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**Paper delivered at the Austrian Scholars' Conference, March 25, 2000, Auburn
Alabama USA**

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Why the present monetary system cannot be reformed

Against the background of continuous instability of financial markets most economic experts are of the view that the present monetary system must be reformed. But most are deeply divided about the nature of these reforms. In the one camp there are the experts who regard speculative flows of money as a source of instability. It is therefore suggested to establish an institution, which will exercise control over these flows. The opposing camp argues that any intervention with the inter country flow of money will stifle economic growth. They advocate that the monetary system be kept free from intervention. It seems that most experts have overlooked that the present monetary system cannot be repaired. The root of the problem is the fiat paper standard, which is fundamentally unstable. This raises several questions. How did this system originate? What causes people to accept pieces of paper in exchange for goods and services?

Has money emerged from government decrees?

According to a popular view, which originated from Plato and Aristotle, people accept money because of government decree². It is government decree, it is argued, that makes a particular thing accepted as a general medium of exchange. But does it make sense? Demand for a good arises from its perceived benefit. For instance people demand food because of the nourishment it offers them. With regard to money, people demand it not for direct use in consumption, but in order to exchange it for other goods and services. Money is not useful in itself, but because it has an exchange value, it is exchangeable in terms of other goods and services. Money is demanded because the benefit it offers is its purchasing power i.e. its price. Consequently for something to be accepted as money, it must have a pre-existing purchasing power, a price. So how does a thing that the government proclaims will become the medium of the exchange, acquire such a purchasing power, a price?

In his writings Carl Menger raised doubts about the soundness of the view that the origin of money is government proclamation. According to Menger,

An event of such high and universal significance and of notoriety so inevitable, as the establishment by law or convention of a universal medium of exchange, would certainly have been retained in the memory of man, the more certainly inasmuch as it would have had to be performed in a great number of places. Yet no historical monument gives us trustworthy tidings of any transactions either conferring distinct recognition on media of exchange already in use, or referring to their adoption by peoples of comparatively recent culture, much less testifying to an initiation of the earliest ages of economic civilization in the use of money³

² Carl Menger, "On the Origins of Money" Economic Journal, volume 2 (1892) p.239-55

³ Carl Menger, *ibid.*

Historically, many different goods have been used as medium of exchange. On this Mises observed that over time

There would be an inevitable tendency for the less marketable of the series of goods used as media of exchange to be one by one rejected until at last only a single commodity remained, which was universally employed as a medium of exchange; in a word, money.⁴

Similarly Rothbard wrote that,

Just as in nature there is a great variety of skills and resources, so there is a variety in the marketability of goods. Some goods are more widely demanded than others; some are more divisible into smaller units without loss of value, some more durable over long periods of time, some more transportable over large distances. All of these advantages make for greater marketability. It is clear that in every society, the most marketable goods will be gradually selected as the media for exchange. As they are more and more selected as media, the demand for them increases because of this use, and so they become even more marketable. The result is a reinforcing spiral: more marketability causes wider use as a medium which causes more marketability, etc. Eventually, one or two commodities are used as general media-in almost all exchanges-and these are called money.⁵

Critical to this process of selection is the fact that demand for money depends on its pre-existing price. On this Rothbard maintained that,

Money cannot originate in any other way: neither by everyone suddenly deciding to create money out of useless material, nor by government calling bits of paper, “money”. For embedded in the demand for money is knowledge of the money-prices of the immediate past.⁶

We know that the law of supply and demand can explain the price of a good. Likewise it would appear that the same law should explain the price of money. But, there is a problem with this way of thinking, since the demand for money arises because money has purchasing power i.e. money has a price. Yet if the demand for money depends on its pre-existent price i.e., purchasing power, how can this price be explained by demand? We are seemingly caught here in a circular trap, for the purchasing power of money is explained by the demand for money while the demand for money is explained by its purchasing power. The circularity seems to cast doubt on the historical selection process of money, as described by Mises and Rothbard, and it seems to provide credence to the view that the acceptance of money is the result of a government decree.

In his writings Mises successfully refuted the popular view as to how money become accepted.⁷ Mises began his analysis by noting that today’s demand for money is determined by yesterday’s purchasing power of money. Consequently for a given

⁴ Ludwig von Mises, *Theory of Money and Credit*, pp.32-33.

⁵ Murray N. Rothbard, “What Has Government Done to Our Money?”

⁶ *Ibid.*

⁷ Ludwig von Mises, *Human Action* Scholars edition chapter 17

supply of money, today's purchasing power is established in turn. Yesterday's demand for money in turn was fixed by the prior day's purchasing power of money. So, for a given supply of money, yesterday's price of money was set. The same procedure applies to past periods. By regressing through time we will eventually arrive at a point in time when money was just an ordinary commodity where demand and supply set its price. The commodity had an exchange value in terms of other commodities i.e. it's exchange value was established in barter. To put it simply on the day a commodity becomes money it already has an established purchasing power or price in terms of other goods. This purchasing power enables us to set up the demand for this commodity as money. This in turn, for a given supply, sets its purchasing power on the day this commodity starts to function as money.

Once the price of money is fixed, it serves as input for the establishment of tomorrow's price of money. It follows then, that without yesterday's information about the price of money, today's purchasing power of money cannot be established. (With regard to other goods and services past history is not required to ascertain present prices. As demand for these goods arises on account of the perceived benefits from consuming them. The benefit that money provides is that it can be exchanged for goods and services. Consequently, one needs to know the past purchasing power of money in order to establish today's demand for it).

Using the Mises framework of thought, also known as the regression theorem, we can infer that it is not possible that money could have emerged as a result of a government decree. For the decree cannot bestow purchasing power upon a thing that the government proclaims will become the medium of the exchange. The theorem shows that money must emerge as a commodity. On this Rothbard wrote,

In contrast to directly used consumers' or producers' goods, money must have pre-existing prices on which to ground a demand. But the only way this can happen is by beginning with a useful commodity under barter, and then adding demand for a medium to the previous demand for direct use (e.g., for ornaments, in the case of gold). Thus government is powerless to create money for the economy; the process of the free market can only develop it.⁸

Also, according to Hoppe,

Money must emerge a commodity because something can be demanded as a medium of exchange only if it has a pre-existing barter demand⁹.

Central banks and paper money

If money must emerge as a commodity, how then does fiat paper money become accepted? Once a commodity becomes accepted as the medium of exchange it will

⁸ Murray N. Rothbard, "What Has Government Done to Our Money?"

⁹ Hans-Herman Hoppe, "How is Fiat Money Possible?-or, The Devolution of Money and Credit, The Review of Austrian Economics vol 7, Number 2, 1994.

continue to be accepted even if its non-monetary usefulness disappears. The reason for this acceptance is the fact that people now possess the information about yesterday's purchasing power, which enables the formation of demand for money today. In other words the key to the acceptance is the knowledge of yesterday's purchasing power.

Through the ongoing selection process over thousands of years people have settled on gold as general medium of exchange. Originally paper money was not regarded as money but merely as a representative of gold. Various paper certificates represented claims on gold stored with the banks. Holders of paper certificates could convert them into gold whenever it was deemed necessary. Since people found it more convenient to use paper certificates to exchange for goods and services, these certificates come to be regarded as money.

The introduction of paper certificates that are accepted as the medium of exchange opens the scope for fraudulent practice. Banks could now be tempted to boost their profits by lending certificates that are not covered by gold. In a free market economy a bank, which over issues its paper certificate will quickly find out that the exchange value of this certificate in terms of other banks certificates will fall. This fall will prompt people to convert the over issued bank paper certificates into gold in order to protect their purchasing power. The over issuing bank will not have enough gold to honour all the issued paper certificates hence running the risk of being declared bankrupt. The threat of bankruptcy therefore, serves to deter banks from issuing paper certificates unbacked by gold. One can thus conclude that in a free market economy paper money cannot assume a "life of its own" and become independent of commodity money.

By a decree the government could however, abolish the convertibility of paper certificates into gold, thereby preventing over issuing banks from going bankrupt. The ending of convertibility does not erase yesterday's purchasing power of paper certificates, which gives rise to demand for them today. In short, what matters is that people know the past purchasing power of these certificates and based on the past information, they can form their demand for the paper certificates today.

Once banks are not obliged to redeem paper certificates into gold, opportunities for large profits are created that set incentive to pursue unrestrained expansion of the supply of paper certificates. The uncurbed expansion of paper certificates runs the risk of a galloping rise in prices of goods and services that could lead to the breakdown of the market economy.

To prevent such a breakdown, the supply of the paper money must be managed. The main purpose of managing the supply is to prevent various competing banks from over issuing paper certificates. This can be achieved through the establishment of a monopoly bank i.e. a central bank, which will manage the expansion of paper money. In order to assert its authority the central bank replaces it's paper certificates for bank

certificates. (The central bank's money purchasing power is established on account of the fact that various paper certificates, which carry purchasing power, are exchanged for the central bank money at a fixed rate. In short, the central bank paper certificates are fully backed up by banks certificates, which in turn have the historical link to gold).

The central bank paper certificates, which are declared as the legal tender, also serve as a reserve asset for banks. This in turn enables the central bank to set a limit on banks' credit expansion. It would appear that by means of monetary policies the central bank could manage and stabilise the monetary system. Monetary management however, entails injections of new money, this invariably leads to persistent declines in its purchasing power to boom-bust cycles and hence to destabilization of the entire monetary system. (On the fiat paper standard system the central bank must constantly manage money flow i.e. create money out of "thin air" to prevent banks from bankrupting each other).

Why the dollar needs a foundation in gold

The fact that various monies in the world today are identified by names like dollar franc, yen and mark has further consolidated the acceptance of the paper money. Names however, do not have life of their own. As an example the name table stands for objects with a flat surfaces. There are a variety of objects labeled table. The common characteristic of these objects is that all have a flat surface. Likewise the name gold refers to things made out of metal of certain durability and, which has a yellow color. The name gold refers to various forms of the yellow metal. Similarly prior to 1933 the name dollar used to refer to a unit of gold that had a weight of 23.22 grains. Since there are 480 grains in one ounce, this means that the name dollar also stood for 0.048 ounce of gold. This in turn means that one-ounce of gold exchanged for \$20.67. Now, the \$20.67 is not the price of one ounce of gold in terms of dollars as popular thinking has it, for there is no such entity as a dollar. Dollar is just a name for 0.048 ounce of gold. Rothbard wrote,

No one prints dollars on the purely free market because there are, in fact, no dollars; there are only commodities, such as wheat, cars, and gold.¹⁰

Likewise, names of other currencies stood for a fixed amount of gold. The habit of regarding these names as a separate entity from gold emerged with the enforcement of the paper standard. Over time as paper money assumed a life of its own it has become accepted to set the price of gold in terms of dollars, francs, pounds etc. The absurdity of all this reached new highs with the introduction of the floating paper currency system. In a free market currencies do not float against each other. They are exchanged in accordance to a fixed definition. Thus if the British pound stands for 0.25 of an ounce of gold and the dollar stands for 0.05 ounce of gold then one British

¹⁰ Murray N. Rothbard "The case for a genuine gold dollar" in the Gold Standard an Austrian Perspective.

pound will be exchanged for five dollars. This exchange stems from the fact that 0.25 of an ounce is five times larger than 0.05 of an ounce and this is what the exchange of 5-to-1 means. The absurdity of a floating currency system is not different from the idea of having a fluctuating market price for dollars in terms of cents. How many cents equal one dollar is not something that is subject to fluctuations. It is fixed forever by definition. *To put it briefly, in a free market currencies do not trade against each other.*

The failure of present monetary reforms

If we accept that the current paper money standard is inherently unstable, monetary reforms cannot “fix” it. This was shown by the failures of financial reforms in the early 1980’s. The idea of these reforms was to free the financial system from the excessive controls of the central bank. In the early 1980’s proponents of financial de-regulation held that freeing financial markets would permit a more efficient allocation of an economy’s scarce resources, thereby raising individual wellbeing. It was argued that an overly controlled monetary system leads to more, rather than less instability. However, far from producing more stability, the liberated system gave rise to a greater instability. The financial de-regulation of the 1980’s resulted in the reduction of the central bank’s supervisory powers. The weakening in the central bank controls gave impetus to greater competition between banks. This in turn sparked the unrestrained creation of credit out of “thin air”, thereby creating a massive misallocation of resources and financial instability.

The failure of financial de-regulation seemed to vindicate the view of interventionists and opponents of the free market economy, that the facts of reality dictate that markets must be tightly supervised. It would appear that the present money paper standard could be made more stable by allowing the central bank to exercise tighter control over the flow of money. But even if one were to accept this proposal many economists are of the view that it would be difficult to implement.

It is argued that as a result of financial deregulation, since the early 80’s the nature of financial markets has changed and consequently we are uncertain as to what money supply is. Without this fundamental knowledge the central bank cannot manage the flow of money. It is argued that in the de-regulated markets whenever a central bank tries to impose control, markets create new means and ways to bypass the central bank. The latest development in this regard is the emergence of a new electronic means of payment, or e-money, which experts maintain is likely to displace government currency. In short, the information technology revolution is expected to further weaken central banks chances of exercising control over monetary flows.

As convincing as it might sound, this view is flawed. Various forms of e-money, like digital currency, are effectively claims against banks. They don’t have a “life of their own”. Similar to demand deposits digital currency can function as long as individuals know that they can obtain cash on demand. According to Mises’s regression theorem

the historical link between paper currency and gold is what holds the present monetary system together. Various financial innovations do not create new forms of money but rather new ways of employing existent money in transactions¹¹. The regression theorem shows that it is not possible to introduce new money without any linkage to the commodity chosen by the market as the general medium of exchange.

Irrespective of financial innovations the nature of money can never change. It will always be the thing that all other goods and services are traded for. When the world was on the gold standard, gold was the standard money. On the paper standard the standard money became coins and notes i.e. cash. In short financial innovations have nothing to do with the central bank's ability to exercise control over the money supply.

Whether the central bank could exercise a better control over the flow of money or whether no intervention in the flow of money is required doesn't address the heart of the problem-that the market money gold was brutally displaced. So to talk about monetary reforms while ignoring the true money is evading the issue altogether.

Most economists cannot stomach the idea of a gold standard because, it is argued, there is not enough gold to serve the modern world. Without an adequate supply of money, it is held, the world will fall into a deflationary spiral. While increases in the supply of goods and services raise benefits to human beings, more money only undermines real wealth generation. Consequently any given amount of money is adequate to provide services of medium of exchange. In a free market a general fall in prices in response to rising real wealth is a mechanism through which wealth expansion permeates throughout the economy. With falling prices and a rising purchasing power of money people can now secure for themselves a greater amount of goods and services.

Money is often said, should function as a yardstick, and therefore its value should be stabilized and fixed. However, money is not some kind an abstract unit of account, detached from concrete goods. It is a commodity demanded mainly as a medium of exchange. Like all commodities, its price in terms of other goods is determined by the interaction of supply and demand.

It would seem, therefore that the chaotic state of world financial markets can only get worse, unless gold, which was chosen by the democratic process of the market, is allowed to assume its monetary role. Allowing gold to assert market wishes implies that there cannot be any role for the central bank. ***In a truly free market the most marketable commodity that serves as the medium of exchange must be completely free. No institution is required to regulate the supply of money in a free market.***

¹¹ Lawrence H.White, The Technology Revolution and Monetary Evolution in The Future of Money in the Information Age, CATO. Also see George Selgin, E-Money: Friend or Foe of Monetarism? In The Future of Money in the Information Age.3/17/00

