefits and costs of each competing model, as well as historical support for that position. This article is quite informative regarding the possibility of free market monetary competition, but does a poor job of comparing this system to existing national fiat systems, or explaining exactly how such a move would improve economic conditions. Dr. White is a cheerleader for Austrian Economics, and as a result, this article is only useful to my research for further general education and for introduction of new concepts.

"Money". *Encyclopædia Britannica. Encyclopedia Britannica Online.* Encyclopedia Britannica Inc., 2012.

Web. 1 June, 2012. <<http://www.britannica.com/EBchecked/topic/389170/money>>.

Encyclopedia Britannica is a well known general encyclopedic resource. The series of articles which cover money, which number well over ten, provide a broad brush overview of monetary notions and history. The intended audience is the general public. The publisher’s point of view is that of a mass market publisher who is looking for a nice generic package of information on every topic. These articles were useful as a general primer and point me to other helpful works, particularly by Friedman. In summary, the articles comprise a history of money, and a fairly comprehensive treatment of the problems that the current monetary systems suffer from.

**Books**:

Sobel, Robert. *Pursuit of Wealth: The Incredible Story of Money throughout the Ages.* Chicago, IL:

McGraw-Hill, 2008. Web. 1 June, 2012.

Dr. Sobel was a financial historian at Hofstra University and has written several books on financial and business history. In this book he explores the history of money as a means of wealth accumulation and exchange from the ancient world (Greece and Rome) through modern times. Throughout the book he explores various means of acquiring and transporting wealth, and what sorts of regimes are most useful in creating the most wealth in general in a society, even going so far as to find suggestions of Keynesianism working in tribal societies. The intended audience for this book is likely economics and history scholars. The bias exhibited by Dr. Sobel is one of an academic who is looking to tie up a wide and varied study into neatly tied packages. This book is interesting, but not particularly useful to me, as it delves far too deeply into nonmonetary economic issues for me to be able to extract much in the way of useful information.

Salerno, Joseph T. *Money, Sound and Unsound.* Auburn, Alabama: Ludwig von Mises Institute, 2010.

Web. 1 June, 2012.

<http://books.google.com/books?id=BUc0QgIJP1cC&printsec=frontcover&source=gbs_ge_summary_r&cad=0#v=onepage&q&f=false>

Joseph Salerno is Professor of Economics at Pace University, Editor of the *Quarterly Journal of Austrian Economics* and academic Vice President of the Ludwig von Mises Institute. The author’s main point in this volume is to give an overview of the mainline Austrian economic view of money, the history of money, and the proper monetary policy for a free market economy. He gives a long history of the foundations of Austrian monetary theory, discusses issues surrounding the problems with fiat currencies, the alternative of a gold standard, provides historical support for his assertions and finally gives criticism of current monetary policy. Salerno is an academic, and as such, his positions are very theoretical. He definitely advocates for free market commodity money, and makes no bones about his position. This book will be useful as it provides a very good overview of the criticism of fiat currencies, though it seems to not fully examine the problems with commodity money. The key to the importance of this book is that it is very recent and provides direct criticism more recent US Federal Reserve Bank monetary policies.

**Periodical Articles:**

Lewis, Nathan. "Why the Gold Standard Still Matters Today." *Forbes* Apr 11 2011: 1. *ABI/INFORM Trade*

*& Industry; ProQuest Research Library.* Web. 2 June 2012.

http://www.forbes.com/forbes/2011/0411/opinions-nathan-lewis-capital-flows-gold-still-matters.html.

Nathan Lewis is a blogger and writer for Forbes magazine. He is a former micro strategist and economist for institutional investors and currently runs a small investment partnership. Forbes magazine is a well known business magazine. It can probably be assumed that both writer and magazine have a pro business slant. In this article, he provides a short and direct explanation of the history of the gold standard, why it is preferable, and why, ultimately, breaking free of measuring money in units of commodity leads to inflation and currency devaluation. His theory is that the current experiment with fiat currency is a lark, and that no real problems can be solved by handing the reigns of currency creation to central planners. This article is helpful in providing context to my other materials.

White, Lawrence H. "A Gold Standard with Free Banking would have Restrained the Boom and Bust."

*Cato Journal* 31.3 (2011): 497-504. *ProQuest Research Library.* Web. 2 June 2012.

Lawrence White is an Economics Professor at George Mason University who earned his PhD at UCLA. The Cato Journal is a free-market public policy journal published by the Cato Institute, a libertarian leaning think tank funded by the Koch brothers. In this article, Mr. White addresses the failure of central banking to prevent the 2006-2008 housing crisis. In fact, he asserts that the lion’s share of the blame falls on the Fed. He then explains how different banking regimes (Central Bank fiat, Central bank gold standard, free bank gold standard) would have handled the problem, and asserts that only free banking has the inherent competitive factors necessary to reign in these sorts of problems. He then addresses the bailouts, explaining that the TARP program was largely theater, and the lion’s share of bailouts was made by the Federal Reserve buying up trash paper to save the shareholders of Bear Stearns and AIG to the tune of 1.25 Trillion. He advocates for a self regulating free banking system to replace central banking. This article was very useful to me as it directly addresses the problems inherent with centralized management of monetary policy.

Kadlec, Charles. "The Price of Abandoning the Gold Standard." *Forbes* Sep 12 2011: 1. *ABI/INFORM*

*Trade & Industry; ProQuest Research Library.* Web. 2 June 2012 .

<http://www.forbes.com/forbes/2011/0912/opinions-charles-kadlec-capital-flows-price-abandoning.html>

Charles Kadlec is a published author and political/monetary activist. Forbes magazine is a well known business magazine. It can probably be assumed that both writer and magazine have a pro business slant. Mr. Kadlec makes the case that the current energy crisis is not a global problem created by political tensions, but rather the reflection of the trashing of the US Dollar, and its corresponding devaluation relative to commodities like oil, gold, food etc. He backs this up with several observations and statistics which, if true, are quite compelling, but he provides no citations for his facts. This article is great information and is directly on point for my topic, but lacks the kind of support necessary to be truly meaningful. With luck, I can check these statistics presented for myself, and that will lead me to further useful information.

**Internet Sources:**

Hanke, Steve H. "Hyperinflation." The Cato Institute. May 17, 2007. 19 May 2012.

<http://www.cato.org/publications/commentary/hyperinflation>

In this article, Mr. Hanke gives insight into what can happen when a government behind a fiat currency becomes so corrupt that the faith behind that currency dissolves completely. He also gives insight into what might be done, besides moving to a commodity standard, to resolve the problem. His example of Zimbabwe's economic woes in 2007 gives an example of what happens when governments abuse their currency with a view to only solving short term problems. In March and April of 2007 alone, Zimbabwean currency devalued by 99%, the economy collapsed, and economic refugees streamed into South Africa. 8 years earlier, Montenegro faced a similar dilemma when the currency it used was unstable. They effected change almost overnight by switching to a more stable currency, and Mr. Hanke suggests in this article that Zimbabwe be forced to do the same. This article provides an interesting point of view that I had not previously considered, that ultimately it is not necessarily the fact that a currency is either fiat or commodity based which greatest effects its stability, but rather the psychological faith that the communities which are served by that currency hold in the currency that matters. Of course a tangible commodity is almost guaranteed to be of limited supply and has extreme advantages in terms of its ability to hold the faith of consumers, but a well disciplined fiat currency may also do a fair job of holding its value. This observation will help me explore the connections between corruption and lack of discipline in government and banking and the instability of fiat currencies.

Bernanke, Ben S. “Money, Gold and the Great Depression”. Remarks at the H. Parker Willis Lecture in

Economic Policy, Lexington, VA. March 2, 2004. Address. Web. 1 June, 2012.

<http://www.federalreserve.gov/boarddocs/speeches/2004/200403022/default.htm>

Ben Bernanke is currently Chairman of the Board of the Federal Reserve Bank. This address was given two years before his appointment. As a central bank insider, Mr. Bernanke is an unapologetic advocate for centralized monetary policy. In this address, Mr. Bernanke describes the evolving state of scholarship in Keynesian economics that eventually comes to blame Federal Reserve conservatism for the great depression, as well as the Gold standard. This address is particularly interesting because in it Mr. Bernanke criticizes the Federal Reserve during the Great Depression for keeping interest rates high, for not bailing out banks, and for maintaining the gold standard. These criticisms speak volumes in explaining the decisions Mr. Bernanke has made as Chairman. This article is useful in giving me an insight into the minds of the current bank management, and how they view themselves and the process that they manage.

**Non-print Sources:**

DiLorenzo, Thomas J. “Rotten from the Start: The Inherent Corruption of Central Banking in

America”. Mises Circle, New Orleans, LA. November 8, 2011. Address. YouTube.

Mr. DiLorenzo gives an Austrian Economics perspective of the origins of central banking in the United States. He puts this in the perspective of the debate between Keynesian, Austrian, and Chicago schools of economics. From the proposal of the first Bank of North America to the 2008 economic crisis, Mr. DiLorenzo connected the dots from his perspective. He began by explaining the relationship between Hamilton, Robert Morris, and the goals of the proponents of the first central banks. He then went on to explain the various corrupt schemes by which political and business insiders used the power of the Federal Government and Central Bank combined to steal legally from the taxpayers. This presentation was very helpful to me in drawing parallels between the effect of State endorsed fiat currencies on democratic institutions and government. It also helped me to visualize the effect of these institutions on our modern society and economy. Finally, it gave me some great ideas regarding possible secondary effects (corruption, control of legislative bodies, etc.) that the creation of a fiat currency might have on an economy.

**Review of My Research Process:**

My method for finding sources was to start with very general search terms and to narrow my results by date and source, and when that was unsuccessful to move on to more specific topics. Sadly much of what I found was opinion as much as it was well researched advocacy. The research process for this project was both frustrating and rewarding. Because this topic is not well understood nor is there much popular interest in it, there is not a wealth of information or research available that doesn’t advocate one particular position or another from the get go. My original problem was that I simply couldn’t find much information, and the information I could find was clearly skewed in one direction or another. Once I set my frustration aside and decided to evaluate each of the positions in light of the others, I was able to move forward.

Like many topics, there are two predominate positions on this topic, the first is that the status quo is the best thing since sliced bread, and the other, that the status quo is evil incarnate. Third positions that take some other position are either non-existent or lack sufficient support to have much in the way of written advocacy. If I had more time, I think would like to test the various theories of both sides against reliable real world data, if there is any, and develop my own analysis of the subject matter.

Finally, the internet was every bit as valuable to me in this process as any other source of information.

Ultimately, a complete treatment of this subject will be impossible without delving into the underlying data and assumptions of both sets of advocates, and comparing their conclusions to others who have studied these issues. As it stands I am aware of at least five schools of economic and political science that touch on these matters, including the Chicago School, Keynesian economics, Austrian economics, the Positive Political Theory, and Public Choice School of economics. Perhaps someday I will have a few years to consume all that and produce a theory of my own.