

TWO CHEERS FOR DEFLATIONARY MONETARY POLICY

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When national central banks eventually took legal custody of the public's gold deposits, they went beyond their initial function of "lender of last resort" during financial crises and assumed discretionary power to manipulate the nation's money supply, that is, to "conduct monetary policy." This occurred in the United States in 1917.¹ As the custodian of the nation's gold reserves, the central bank would on occasion deliberately engineer bank credit deflation in order to avert or mitigate impending financial crises provoked by its previous inflationary policy. This "contractionary" or "deflationary"² monetary policy was usually invoked after a bank credit expansion in order to arrest and reverse an outflow of the stock of nationalized gold reserves abroad and to forestall depositors' loss of faith in the banking system that inevitably culminated in the dreaded bank runs discussed above. This policy was implemented at first by raising the discount rate on collateralized central bank loans to commercial banks and later by open market sales of government securities to the public. The result of this policy was a contraction in outstanding bank credit and deposits and a reduction in the overall money supply.

How are we to classify such a deliberate reduction in the money supply by a central bank. Superficially, it appears to be a malign and arbitrary interference in the

¹ The Amendment to the Federal Reserve Act of June 21, 1917 mandated that only reserve deposits held at the Federal Reserve Banks would be counted as legal reserves of member banks, resulting in a centralization of gold reserves at the Fed (Philips, McManus and Nelson 1972, pp. 24-25; and Harding, pp. 72-74). As Benjamin Anderson (1979, p. 56) pointed out, the theory underlying this Amendment was "not very clear" but "in 1916 and in early 1917 there was a very definite practical consideration that we might be involved in war, and that it was important that the gold of the country be concentrated in a central reservoir as a basis for war finance." So the centralization of gold reserves in the Fed was undertaken with the definite intention of facilitating an inflationary monetary policy.

² In this context we will use these two terms interchangeably to describe a policy-induced reduction or "contraction" of the money supply that results in a fall or "deflation" of prices. The two terms describe aspects of a single economic process that are related as cause and effect or as means and end.

functioning of the market process on a par with monetary expansion, which misallocates resources and reduces the welfare of property owners. However, in evaluating the policy one must bear in mind the concrete institutional circumstances. A central bank operating within the framework of a gold standard has in effect arrogated to itself the monopoly of warehousing the gold deposits of the public. Its so-called “liabilities” in the form of bank notes and reserve deposits are not money *per se* but merely instantaneously redeemable property titles to the money commodity housed within its vaults. By issuing deposits and notes in excess of its gold reserves, it is creating and multiplying fictitious claims to property that have no counterpart in real goods and that derange market processes and arbitrarily redistribute real wealth and income. The destruction of such pseudo titles to the money commodity is no less a benign development than the eradication of counterfeit titles to any other type of non-existent property.

Certainly, it is an uncontroversial conclusion of value-free economic analysis that markets work more efficiently in serving consumers when the creation and exchange of counterfeit property titles to stocks of non-monetary commodities is suppressed. For example, a large and reputable land development and real estate management company may begin contracting for the sale of fully furnished vacation homes in remote locations to more than one buyer, confident that multiple buyers will never occupy the same home simultaneously. Nevertheless this practice would still alter prices in this and related markets and alter the distribution of income and wealth and the structure of consumer demands throughout the economy. The discovery and elimination of this scam would reorient prices and quantities to more accurately reflect the scarcities of concrete goods. Hence, the economist would remain strictly within the bounds of *Wertfreiheit* in

appraising this new constellation of market outcomes as superior to the old in terms of social welfare. Similarly, in carrying out a contractionary monetary policy, the central bank is merely ceasing to violate its contractual responsibility to maintain the integrity of its depositors' titles to their stored money balances, and, therefore, the consequent readjustment of the purchasing power of money to the real scarcity of the money commodity implies a value-neutral judgment that social welfare has been enhanced.

Some will object that the economic distortions caused by monetary expansion occur when the new money is injected into the economy, so that a subsequent monetary contraction is unnecessary and only burdens the economy with further distortions. However, this objection does not take into account the fact that deflationary monetary policy has generally been implemented while the economy is still undergoing an inflationary boom and, therefore, operates to counteract and reverse the tendencies to malinvestment and arbitrary wealth redistribution that have not yet been consummated. In addition, and more importantly, any economic dislocations that may occur during deflation are the inevitable concomitant of a transition process back toward the original regime of pure commodity money. Given the historical market process in which it evolved, this regime is demonstrably consistent with the preferences of property owners and the mutually beneficial exchanges of genuine property titles that improve *ex ante* social welfare. It is the central bank's facilitating and encouragement of the creation of "unbacked" bank notes and deposits in the first place that is the ultimate cause of the inflationary *and* transitional deflationary problems.

However, the nature and severity of these transitional deflationary problems are too frequently taken for granted and bear closer scrutiny. While a contractionary

monetary policy will result in a tendency for the value of money to increase as overall prices decline, this does not present a serious problem in economic theory or history as long as markets are permitted to clear without the interference of political authorities. A case in point is the post-World War I American depression of 1920-21. From 1915 through 1919, the Fed stimulated a massive inflationary bubble. This was partly the result of the reduction of reserve requirements mandated by the Federal Reserve Act of 1913 and partly due to the Fed's efforts to accommodate deficit financing of the huge expenditures associated with World War I and its aftermath.

During this five-year period, the money supply (M2) was increased at an average annual rate of 15.5 percent. Prices as measured by the GNP price deflator rose from 1916 to 1920 by 15.4 percent per annum while the CPI increased by 14.1 percent per annum from 1917 to 1920. The Fed began to recognize the dangerously inflationary nature of its policies in 1919 and raised its discount rate from 4 percent to 4.75 percent in December 1919, to 6 percent in January 1920 and to 7 percent in June 1920, where it held fast until May 1921. The consequence was a steep decline in the annual rate of growth in the money supply to 2.9 percent in 1920 and to -7.5 percent in 1921, causing the GDP deflator to decline by 16.6% in 1921 and 8.1 percent in 1922, while the CPI dropped by 10.9 percent in 1921 and 6.3 percent in 1922. Wholesale prices dropped even more precipitously, diving by 36.8 percent in 1921 and plummeting by an incredible 56 percent from mid-1920 to mid-1921. The fall in nominal wage rates was more moderate, but, nonetheless, as one Keynesian observer (Gordon 1974, p. 22) noted, "wage decreases were both general and substantial" and outside of agriculture wage rates fell by nearly 11% over the two-year period 1921-1922. Despite—or because of—this massive and

broad-based price deflation, however, the economy began to recover by August 1921, 18 months after the downswing had started in January 1920.³

Modern commentators on the 1920-21 Depression, to the extent that they have taken note of it, tend to be surprised by its brevity, given the sharp, policy-induced deflation that accompanied it and the extreme reluctance of political and monetary authorities to undertake stimulatory measures to mitigate its severity. One of the leading Keynesian authorities on “business fluctuations,” Robert A. Gordon (1974, pp. 21-22) described this depression thusly:

The downswing was severe . . . but relatively short. Its outstanding feature was the extreme decline in prices. . . . Government policy to moderate the depression and speed recovery was minimal. The Federal Reserve authorities were largely passive. . . . Nor was any use made of fiscal policy. . . . In short, the federal budget was deflationary while the downswing was in progress. . . . Despite the absence of a stimulative government policy, however, recovery was not long delayed.

The monetarist macroeconomic historian Kenneth Weiher (1992, p. 34) predictably blamed the Fed for the depression, arguing “the Fed earned all the criticism it has since received for inaction. In the face of such a severe contraction, accompanied as it was by unprecedented deflation, the Fed did nothing.” And yet Weiher (1992, p. 37) appeared to be baffled by the fact that such a Fed-engineered “contraction-deflation of

³ Accounts of the Depression of 1920-21 and the preceding inflationary boom can be found in: Weiher 1992, pp. 26-37; Degen, 1987, pp. 30-40; Gordon 1974, pp. 17-23; Anderson 1979, pp. 61-89.

historic proportions” did not lead to total financial and economic ruin and that the economy rapidly and smoothly returned to prosperity. As Weiher (1992, p. 36) was forced to admit: “The Fed was not really called on to act as a lender of last resort to the banking system, because the system never really faced a major liquidity crisis. Why such relative calm persisted compared with the situation in earlier contraction periods is unclear.”

If contractionary monetary policy is benign when the central bank exists within the institutional framework of a classical gold standard, how would we evaluate such a policy implemented in a pure fiat money system? For example, the current U. S. dollar is a pure name with no functional link whatsoever to a specific weight of gold or any other market produced commodity. Surely in this system a contraction of the money supply engineered by the Fed is purely arbitrary and cannot be remotely linked to an improvement in social welfare. But this situation is not as simple as it seems and it requires deeper analysis before we can arrive at an informed welfare judgment.

For purposes of argument, let us begin with the assumption that deflation is just as damaging in its economic effects as inflation of equal magnitude. *Ceteris paribus*, that is, in a “stationary” or no-growth economy with a constant demand for cash balances, then, a 3 percent per annum contraction in the stock of fiat dollars should pose no more cause for concern than a 3 percent expansion of the stock of dollars. Economic effects thus placed temporarily to one side, as Hayek (1972, pp. 330, 333) courageously warned at the height of the Keynesian era in 1960, political and psychological factors always operate to make monetary inflation much more dangerous than monetary deflation:

It is, however, rather doubtful whether, from a long-term point of view, deflation is really more harmful than inflation. Indeed, there is a sense in which inflation is infinitely more dangerous and needs to be more carefully guarded against. Of the two errors, it is the one much more likely to be committed. The reason for this is that moderate inflation is generally pleasant while it proceeds, whereas deflation is immediately and acutely painful. . . . The difference between inflation and deflation is that, with the former, the pleasant surprise comes first and the reaction later, while with the latter, the first effect on business is depressing. There is little need to take precautions against any practice the bad effects of which will be immediately and strongly felt; but there is need for precautions wherever action which is immediately pleasant or relieves temporary difficulties involves much greater harm that will be felt only later. . . . It is particularly dangerous because the harmful aftereffects of even small doses of inflation can be staved off only by larger doses of inflation. Once it has continued for some time, even the prevention of further acceleration will create a situation in which it will be very difficult to avoid a spontaneous deflation. . . . Because inflation is psychologically and politically so much more difficult to prevent than deflation and because it is, at the same time, technically so much more easily prevented, the economist should always stress the dangers of inflation.

Hayek's argument clearly explains why a contractionary monetary policy is never likely to be chosen by a monopoly central bank in a fiat money regime and why, especially under current conditions, fear of deflation is completely groundless.

Moreover, granting the premise that we began with regarding the equally pernicious economic effects of inflation and deflation, a case can be made based on Hayek's argument that the central bank should err on the side of deflation, because a mildly deflationary monetary policy is far less dangerous in the long run than the mildly inflationary policy of "inflation targeting" recommended by a consensus of contemporary economists.⁴ Of course, Hayek himself was opposed to monetary deflation and referred to it as an "error" in the passage quoted above. Nor is it our aim here to construct a case for a particular fiat money policy based on its long-run costs and benefits. Rather it is to challenge the initial premise that the welfare effects of deflationary and inflationary monetary policies are symmetrical by elucidating the purely *economic* advantages yielded by a deliberate reduction of the supply of fiat money—advantages which have been overlooked even by leading Austrian monetary theorists.

Writing in *Human Action* 1949, Mises (1998, pp. 564-65) emphasized the psychological reasons underlying the broad popular appeal of "inflation and expansion" and the even more widespread and violent opposition to "deflation and contraction" in terms very similar to Hayek's. However, in his earlier *Theory of Money and Credit*, which was written before the dread of falling prices had been entrenched and universalized among the public by the Keynesian misinterpretation of the Great Depression, Mises attributed much greater weight in the resistance to monetary contraction to the narrowly economic interests of the ruling class or "caste," whose

⁴ On inflation targeting, see Bernanke and Mishkin 1997 and Meyer 2001. At an IMF conference recently Laurence Ball (Rogoff et al. 2003, p. 14) advocated an inflation target in the 2 to 4 percent range, proclaiming, "there's absolutely no evidence that that level of inflation has any economic cost we need to worry about." It is noteworthy that in the 1960's "Old" Keynesians such as Paul Samuelson (1967, p. 135) considered rates of inflation of the magnitude aimed at in this New Keynesian monetary policy as "a new disease—a tendency for anything like an approach to full employment to lead to 'creeping inflation.'"

members: 1. control or have access to the funds disbursed by the State; and 2. tend to be debtors rather than creditors. As Mises (1980, pp. 263-264) incisively noted:

Restrictionism [or “deflationism”] demands positive sacrifices from the national exchequer when it is carried out by the withdrawal of notes from circulation (say through the issuance of interest-bearing bonds or through taxation) and their cancellation; and at the least it demands from it a renunciation of potential income by forbidding the issuance of notes at a time when the demand for money is increasing. This alone would suffice to explain why restrictionism has never been able to compete with inflationism. . . . But furthermore . . . an increase in the value of money has not been to the advantage of the ruling classes. Those who get an immediate benefit from such an increase are all those who are entitled to receive fixed sums of money. Creditors gain at the expense of debtors. Taxation, it is true, becomes more burdensome as the value of money rises; but the greater part of the advantage of this is secured, not by the state, but by its creditors. Now policies favoring creditors at the expense of debtors have never been popular. . . . Generally speaking the class of persons who draw their income exclusively or largely from the interest on capital lent to others has not been particularly numerous or influential at any time or in any country.

Now, like Hayek, Mises (1980, pp. 265-68) opposed a deflationist policy and went on to argue that it was deeply erroneous even in the case in which a country was attempting to revalue its depreciated currency in to order to return to the gold standard at

the previous gold par, as Great Britain did after the Napoleonic Wars and after World War One. To avoid monetary contraction, Mises favored a restoration of gold parity at or near the currently prevailing price of gold. Even Murray Rothbard, although an enthusiastic proponent of bank credit deflation that results from spontaneous bank runs, generally refrained from advocating a deliberate contraction of the money supply engineered by the central bank under an existing fiat money regime. Thus, he referred to “the crucial British error” and “fateful decision” of returning to the gold standard in the 1920s at the prewar parity. For Rothbard (1990, pp. 94-95), “The sensible thing to do would have been to recognize the facts of reality, the fact of the depreciated pound, franc, mark, etc., and to return to the gold standard at a redefined rate: a rate that would recognize the existing supply of money and price levels.” Additionally, in his proposals for the restoration of a 100 percent gold standard in the latter-day United States, a contraction of the supply of fiat dollars is conspicuously eschewed as a transition policy.⁵

Nonetheless, when combined with Mises’s explanation of the opposition of the ruling elites to monetary contraction, Rothbard’s positive analysis of the distribution effects of deflation reveals the asymmetric welfare effects between monetary expansion and monetary contraction and suggests that the latter policy can indeed play a benign role in the transition back from a fiat to a full-bodied commodity money. According to Rothbard (1993, 2: 865) deflationary bank credit contraction:

. . . in a broad sense, takes away from the original coercive gainers [from credit expansion] and benefits the original coerced losers. While this will certainly not

⁵ Rothbard has presented two different proposals for transforming the present U. S. fiat dollar into a 100 percent gold dollar, which are outlined, respectively, in Rothbard 1983, pp. 263-69 and Rothbard 1994, pp. 145-51.

be true in every case, in the broad sense much the same groups will benefit and lose, but in reverse order from that of the redistributive effects of credit expansion. Fixed-income groups, widows and orphans, will gain, and businesses and owners of original factors previously reaping gains from inflation will lose.

Now Rothbard was referring here to the consequences of a bank credit contraction induced by the bank runs occurring during the downswing of a business cycle. But his analysis may be generalized to the case described by Mises above in which the money supply is contracted by the liquidation of central bank notes composing a fiscal surplus. A modern Austrian welfare analysis of this case, which might be called “fiscal deflation,” is interesting because it presents a potential route back to a 100 percent gold dollar from our present fiat dollar.

In order to analyze the case within the context of contemporary institutions, it is necessary to provide some technical details of the relationship between the U. S. Treasury and the Fed. The Treasury maintains deposit balances at the Fed and at the commercial banks. The latter are called “tax and loan accounts” and are the temporary abode of funds that it has borrowed and collected in taxes. The Treasury makes its disbursements from its general working balances held at the regional Fed banks. When it needs to replenish the latter, it transfers funds from its tax and loan accounts at the commercial banks. All other things equal, this shifting of Treasury funds from commercial bank deposits to Fed deposits reduces reserves in the commercial banking system and exerts contractionary pressure on the money supply. To avoid this, the Treasury tries to coordinate expenditures from its general working balances at the Fed with drafts on its

tax and loan accounts at commercial banks, since the recipients of the Treasury's spending quickly redeposit the funds in commercial banks thus replenishing their reserves.⁶

Now, fiscal deflation requires that a portion of the funds collected in tax and loan accounts are transferred to the Fed where they are either cancelled or "spent" on programmed increases in required reserves for commercial bank deposits by distributing them on a prorated basis among the reserve deposits held by commercial banks at the Fed. In either case, the money supply would decrease, but we are interested in analyzing the latter case as one possible method of restoring a 100 percent gold dollar.

Let us assume, for example, that the fiat money stock is \$1,000, all held in commercial bank demand deposits and that the required reserve ratio is 10 percent. If all banks are fully loaned out, they are holding \$100 in required reserves in reserve deposits at the Fed. When the Treasury shifts a surplus of, say, \$20 to its general account at the Fed, it will leave the commercial banks with only \$80 in reserves and the money supply will eventually shrink by \$200 to \$800. The Fed will then mandate an increase in the required reserve ratio to 12.5 percent and simultaneously the Treasury will "spend" its surplus funds by transferring them to the reserve deposits of the commercial banks permitting them to meet the new reserve requirement with total bank reserves once again equal to \$100 but now supporting only \$800 of demand deposits. In the following year, the Treasury again runs a surplus of \$20 (which at the new higher purchasing power of money exceeds in real terms the prior year's surplus). Following the same procedure of disposing of the fiscal surplus, the money supply shrinks by another 20 percent, or by

⁶ A very clear and comprehensive discussion of the effects of Treasury activities on the money supply can be found in Ranlett 1977, pp. 218-34.

\$160 to \$640, and the Fed raises the required reserve ratio to 100/640 or 15.63 percent. In the next round, again assuming a surplus of \$20, the money supply would be contracted by \$128 or 20 percent to \$512 and the required reserve ratio raised to 19.53 percent.⁷ This fiscal deflation of the fiat money stock will continue until demand deposits are backed 100 percent by reserves, at which point the Fed would be abolished and the dollar rendered convertible into gold along the lines suggested by Rothbard (1983, pp. 263-69) to yield a pure gold dollar.

The purpose of the foregoing exercise was not to present an optimal plan for restoring a pure commodity money, but to highlight certain features of a policy of monetary contraction and deflation that are crucial to distinguishing its welfare effects from those of a policy of expansion and inflation. Let us begin with differences in their short-term effects. Almost all current macroeconomics textbooks characterize “seignorage” or “the revenue raised through the printing of money” as an “inflation tax” on money holders that adds to the existing tax burden on the private sector (Mankiw 2003, p. 88). In sharp contrast, because deflationary monetary policy has been considered beyond the pale at least since World War Two, it would be difficult to find one modern macroeconomics textbook that recognizes, let alone applies a name to, the opposite effect, which results when the State destroys money via fiscal deflation. Mises and Rothbard, in their respective writings quoted above, generally recognized this effect but failed to name it or to elaborate its welfare implications.

⁷ The nominal constancy of the fiscal surplus is assumed only for purposes of illustration and is not crucial to the social welfare inferences drawn below. In this case, it assures a 20 percent per annum contraction of the money supply. A much more realistic and mild contraction, say 2 or 3 percent per year, would not change the conclusions of the welfare analysis. It should be noted, however, that a fixed rate of monetary contraction requires a fixed nominal dollar surplus and therefore an increasing real surplus. In contrast, an annually recurring surplus that is constant in real terms will result in a continually declining rate of monetary contraction.

We may identify this effect by the French term *rabattage*, which signifies a diminution or abatement—in this case, of the fiscal burden of government on the private economy. In the fanciful scenario of fiscal deflation outlined above, the *rabattage* effect comes about in the following way. The Treasury is deprived of a part of the funds appropriated through taxation thereby effecting a reduction in government expenditures in both nominal *and* real dollars, because the spending occurs before the increase in the purchasing power of money caused by the fiscal deflation has taken place. Likewise, the recipients of pure transfers from and the suppliers of resources to government suffer an immediate fall in their nominal subsidies and selling prices while the prices of the goods they purchase remain near pre-existing levels, thus causing a decline in their real incomes. *Ceteris paribus*, as these separate spending-and-income chains that emanate from government progress and intersect one another throughout the economy, the monetary demands for more and more goods decline and their prices progressively adjust to the reduced stock of money. The final outcome of this deflationary adjustment process is that real income is distributed from the net “tax consumers,” that is, the political-bureaucratic establishment and its subsidized constituencies and privileged resource suppliers, back to the taxpayers who originally produced the income in voluntary market activities. By way of contrast, the seignorage effect of inflationary finance operates to enlarge the real incomes of government and the direct recipients of government largesse and purchases, precisely because they gain access to the newly created money at the outset of the inflationary adjustment process. Those who “pay” the seignorage are the receivers of fixed incomes as well as entrepreneurs and resource owners who do not sell

to government and are therefore forced to endure progressively rising buying prices until their selling prices rise much later in the process.

In thus altering the configuration of income distribution in favor of taxpayers and to the disadvantage of political tax consumers, the *rabattage* effect of fiscal deflation results in a new structure of consumer demands and pattern of resource pricing and allocation that more accurately reflect the preferences of those who earn income from the production and exchange of goods on the market. From the standpoint of Austrian welfare economics this result represents an improvement in social welfare and economic efficiency because, even if the precise pre-tax pattern of income and wealth distribution is not restored, fewer resources are siphoned off from producers in the social division of labor mitigating the distortion of economic calculation inherent in all government activities.⁸ In light of the *rabattage* effect, the monetary contraction associated with fiscal deflation therefore must be judged as socially benign. In comparison, holding all other things equal, because the seignorage effect of inflationary finance permits a further appropriation of property by the nonproductive, tax-consuming political sector, monetary expansion is socially malign and destructive of economic efficiency. In short, at a given level of taxation, fiscal deflation lightens the fiscal burden on the market economy whereas inflationary finance intensifies it.

There is another effect of fiscal deflation that is socially benign, which has an admittedly narrower application than the *rabattage* effect but is important nonetheless.

⁸ The case that all government expenditures introduce calculational chaos and economic inefficiencies into the market process is elaborated in Rothbard 1970, pp. 125-49. See Salerno 1993, pp. 130-31 for the argument that the “preferences and demands” of the participants in the social division of labor “must serve as the sole and ultimate standard of socially efficient resource use” and that the market demands of tax consumers falsify monetary calculation and lead to “a socially inefficient reallocation of productive resources.”

In the example of fiscal deflation presented above, the monetary contraction involved an ongoing increase in the required reserve ratio toward 100 percent. This deflationary process effectively involves the extinguishing of pseudo property titles to the money commodity, in this case the paper currency embodying the fiat dollar. As argued above, the suppression of fictitious property titles to any commodity ends the distortion of economic calculation and realigns the pattern of productive activities with actual underlying resource scarcities.

It bears reiteration that deflationary monetary policy is not the only, or even the best, route back from a fiat to a commodity-based currency. Nonetheless, it *is* one such route and it has succeeded historically, e.g., in Great Britain after the Napoleonic Wars and in the United States after the Civil War. And although the example of fiscal deflation above was constructed primarily to highlight the socially benign effects of *rabattage* and the suppression of pseudo titles to money balances, it does point up another social advantage of State money destruction vis-à-vis money creation. Whereas inflationary finance never moves us closer to a commodity money and risks hyperinflation and the abolition of money in the bargain should the State's hunger for seignorage revenues exceed certain bounds, fiscal deflation, if carried out properly, conceivably moves the fiat monetary regime back toward its original roots in a market commodity.

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