Before and After the Euro: Strategies for Sound Money in the 21st Century

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Since August 15, 1971, the entire world has been submitted to *de facto* paper monies. No commodities, not even silver or gold could be used for commercial transactions.

To render fiat paper currencies permanent, gold was officially "demonetized" in 1976. European currencies began to float against the dollar or the yen. The exchange rates fluctuated rapidly and the magnitude of their variations threatened European as well as world trade.

A "solution" was attempted through "fixed exchange rates" first internationally (December 1971), and later (1972) a limited system, the European "snake" was established. The Smithsonian agreement collapsed quickly (March 1973) and the snake survived only a few years. The European fixed rates mechanism collapsed in the mid-1970s against a backdrop of worldwide rising inflation. The amplitude and speed of exchange rate variations could obviously not correspond to changing purchasing powers of European currencies. As a result new obstacles to the European trade of the common market appeared and necessitated a quick remedy. To ensure a European zone of monetary stability, a "European Monetary System" was created in March 1979. Although more sophisticated than the "snake," the European Currency Unit ("ECU") was introduced in the middle, this new system was still an "arbitrary fixed exchange rate mechanism" for the European fiat paper currencies. Its destiny could not be monetary stability and that defect was explained as early as 1979 by Professor Pascal Salin in "*L'unité monétaire européenne: au profit de qui?*"

Monetary instability took the form of sudden devaluations and occasional reevaluations. In August 1993, the "fixed rates" were allowed to fluctuate within a margin of + or – 15 percent around the ECU. *De facto* the European Monetary System had collapsed. Early in the 1990s, it was generally admitted that "fiat national currencies" seriously hampered free trade in Europe, either through free or dirty float or through fixed rates mechanisms. Consequently, it was decided to abandon the national monies and to introduce a new currency called the "euro."

Although the old fiat papers should not be regretted, it is important to assess if the euro, in the form of a single new fiat money, is the only alternative. If another direction is possible and desirable, it then becomes appropriate to investigate the means to get there.

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To answer these questions we will begin by an overview of monetary history during the last two centuries, then we will assess the contemporary problems of European monetary integration and a free market alternative for sound money in Europe and potentially for the world.

Monetary History Overview from 1792 to the Present

The Gold Coin Standard

The gold coin standard of the nineteenth and twentieth centuries appeared progressively in different ways. The United States adopted a bimetallic system of gold and silver in 1792. The legal ratio between gold and silver of 15 to 1 was established with reference to the then current market rate (1 gram of gold was worth 15 grams of silver *de facto* and *de jure*).

France also adopted silver-gold bimetallism as early as 1803 with a legal ratio of 15.5 to 1. But it was left to England to start, after the Napoleonic Wars, the realization of an international gold standard. Metallic convertibility, reestablished *de jure* in 1816 and *de facto* in 1821, enabled gold to function as the basic money of the United Kingdom. Progressively gold became the international money.

Since antiquity gold has been used especially for large scale trade. Historian Henri Pirenne (1971, pp. 29–30; 1985, pp. 81–82 and 250–83) maintains that gold disappeared in Western Europe during the great commercial contraction of the eighth and ninth centuries, but that it reappeared with trade rebirth (eleventh to thirteenth centuries).

It has been customary over the last two centuries to speak of the convertibility or inconvertibility of national currencies (dollar, pound, franc). In the nineteenth century the dollar was defined as 1504.65 mg. of pure gold, the pound as 7.322 gr., the franc as 290.32 mg.

This means that "national currencies" like the dollar, the pound sterling, or the French franc were only names or more exactly claims to a certain amount of gold.

A 5 pound sterling note was a claim redeemable into 5 coins (5 sovereigns) containing 7.322 gr. of pure gold each. The 500 franc note was redeemable into 25 coins of 20 francs containing 5.8064 gr. of pure gold each. The 5 dollar notes were redeemable into 5 dollar coins containing 7.5231 gr. of pure gold and so on for each currency.

It insured "fixed exchange rates" between the different monetary units. Thus, in round numbers, one pound was worth 25 francs or 5 dollars. One dollar was worth 5 francs (1 pound = 5 dollars = 25 francs).

Consequently these "fixed exchange rates" did not stem from arbitrary control but rather from the nature itself of these convertible "national currencies," as, in the same manner, a dime (a 10 cent coin) is worth exactly two nickels (5 cent coins).

In the classic gold standard, gold coins form the basis of the monetary system. Bank notes and deposits are not strictly speaking money but only claims on money, claims repayable in gold. Notwithstanding some obstacles the issuance of these money substitutes tends to adjust to the needs and preferences of the users. The basic money supply in gold is also independent of the political powers. The quantity of gold in circulation is not decided by monetary authorities, the central bank or the government, but rather by the users' demand, through free coinage.

Free coinage in the United States, France, England and later in other countries represents an essential characteristic of the gold standard. Each citizen has the right to ask the mint to produce new coins at his asking. (Napoleons of 20 francs, sovereigns of 1 pound, or 20 dollar coins for example). Thus the quantity of circulating gold is not arbitrarily fixed by a government agency but by a spontaneous process adjusting supply to demand in each country and consequently throughout the whole

area trading in gold. To avoid the long and complex history of silver (as a parallel or a bimetallic standard) and consequently the working of Gresham's Law in the nineteenth century we refer the reader to the in-depth and pertinent study realized Charles Coquelin (1844, pp. 350–74).

It is necessary to distinguish between free coinage and private coinage. Private coinage is the minting of coins by numerous private actors. It existed in several American states before the Civil War. Free coinage is a similar process but through the government monopoly mint which unwisely forbids engraving the weight on the issued coins. This prohibition was criticized throughout the nineteenth century by J.B. Say and later by the *Journal des Economistes* (J. Garnier, J.G. Courcelle-Seneuil, M. Chevalier and many others). However, this criticism does not change the fact that the coin quantity was not affected by this restriction. The questioning (by the same economists) of the perverse effects of bimetallism cannot be analyzed here, but does not change the general outlook. In short, under free as well as under private coinage no government can control the money supply base.

It is important to note that the sound functioning of the gold standard did not need legal tender for bank notes. For instance, French bank notes were used without legal tender until 1870. They had *cours libre* (free tender or freedom of acceptance). For the Bank of France as well as for departmental banks of issue it meant that their notes "could be refused as a means of payment." Legal tender in 1848–1850 was an exception resulting, for less than two years, from the fall of the French monarchy. "Fiat paper money" (*cours forcé*) should be clearly distinguished from "legal tender." Fiat paper means "the suspension of the obligation to redeem bank notes." If a "legal tender" note is still convertible, payable in commodity money, fiat paper money on the contrary is inconvertible. It is irredeemable and the quantity issued does not depend on the wishes of the users but of the decision of a public monopoly of one kind or another.

The users are forced to accept fiat notes in payment of any transaction. Bank notes can thus change their nature overnight without any notice by public opinion or immediate trouble in daily life. From a simple claim or money substitute, the bank note can instantly become a money by itself, a basic money in its narrower sense. Without much public understanding a commodity monetary system can be quickly transformed into a completely new system based on an inconvertible fiat paper. Very rare in the nineteenth century, "fiat national currencies" were imposed *de facto* in 1971 and *de jure* in 1976.

Professor Murray N. Rothbard explained the importance of the gold standard in his enlightening booklet *What Has Government Done to Our Money?* "The international gold standard," he wrote,

> meant that the benefits of having one money medium were extended throughout the world. One of the reasons for the growth and prosperity of the United States has been the fact that we have enjoyed *one* money throughout the large area of the country. We have had a gold or at least a single dollar standard with the entire country, and did not have to suffer the chaos of each city and county issuing its own money which would then fluctuate with respect to the moneys of all the other cities and counties. The nineteenth century saw the benefits of one money throughout the civilized world. One money facilitated freedom of trade, investment, and travel throughout that trading and monetary area, with the consequent growth of specialization and the international division of labor.
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> It must be emphasized that gold was not selected arbitrarily by governments to be the monetary standard. Gold had developed for many centuries on the free market as the best money; as the commodity providing the most stable and desirable monetary medium. Above all, the supply and

> provision of gold was subject only to market forces, and not to the arbitrary printing press of government. (Rothbard 1985, p. 51)

The international gold standard provided "an automatic market mechanism for keeping the balance of payments of each country in equilibrium" (p. 51). How did this spontaneous adjustment function? To answer this question let us suppose monetary inflation in one country alone, there ensues an internal increase of prices. Imports are consequently stimulated and exports decreased. As a result some gold has to leave the country to pay for the increased imports. Monetary inflation is forced to stop and thus, price inflation. The balance of payments then tends to recover its equilibrium. Under these conditions a "currency" cannot drop significantly on the foreign exchange market.

Each national currency, in such a system, can fluctuate only within narrow margins called "gold points." A special edition of the *Revue Economique* states that "from 1821 to 1869 the maximum variations of gold prices . . . were of 1% for France and 0,1% in England" (Boyer-Xambeu 1994, p. 1167). If the pound sterling drops on the foreign exchange market for an amount in excess of the cost of gold transportation, there ensues a "gold drain" out of England which forces its value back to parity. Inversely, if the pound appreciates, there ensues an inflow of gold into England which forces its value back down to parity. Under the gold standard the currency exchange rates are forced, by a market mechanism, to fluctuate within such narrow margins (less than 1 percent) that one could rightly call this a "fixed exchange rate" system.

The franc/dollar ratio, during the 20-year period 1979–1999, is significant in this regard. The dollar was worth between 4 and 10 french francs during that period. Major and rapid variations recurred frequently. The "stabilization" at around 6 francs was far from its supposed purchasing power parity of 6.5 francs. As an example, let us suppose a parity of 1 dollar for 5 francs under a gold standard. This means that the maximum variation would be less than 5 centimes (a dollar could not be exchanged for more than 5.05 francs or for less than 4.95 francs). With a parity of one dollar for one euro, under a gold standard, the dollar could fluctuate only within a narrow range (1.01 euro and 0.99 euro) and *vice versa* with the euro.

It is in this perspective that international monetary stability in the nineteenth century constituted an important factor for the development of international trade and economic progress. If not perfect, this monetary organization did not present the disadvantages engineered by fiat paper currencies: inflation and erratic fluctuations.

Some financial centers like Paris, London, or New York, working under central banking or under the bond deposit system, were disrupted by recurring business cycles. In contrast, Scotland and the six New England states, working under freedom of money and banking, did not engender the recurrence of booms and busts. Boston, Glasgow, or Edinburgh, benefiting from monetary competition did not generate such crises (Nataf 1982, 1984). Rather, these cities absorbed economic troubles coming from the outside with striking ease. It is thus logical to credit the classical gold standard, not with disturbances, but with stabilizing effects during its era.

From the Gold Standard to the Gold Exchange Standard (1914–1944)

The gold coin standard functioned until 1914. In order to finance the war, the pound, the franc, and the mark were *severed* from gold. Governments suspended their convertibility. Overnight, the European monetary framework based on gold was radically transformed and pounds, francs, and marks became merely fiat paper currencies which depreciated rapidly against gold or the dollar (still a gold dollar). The metallic parities disappeared *de facto* and the "national currencies" began to float in a disorderly fashion. This monetary chaos lasted long after the war.

The will to reestablish a rational and stable international monetary system drove the Genoa Conference (1922) to reinstate gold as the international money. But it was only in 1925–1926 that gold convertibility was reestablished with one serious restriction, however. With the exception of the dollar, the European currencies were convertible only in bullion; thus the terminology of the gold bullion standard. Gold coins disappeared from European daily life. The monetary system became more flexible, the Bank of England was induced to use dollars as "reserves" in addition to its gold. Continental central banks added pound sterling to their own gold reserves in order to increase flexibility. This new international monetary system resembled a pyramid where the dollar was superimposed upon gold, the pound sterling on the dollar, and the European currencies on the British pound. In addition to gold, two "key currencies" were used as reserves, in a system where the different currencies, with the exception of the dollar, had their convertibility reinstated at overvalued pars. This monetary "construction" largely separated from the pre-war regulating mechanisms could only be unstable and short-lived. Known as the first gold exchange standard, this edifice lasted only a few years.

It is to fight monetary inflation and its consequences that Ludwig von Mises (1971, pp. 395–99) explained the advantages of free banking as early as 1924. In the 1966 edition of *Human Action* he again developed his views on that topic. Building on Cernushi's theories that, under freedom of banks, monetary expansion (including notes) would be completely curtailed, Mises explained that "free banking keeps credit expansion within narrow limits" (p. 447). Business cycles would be eliminated under such a system. He sadly remarked that "nothing harmed the cause of liberalism more than the almost regular return of feverish booms and of the dramatic breakdown of bull markets followed by lingering slumps. Public opinion has become convinced that such happenings are inevitable in the unhampered market economy" (p. 444). For him the solution was clear: "Only free banking would have rendered the market economy secure against crises and depressions" (p. 443). Short of this, Mises insisted that, under a new gold standard, gold coins should be allowed to circulate.

Starting in 1931, England abandoned a new gold convertibility. Progressively, the European countries and even the United States followed the same path and the world was again subjected to widespread floating exchange rates of fiat paper currencies that would last until the end of the second world war.

The Role of Gold in the Bretton Woods System: The Stable Parities (1945–1971)

As early as 1944 the goal of the Bretton Woods conference was the reinstatement of a stable monetary system for all its participants.

It was decided that gold should serve anew as the base of the international system as during the period from 1926–1931, but with one significant difference. Instead of two "key currencies" there was only one, the dollar. As before, each "national currency" was defined as a weight of gold. Metallic parities would engender fixed exchanged rates.

Domestically inconvertible, the dollars served as reserves in assets of the European central banks. This new gold exchange standard carried a similar defect to the preceding one. Dollars accumulated outside the United States were in principle redeemable in gold by the Federal Reserve System. In fact, they continuously accumulated without repayment.

This new system, based on gold, demonstrated great stability from 1945 to 1958. Following a slight monetary creation the American balance of payments deteriorated from 1958 to 1960. There ensued weakness of the dollar that brought on a flight from the dollar and an increase of gold "prices" in the free market. To stop this variation it was decided that the gold "price" would be stabilized by central bank interventions in the free market. This gold Pool could only postpone the monetary dysfunction that in

fact was worsening. To understand the monetary deterioration of this time a few figures will suffice. In 1957 the American gold stock approximated 25 billion dollars whereas the external claims for dollars did not exceed 10 billion dollars.

In the short run, the Bretton Woods system was not threatened. But the acceleration of monetary inflation in the United States would increase the deficit in the U.S. balance of payments. There followed a rapid growth in the dollar balances and a correlative decrease in the American gold stock. With the regulating mechanisms of the authentic gold standard, the gold coin standard, no longer functioning, dollar balances built up outside the United States. On March 17, 1968, the artificial "price" of gold on the free market (at $35 per ounce) became untenable. Central bank interventions on the Gold Pool were abandoned. A double market for gold was then created, one for monetary gold, the other for industrial gold.

Inflation and American deficits continued, external claims on dollars rapidly built up and exceeded 80 billion dollars. At the same time, the American gold stock diminished down to the critical threshold of 10 billion dollars. The free "price" of gold tripled and President Nixon was faced with a simple choice: either pronounce a major devaluation of the dollar or abandon the Bretton Woods system. He chose the second alternative and let the dollar float. In one day the international monetary system radically changed in nature. All metallic convertibilty was abolished and national currencies were nothing more than inconvertible paper monies fluctuating erratically against each other.

From De Facto *Inconvertibiliy to Legal Inconvertibility*

Such wide variations on the exchange markets slowed international trade so much that on December 18, 1971, the Smithsonian Agreement instituted a fixed exchange rate system with no basis in gold. This artificial arrangement could not function very long. It collapsed in February–March 1973, only 15 months after its inception. International monetary disorder rapidly regained ground. A worldwide recession followed in 1973 (explained only in part by oil price increases), an acceleration of monetary inflation in the United States, and double-digit price increases which engendered a significant drop in the dollar on the foreign exchange markets. Professor Hans F. Sennholz (1972, pp. 666–73) forecasted accurately in 1972 the "inflationary depression" of 1973–1974 known as "stagflation" and in 1975 he explained why *Gold Is Money*. The Jamaica agreement of January 1976 legally consecrated gold demonetization. All currencies lost their legal parities in gold. International law caught up with fact.

As a result, has gold lost any monetary role? Absolutely not. The monetary demand for gold increased after 1976 and consequently the free "price" of gold rose to over 800 dollars per ounce. A spontaneous and "unexpected" remonetization of gold began.

Professor Marchal noted in 1979 and in the 1984 reprint in his book *Le Système Monétaire International* that "the integral demonetization of gold is in no way established today and would not appear to be so in the near future" (p. 151). Two decades later history has proven him correct.

Euro: Inconvertible Fiat Paper Money or Commodity Money?

The Smithsonian Agreement (December 1971) on fixed exchange rates authorized the "national monies" to function within margins too wide for European currencies. So the the European "snake" (1972) was created, with narrower margins, which permitted fluctuations only within the "international tunnel." However, the collapse in March 1973, of the Smithsonian Agreement on worldwide fixed exchange rates broke the "tunnel" but not the "snake" which would last a few more years. By March 1976, it had

completely collapsed and the erratic monetary variations threatened anew free trade within Europe.

Several solutions were proposed. They included suggestions such as a parallel common money, a Europa, a denationalization of money, and a new European Monetary System. This last project was adopted and began to function in 1979 with a European Currency Unit (ECU), a central component of the system. Basically, it was merely a new kind of arbitrarily fixed exchange rates of fiat paper monies.

In addition to the distortions of production and malinvestments engendered by the worldwide floating exchange rates, new distortions resulted from the European Monetary System (EMS). In effect, this system imposed artificial rates increasingly at variance with their real value (i.e., their purchasing power parity). Devaluations and sometimes reevaluations ensued one after another, then came "competitive devaluations." Logically this system became more and more unstable and the monetary crises of 1992–1993 forced the European governments to terminate its basic mechanism by allowing margins of plus or minus 15 percent.

As a result, two currencies could legally be exchanged with variations as large as 60 percent. Fixed exchanged rates had collapsed once again. It is within this context that the decision was made in favor of a "single money" rather than a "common money" in Europe. First called ECU or Ecu, its final name became the Euro.

But the European Union Treaty (Maastrich) did not "define" the Euro. It became a new fiat paper currency when it could have been a convertible gold money. The Europeans had and still have a choice and the scope of the present debate on monetary orientation should be extended to more basic questions. The Euro, introduced first as bank money from January 1999 through December 2001, replaced 12 European currencies in February 2002 after six weeks of withdrawals of "national" coins and notes. Euro coins and notes became the only "base" of Eurobank deposits. These new bank deposits were claims on the European token coins and notes but not on gold coins as they could have been.

Monetary Freedom and a Private Gold Coin Standard

Freedom in money and banking existed and performed extremely well in the past. So today's question is: can a private gold coin standard function in competition with the euro? The answer is yes, without any doubt. Monetary freedom would lead to, at least, a common and parallel gold money which could, in due course, become the basis for a convertible Euro, free of political manipulations.

Monetary Competition

To start down the road to sound money it would be necessary to abolish the obstacles to property rights and the freedom of contracts in the monetary domain. This would permit genuine monetary competition to emerge, as renowned economists proposed in the 1970s (Sennholz 1973; Hayek 1978, p. 19).[1] This implies:

A. The abolition of legal tender on national paper currencies.

B. For gold, this means: (1) abolition of the tax on gold; and (2) the freedom to contract in gold: in particular freedom of commercial transactions (buying and selling) and the freedom for banks to open time or demand deposit accounts in gold.

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[1]Professor Sennholz analyzed the 1987 crash in a booklet *The Great Depression: Will We Repeat It?* (1988) and in the *Savings and Loans Bailout* (1990) he explains the seeds of this new disaster.

At this stage, a parallel gold standard competing with the euro would emerge gradually and spontaneously in any country that followed this route. If only two countries within the European Union were to start down this road, private gold money would become the common currency for them. This principle could be extended easily to all other 25 nations and obviously also to non-European countries.

The next stage requires: (3) the freedom to coin gold in existing mints; and (4) the right of users of money to freely determine the units of weight (ounces or grams) which best suit their needs.

For the countries that adopt this system, gold would gradually come to circulate both as a parallel and as a common currency. This common gold currency would compete with the European Central Bank (ECB) issued euro. Any monetary expansion of this nonconvertible paper currency would gradually provoke a trend toward the gold common money.

Monetary Privatization

From January 1, 1999 until January 1, 2002 the euro consisted only of "checkbook" money. It was only during the first six weeks of 2002 that previous token coins and bank notes were removed. During this six-week period the European Central Bank and the System of European Central Banks issued new token coins and notes labeled in euro.

There is no economic justification for prohibiting a private gold standard from circulating and competing with the euro. This private gold standard would thus provide the best obstacle to inflationary pressures on the European fiat paper money.

Without monetary competition the inevitable politization of the fiat euro could progressively pave the way for an evermore lax monetary policy. But, the present ECB policy of "price stability" is already generating severe production distortions and its correlated boom and bust cycle.

DEPOLITIZATION OF THE EURO?

Monetary competition, a result of the abolition of legal tender, would seriously curtail the politization of the euro. But is it possible to completely separate the euro from politics without returning to the chaos of fiat national currencies (with either fixed or floating rates)? The answer is yes, certainly. A very simple alternative should be envisioned.

1. After a period of stabilization between the euro and new private gold standard, the euro could be "defined" by the weight of gold corresponding to the market rate.

2. At this moment, in addition to the issue of euro coins and euro notes, the European Union could authorize free coinage as it used to function in the nineteenth century. But today gold coins could be labeled simultaneously in euro and in their corresponding weight of gold.

3. Finally, the huge quantities of gold kept by European central banks could be used to ensure the gold convertibility of the euro. Consequently, the euro would be severed from political pressures and its control would be transferred to its users, that is the European citizens. Today owned by central banks, gold would return to millions of citizens' pockets. Instead of public and centralized ownership, gold would become a private and decentralized holding.

Money users would be free to count and calculate in euro, but they could also use other units such as ounces or grams of gold. They would be free to use coins, convertible bank notes or deposits of one kind or another. Diversity of monetary instruments would result from the free choices of money users. Several kinds of private monies could emerge from new monetary needs. It is however probable that the huge amount of gold already in the hands of millions of persons would be used first.

This system would not lead to one of the past forms of the gold standard, but rather to a private gold standard of a new sort, beyond the manipulations of politicians and public authorities. Being the property of the users of money, the money supply would be determined by the holders of coins or claims on gold (notes or deposits). Freed from state control, the new commodity money would gradually and spontaneously generate monetary unification (integration) in Europe, without state-oriented constructivism; no central bank would be needed. It would not be subject to a "dirty float" and would tend to stabilize exchange rates with other paper currencies (the yen and the dollar in particular). But, because of its geographical dispersion, gold would in all likelihood become a universal common currency, and perhaps recover its role as a worldwide commodity currency. People would then hold a private gold standard, a source of monetary stability and economic progress. Actually a gold-euro has already been proposed by Aristotle (1994, pp. 72–79; 1996) a pseudonym for the Group of Paris), by Robert Mundell, and by several other economists.

Within this system, the production of the basic metallic money would be free. As a result of the free minting of gold coins, supply would adjust to demand. The new competition in currency would transform gold into a parallel and common currency. The sale or the redemption by central banks and ECB of their substantial gold assets, and the convertibility of bank notes, would limit their power to artificially increase money and bank credit. A system approaching true free banking would in fact be established. It would function like the Misesian model, that is without credit expansion as in a 100-percent reserve system. Free competition would tend to nearly eliminate the creation of new fiduciary media.

Freed from the burden of fluctuating exchange rates and dirty floating, as well as the malinvestments which flow from these, international trade would develop steadily and significantly. The risks of protectionism and trade wars would rapidly diminish. The disappearance of monetary depreciation would tend to cause interest rates to decline significantly and to increase the rate of savings. The private gold coin standard would impose a limit on deficit spending and would open the road for noninflationary economic progress. Spontaneous and gradual monetary unification would occur in Europe without any need for the European central bank. These steps, indeed, are the best way to escape from the politization of the euro and the current pressures to "ease" its monetary policy.

Another Road to Sound Money

As an alternative to these simple steps another route has already been opened by central banks. From time to time, they sell gold more or less discretely. It is a *de facto* privatization of gold. Gold centralized in public institutions could go back to private hands through this road. This trend should be openly encouraged and combined with the removal of legal tender laws (Sennholz 1985, pp. 61–83). This could be a path, not to "price stabilization" but to sound money and a definitive end of business fluctuations.[2]

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[2]For a historical "experience" of free banking, see Nataf (1993, chap. titled "New England's Depression-Proof Free Banking System").

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