THE GOAL OF MONETARY REFORM

GEORGE REISMAN

The essential reason that a 100-percent-reserve gold standard should be the ultimate goal of monetary reform is that it would secure the economic system against the evils both of inflation and of deflation–depression. In addition, it would be consistent with the fundamental moral–political principle of the absence of the initiation of physical force and thus the positive presence of individual freedom. Indeed, by virtue of the safeguards it imposes against inflation and deflation–depression, it would secure the individual's freedom against the state better than any other monetary system.

These are propositions for which I supply far more extensive support in my book *Capitalism: A Treatise on Economics* than it is possible for me to supply here.[1] Here I will concentrate on the proposition that such a gold standard would be a guarantee against deflation–depression. The security it affords against inflation is relatively obvious and far less controversial and is thus much less urgently in need of explanation.

Indeed, the very success of gold in safeguarding against the rising prices that so prominently feature in inflation is what has been made the basis for believing that gold implies deflation–depression. This happens for no other reason than that the typically modest increase in the quantity of money and volume of aggregate spending that takes place under a gold standard is accompanied by actually *falling prices* whenever greater increases in the production and supply of ordinary, i.e., nonmonetary, commodities take place. Such falling prices occurred in the United States in the generation prior to the discovery of the California gold fields in 1848, and again in the generation

GEORGE REISMAN is professor of economics at Pepperdine University. He is the author of *Capitalism: A Treatise on Economics* (Ottawa, Ill.: Jameson Books, 1996) and is the translator of Ludwig von Mises's *Epistemological Problems of Economics* (New York: D. Van Nostrand, 1960). His web site is http://www.capitalism.net. This paper was delivered at the Ludwig von Mises Institute's Austrian Scholar's Conference, March 2000.

[1]See Reisman (1996, pp. 21–27, 510–17, 569–80, 762–76, 813–18, 825–26, 954–59).

following 1873. Because of the fall in prices in these two generations, prices in the United States are estimated to have fallen by half over the nineteenth century as a whole.[2] The fall in prices, of course, would probably be significantly more pronounced under a 100-percent-reserve gold standard.

As I say, such falling prices, the result of increases in production and supply exceeding the increase in money and spending, are typically described as deflation and are thereby made to conjure up the specter of depression.[3]

ESSENTIAL PROPOSITIONS

The essential propositions I want to establish are: (1) Falling prices caused by increases in production and supply are *not* deflation. (2) Deflation is a decrease in the quantity of money and/or volume of spending in the economic system. This, not falling prices *per se*, is what causes the symptoms of depression. (3) A 100-percent-reserve gold standard is the best possible guarantee against deflation thus understood, because once new and additional gold money comes into existence, it does not, for all practical purposes, go out of existence. Instead, its quantity tends continually to increase, at a modest rate. Moreover, its modest rate of increase serves to avoid situations of an artificially induced decline in the demand for money for holding, which then set the stage for a sudden need to rebuild cash holdings later on, with an ensuing contraction of spending.[4]

---

[2] See Robert Sahr, "Inflation Conversion Factors for Dollars 1800 to Estimated 2010," specifically the graph "Price levels 1800 to 1900 with 2000 = 100" at http://www.orst.edu/Dept/pol_sci/fac/sahr/pr180.htm. This is a web site maintained by Oregon State University's Department of Political Science. It can be accessed from the website "World Wide Web Resources in Economics" (www.helsinki.fi/WebEc/).

[3] Regrettably, this usage of the word "deflation" is present even in the very excellent little book *Less Than Zero* by Selgin (1997), which independently confirms much of my analysis of the actual effects of falling prices caused by increases in production and supply. To their great credit, the writings of Mises and Rothbard represent prominent exceptions to this usage. See, for example, Mises (1966, pp. 422–24), and Rothbard (1962, p. 864). These authors' ideas concerning the meaning of the closely related subject of inflation are equally atypical.

[4] The question may be raised of whether a sudden major increase in the demand for gold for commodity purposes could occur, which would operate to reduce the supply of gold available for monetary purposes and thereby represent a deflation. Such a possibility is extremely remote and would be contrary to the whole course of historical development of gold as money. Gold began as a commodity, and the growing monetary demand for gold steadily reduced the portion of the gold supply available for commodity purposes. Furthermore, under a 100-percent-reserve gold standard, the portion of the accumulated gold stock devoted to commodity purposes would likely be so small that even a significant percentage increase could easily be accommodated simply by diverting, for a time, a somewhat larger proportion of the current production of gold to meeting it. In other words, the effect would almost certainly be at most somewhat of a reduction for a time in the rate at which the stock of monetary gold increased. And even if, under the most extraordinary circumstances, the supply of monetary gold actually did decrease temporarily, the decrease would be modest indeed compared with the potential for decrease under a

FALLING PRICES CAUSED BY INCREASES IN
PRODUCTION AND SUPPLY ARE NOT DEFLATION

I will now elaborate on my first proposition, i.e., that falling prices caused by increases in production and supply are not deflation. Such falling prices are not deflation, because they result neither in a reduction in the average nominal rate of profit on capital in the economic system nor in any generally greater difficulty in repaying debts, which are two essential symptoms of any genuine deflation. In a genuine deflation, profits are sharply reduced, perhaps even wiped out altogether, and, at the same time, debt repayment becomes so difficult that widespread insolvencies and bankruptcies occur. Neither of these phenomena occur as the result of falling prices under a 100-percent-reserve gold standard.

Indeed, I will show that the falling prices that take place under a 100-percent-reserve gold standard are actually accompanied by some significant *rise* in the average nominal rate of profit on capital and a correspondingly greater *ease* of repaying debt. The rise in the rate of profit and greater ease of repaying debt results from the fact that the 100-percent-reserve gold standard is accompanied by a continuing production of gold and addition to the stock of gold money, which serves to increase aggregate spending, sales revenues, profits, and money incomes of all kinds and to make the earning of any given sum of money correspondingly easier. The fall in prices that accompanies it is the result of the increase in production and supply exceeding this increase in the quantity of money and volume of spending.

In other words, the increase in the quantity of money and volume of spending exerts a positive effect on the rate of profit and the ease of repaying debt, *alongside the fall in prices.* Under a 100-percent-reserve gold standard both phenomena—falling prices caused by an increase in production and supply and an elevated rate of profit and greater ease of repaying debt caused by an increase in the quantity of money and volume of spending—exist together, side by side, at the same time.[5]

---

fractional-reserve gold standard, in which the monetary character of all fiduciary media has the very real potential for being destroyed, once a process of bankruptcies and bank failures gets underway. The real problem of deflation is never a rise in the commodity demand for gold, but a rise in the monetary demand for gold, which the creation of fiduciary media first artificially reduces.

[5]In Reisman (1996), I explain why neither an increase in the supply of labor nor a lengthening of the structure of production are causes of deflation, even though the latter may for a time be accompanied by a reduction in the aggregate expenditure for consumers' goods (see pp. 579–80 and 817–18). Here I must say that a fall in demand for consumers' goods resulting from a fall in time preference and accompanying greater saving and provision for the future represents the exact opposite of deflation in an essential respect, namely, it represents greater availability of capital and thus of credit, while in a deflation, with its

FALLING PRICES AND CONSTANT OR RISING PROFITS

To understand the effect or, more precisely, lack of effect of increases in aggregate production and supply on business profits, let us begin with the assumption that the quantity of money has become rigidly fixed and that it serves to support no more than a fixed dollar amount of aggregate business sales revenues for newly produced products. In order to minimize the use of zeros and the corresponding waste of brain space, let us call this fixed amount of aggregate business sales revenues 1,000 monetary units. (In today's context, a monetary unit would represent perhaps twenty billion dollars, which would imply aggregate business sales revenues for newly produced products on the order of twenty trillion dollars.)

In addition, let us assume that year in and year out business in the aggregate spends 900 monetary units for capital goods and labor to produce the products that bring in these 1,000 monetary units of sales revenues. On this assumption, the aggregate costs of business can also be taken as 900 monetary units per year. And the result is that aggregate profit will be 100 monetary units per year.

---

accompanying bankruptcies and bank failures, there is a sudden sharp reduction in the supply of capital and credit. Moreover, a fall in the aggregate demand for consumers' goods in this context is by no means a fall in the aggregate demand for goods as such: it is offset by an equivalent rise in the aggregate demand for capital goods. The accompanying increase in the supply of capital goods, of course, operates to increase the general ability to produce, including the ability to mine gold and, especially relevant in the case of a country without gold mines, the ability to trade for gold. Thus the quantity of gold money is made to grow more rapidly as the result of a fall in time preference and lengthening of the structure of production and soon succeeds in raising the aggregate demand for consumers' goods further and further above what it was before these developments took place. (Note 16, below, is relevant to this point.)

It should be realized that the increase in population, which is a major underlying cause of a sustained increase in the supply of labor, does not bring about any tendency toward a rise in the demand for cash balances. The existence of more people does, of course, mean that now more people need to hold and use money. That much is true. But the critical question is, is anything present that would make people need to hold money more heavily relative to their need and desire to spend money? I do not see any such factor. The question of the effect of a possible reduction in money wage rates resulting from a growing population and supply of labor, I believe, is more significant, even though the increase in the supply of gold would almost certainly normally be sufficient to bring about a modest rise in money wage rates from year to year. But even if it were not, and a fall in money wage rates resulted, the rate of fall would be essentially limited to the rate at which the growth in the supply of labor exceeded the rate of increase in the supply of gold, which must be extremely modest indeed. Such a modest rate of fall could not possibly be sufficient to cause widespread bankruptcies of wage earners, as is characteristic of a genuine deflation. And if it proved to be a long-term phenomenon, the combination of a somewhat more rapid rate of fall in prices and a somewhat lower rate of interest would operate to establish the same height and rate of increase in real wages, and the same degree of burden of debt, as would exist if the quantity of money and volume of spending rose rapidly enough to maintain or increase the level of money wage rates from year to year. (The discussion below, on page 10, concerning the effect of the rate of increase in the quantity of money on the rate of profit and interest is very relevant to the discussion here.)

If we further assume a fixed aggregate monetary value of the capital invested in business, say, 2,000 monetary units, then an economy-wide average rate of profit on capital invested of 5 percent is implied.

So long as these three monetary aggregates remain the same, i.e., 1,000 in sales revenues, 900 in expenditure for the factors of production and thus in costs, and 2000 of nominal capital, the aggregate amount and average rate of profit in the economic system remain the same, at 100 monetary units and 5 percent respectively.

Now the question is, what is the effect of increases in the production and supply of products that must exchange for the fixed 1,000 of sales revenues? Clearly, the answer is a fall in prices; indeed, an inversely proportionate fall in prices. For example, if over some period of years production and supply were to double and the doubled output had to be sold for the fixed 1,000 of sales revenues, the general price level would be cut neatly in half. That is quite a fall in prices.

But despite even such a large fall in prices, there is absolutely no negative effect on the aggregate amount or average rate of profit in the economic system. They continue to be 100 monetary units and 5 percent respectively.

It should be noted that to precisely the same extent that there is a fall in prices, there is a perfectly equivalent fall in average unit cost in the economic system. In this case, there is a perfect halving of average unit cost, which comes about by dividing the doubled production and supply into the 900 of aggregate business costs.

Indeed, this example shows that the amount and rate of profit in the economic system has no fundamental connection with changes in the price level originating on the side of production and supply. More production and supply operates to reduce unit costs to the same extent as it operates to reduce prices. It is merely a question of dividing a larger denominator into two unequal numerators—the numerator representing aggregate sales revenue and the numerator representing aggregate cost. The amount of profit in the economic system is the difference between these two numerators and remains the same so long as they remain the same. The division of the two numerators by a growing denominator representing increases in production and supply and causing falling prices and falling unit costs simply has no effect on the amount of profit. And, of course, the rate of profit in the economic system remains the same so long as the amount of profit and the amount of nominal capital remain the same.[6,7]

_____

[6]There are, of course, numerous cases in which the physical output resulting from a given investment remains unchanged and the fall in price of such output implies a

Furthermore, whatever the division of the nominal capital between equity capital and debt capital, the fall in prices resulting from an increase in production and supply operates to benefit debtors to the same extent as creditors so long as the aggregate nominal capital remains the same. If, for example, the 2000 monetary units of nominal capital that we have assumed were divided equally between stockholders and bondholders, with the capital of each class of investors represented by 1,000 units of nominal capital, the halving of prices caused by the doubling of production and supply would double the buying power of the stockholders no less than that of the bondholders. True enough,

_____

corresponding fall in the revenue associated with the investment as the years pass. In such cases, the effect of any given continuing compound rate of increase in production and supply and corresponding fall in prices is to cause revenues earned from the investment to be as much elevated in the early years of the investment's life as they are reduced in the later years of its life. That is to say, the investments of any given year would gain as much additional sales revenues in competition with the less productive investments remaining from the past as they would lose in competition with the more productive investments of the future. The result would be not that such investments incurred reduced profits, but that their profit accounting would require a system of accelerated depreciation. On these points, see Reisman (1996, pp. 576–78).

[7]The question may be asked whether my assumption that the aggregate expenditures for products and factors of production remain fixed, along with the aggregate monetary value of capital invested, is logically compatible with my assumed doubling of production. For increases in production normally require additional capital goods, which Austrian economists usually assume presupposes a fall in time preference, a rise in saving and demand for capital goods relative to the demand for consumers' goods, and a fall in the average rate of profit and interest. Here I must point out that in my view the relationship between these last three factors, on the one side, and the increase in the supply of capital goods, on the other, is not as one to one, or as force to motion, but rather as force to *acceleration.* Thus, it may readily be granted that to transform a stationary economy into a progressing economy, a fall in time preference and rise in saving and demand for capital goods relative to the demand for consumers' goods is necessary and that this development will result, other things being equal, in a fall in the average rate of profit and interest. However, once the supply of capital goods has been increased on the foundation of these factors, the ability to produce is increased, and this greater ability to produce applies to the subsequent production of capital goods no less than to the production of consumers' goods. (For example, an economy that already possesses railroads and steel mills can far more easily produce railroads and steel mills, and more and better railroads and steel mills, as well as most other kinds of capital goods, than one that doesn't. Similarly, an economy that possesses computers with x86 chips is in a better position to produce such computers and computers with (x+1)86 chips than one that doesn't.) Thus, a second increase in the supply of capital goods takes place, which serves further to increase the ability to produce capital goods as well as consumers' goods, and so on indefinitely. The net upshot is that with a sufficiently low, but not continually falling time preference, and with a sufficiently high, but not continually rising demand for capital goods relative to the demand for consumers' goods, and with a sufficiently low, but not continually falling average rate of profit and interest, capital accumulation and increases in production may then proceed indefinitely, which is the situation implicitly assumed in my example in the text, above. A further fall in time preference and rise in demand for capital goods relative to the demand for consumers' goods thus turns out to be necessary not for the continuation but for the acceleration of capital accumulation. For a full elaboration and explanation of my theory of capital accumulation and its relationship to time preference and the average rate of profit and interest, I must refer the reader to Reisman (1996, pp. 622–42, 809–24, 834–37).

the fall in prices would benefit the bondholder–creditors, whose fixed-money assets would now have a correspondingly greater buying power. But at the same time, the monetary net worth of the stockholder-debtors would be no less, and it would have the same increase in buying power.

When prices fall because of increases in production and supply, the stockholder–debtors have no greater difficulty in repaying debts of greater purchasing power, because to precisely the same extent that prices have fallen, their firms possess correspondingly more goods to sell. It is no more difficult to earn a dollar of sales revenue at a price of 50 cents per unit than it is at a price of a dollar per unit, if when one must sell for 50 cents per unit, one has twice as many units to sell. And precisely this is the case when prices fall because of increases in production and supply coming in the face of a fixed amount of aggregate expenditure.

Indeed, when we allow for the fact that under a 100-percent-reserve gold standard, the quantity of money and volume of spending in the economic system would be increasing and that sales revenues would be rising, we see that it would actually become somewhat easier to earn any given sum of money. If, for example, over the same period of time that production and supply double, the quantity of money and volume of spending in the economic system increase by half instead of remaining constant, then prices would still fall, but by only a fourth instead of by a half. For three-halves the aggregate expenditure divided by double the quantity of goods produced and sold equals three-fourths the price level. The sellers would thus be in the position of having two units to sell for 75 cents each instead of only one unit for a dollar. It would thus be correspondingly easier for them to earn a dollar and to pay a dollar of debt than it was before.

Furthermore, as I have said, the increase in the quantity of money and volume of spending that takes place under a 100-percent-reserve gold standard serves to increase the amount and rate of profit in the economic system and to add to the total nominal capital of the economic system. This is because while sales revenues rise immediately in response to an increase in spending, the costs deducted from those sales revenues rise only with a time lag. For example, additional spending for plant and equipment, and for inventory and work in progress, serves immediately to increase sales revenues in the economic system by a virtually equivalent amount. (The additional demand for machinery and materials is simultaneously additional sales revenues to the sellers of the machinery and materials. The additional demand for labor is very quickly the source of an additional demand for consumers' goods and thus of additional sales revenues to the sellers of consumers' goods.) However, depreciation and cost of goods sold rise to equal the larger expenditure for factors of production

only with a more or less significant time lag, and by the time they come to equal the larger expenditure for factors of production reached in any given prior year, the expenditure for factors of production has further increased. Thus, there is a permanent and growing addition to aggregate profits.[8]

In my book, I show that the addition to aggregate profit is such that it tends to add a percentage to the rate of profit approximately equal to the percentage at which the quantity of money and volume of spending in the economic system increase. For example, if the average rate of profit would otherwise be three percent and the quantity of money and volume of spending are continually increasing at a rate of two percent, then the rate of profit will tend to equal 5 percent instead of 3 percent.[9]

Such an addition to the rate of profit exists under a 100-percent-reserve gold standard and serves to increase the nominal capital of the stockholder–debtors, who are in a position to save and invest out of their elevated level of profits. Indeed, in the absence of a rise in the rate of interest on loans corresponding to the rise in the rate of profit on capital invested, the effect of the increase in the quantity of money and volume of spending under a 100-percent-reserve gold standard would be to benefit the stockholder–debtors at the expense of the bondholder–creditors at the same time that prices fell.

---

[8]The rise in aggregate sales revenues and profits that results from an increase in the quantity of money and volume of spending does not mean that the sales revenues and profits of each and every firm and industry are increased, and certainly not immediately. It is possible to imagine cases in which new and additional money and spending serves to raise the prices of factors of production and thus the costs of production of firms and whole industries whose sales revenues have not yet been increased by the new and additional money and spending , simply because it has not yet reached them. (On this point, cf. Mises 1966, pp. 412–13.) Nevertheless, to whatever extent such cases may represent an actual decrease in the profits of the firms and industries concerned, the implication is that the profits of the firms and industries constituting the rest of the economic system have been correspondingly further increased. For example, a firm selling an unchanged quantity of output at an unchanged price and thus earning unchanged sales revenues, but at the same time confronted with higher unit costs of production because of a rise in factor prices resulting from the greater demand for factors coming from other industries, incurs higher total costs and thus earns lower profits by virtue of having had to increase its expenditure for the means of production. It is this additional expenditure which constitutes the increase in its total cost. However, its additional expenditure for factors of production implies, given the same total expenditure for factors of production in the economic system, that other firms have an equivalently reduced expenditure for factors of production, and, therefore, other things being equal, equivalently reduced costs and higher profits. The upward bias in the economywide *average* rate of profit and interest is still clearly present. And had the ability existed to correctly anticipate developments, the industries whose sales revenues failed to increase, or increase as rapidly, would have been somewhat smaller while the rest of the economic system would have been somewhat larger, with the result that the former would have shared more quickly in the rise in the economywide average rate of profit.

[9]See Reisman (1996, pp. 762–73).

That is to say, an effect normally associated with *inflation* would be present at the same time that the alleged deflation represented by the falling prices took place.[10]

This is certainly not to say that the increase in the quantity of money and volume of spending that takes place under a 100-percent-reserve gold standard would in fact represent inflation. Inflation should not be defined in such a way that its existence becomes virtually inescapable—i.e., to be held to exist to the extent that there is any increase in the quantity of money and volume of spending whatever. Rather, it should be defined as an increase in the quantity of money more rapid than the increase in the supply of gold.[11] This definition serves to limit the phenomenon to one that represents government intervention into the economic system and that has the potential to bring about a financial revolution and even the destruction of money.[12]

In sum, what is present under a 100-percent-reserve gold standard are two distinct phenomena: an increase in the quantity of money and volume of spending, which operates to add to the nominal rate of profit and make debt repayment easier, and a greater increase in the production and supply of goods, which serves to reduce prices despite the increase in the quantity of money and volume of spending and, at the same time, has no negative effect of its own on the economywide average rate of profit or difficulty of repaying

---

[10]The gain of the stockholder–debtors at expense of the bondholder–creditors would consist in the fact that the increase in the quantity of money and volume of spending would serve to increase their nominal capital but not that of the bondholder–creditors, whose incomes and thus capacity to save and invest would not be increased in the absence of a rise in the rate of interest. The stockholder–debtors would thus gain a larger proportion of the benefit of the increase in production. Using the examples above, instead of the stockholder-debtors and the bondholder–creditors both having the same nominal capitals and buying at half the price level, the stockholder-debtors would tend to gain the whole of the increase in nominal capital, which, if in the same proportion as the increase in the quantity of money and volume of spending, namely, fifty percent, would mean that they would come to own twice their original nominal capital and buy at prices three-fourths as great. Their greater buying power would thus be equal to two divided by three-fourths, i.e., in the ratio of eight to three, which reduces to two and two-thirds. That is, they would have two and two-thirds the buying power instead of only twice the buying power. The gain of the bondholder–creditors, on the other hand, would be only in the ratio of one, their unchanged nominal capital, to three-fourths, i.e., four-thirds, instead of two. In other words buying power equal to two-thirds of the original capital of either category of investor would be transferred to the account of the stockholder-debtors from the account of the bondholder–creditors. What is necessary to prevent this result is a rise in the rate of interest corresponding to the rise in the rate of profit. To the extent that it is delayed in coming, the stockholder–debtors do in fact gain at the expense of the bondholder–creditors. On this point, cf. Selgin (1997, pp. 41–43).

[11]On this point, see Reisman (1996, pp. 920–21) and Rothbard (1962, p. 940, n. 106 and p. 942, n. 131).

[12]Cf. ibid. (p. 940, n. 106).

debt. The combined outcome is falling prices accompanied by a higher rate of profit and greater ease of repaying debt.[13]

GENUINE DEFLATION

Having shown that despite its tendency toward falling prices, a 100-percent-reserve gold standard is so far from being deflationary that the question arises of why it should not be considered inflationary because of its effects on the relationship between stockholder–debtors and bondholder–creditors, we are now ready to turn to a discussion of deflation properly so called.

Such deflation, as I have said, is a decrease in the quantity of money and/or volume of spending in the economic system. *That* is what produces not only a fall in prices but at the same time a sharp reduction or even total wiping out of business profitability and a greatly increased difficulty of repaying debts and thus widespread insolvencies and bankruptcies.

Profits are cut because the monetary contraction reduces sales revenues immediately, but aggregate costs, specifically aggregate depreciation cost and aggregate cost of goods sold, fall only with a time lag in response to the reduction in business firms' expenditures for the factors of production.[14]

At the same time, the monetary contraction increases the difficulty of repaying debt, simply because there is less money out there to earn. It should be clearly understood that this is the problem, not the fall in prices, and that it would not be helped if prices did not fall. If production were reduced sufficiently, prices would not fall; they might even rise. However, the stability of prices, or their rise, would not serve to make it any easier for the average debtor to earn any given sum of money, because offsetting the rise in prices or the lesser fall in prices, would be a correspondingly reduced quantity to sell on the part of the average seller.[15]

---

[13]The preceding discussion implies a need to conceive of the so-called purchasing-power price premiums in the loan market rate of interest not on the basis of changes in prices but on the basis of changes in the quantity of money and volume of spending in the economic system, which result in general price changes only insofar as the changes on the side of money and spending outstrip the changes on the side of production and supply. On this subject, see Reisman (1996, pp. 825–26).

[14]It should be realized that the nature of this relationship cannot be avoided by any speculative anticipation of the contraction taking place which might serve to reduce the prices of the factors of production in advance of the fall in sales revenues. As soon as the onset of a depression becomes generally expected, it has already arrived and it is too late to avoid it. For such a general anticipation of depression means that right away there is a contraction of spending and thus a plunge in sales revenues, while costs go on reflecting the higher level of expenditure for the factors of production made in the past. Concerning this point, cf. Mises (1966, pp. 871–72).

[15]Cf. Selgin (1997, pp. 43–44).

DEFLATION:
SOME EPISTEMOLOGICAL CONSIDERATIONS

The preceding discussion makes clear that what falling prices signify can be radically different, depending on the *cause* of the falling prices. Insofar as falling prices are caused by increases in production and supply, they are not accompanied by any of the other consequences one normally associates with a deflation, i.e., a sudden sharp reduction or wiping out of business profitability and a greatly increased difficulty of repaying debts, to the point of widespread insolvencies and bankruptcies.

Those consequences occur only insofar as the fall in prices is the result of a monetary contraction. And, as we have just seen, given the monetary contraction, the plunge in profitability and the difficulties of debtors would not be helped by any diminution of the fall in prices that might be achieved by a reduction in production and supply. Business sales revenues would continue to suffer the same reduction and the difficulty of repaying debt would continue unabated. The most that could be achieved by a reduction in production would be to the extent that it is *one's competitors'* production that is cut, rather than one's own, one might experience some relief. But by the nature of the case, any such relief is obtained only at the price of the greater suffering of others—i.e., the suffering both of one's competitors, who have lost as much in sales revenues as one has gained, and of the consumers, whose real incomes are reduced by the rise in prices. There is no alleviation whatever of the problems of business as a whole or of debtors as a class. There is just the addition of the problem of a rise in prices and corresponding decline in real income caused by the reduction in supply.

It may be helpful to think of matters in terms of the following three-column table. The center column shows falling prices. The top portion of the left-hand column shows increasing production and supply. The top portion of the right-hand column shows monetary contraction—a decrease in the quantity of money and/or volume of spending. Both are causes of falling prices, which is indicated in the table by downward sloping arrows originating at the top of the left- and right-hand and columns and terminating in the center column, where falling prices are shown.

Falling prices are the only thing that these two phenomena, namely, increases in production and supply, on the one side, and monetary contraction, on the other, have in common. Both phenomena also have other effects, besides the fall in prices. And those effects are radically different—as different as day and night. The differences are not only with respect to the effects on general business profitability and the difficulty of repaying debt, which we have

Table 1
Falling Prices and Their Causes

Increases in Production and Supply	Monetary Contraction
→ Falling Prices ←	

Other Consequences of Increases in Production and Supply	Other Consequences of Monetary Contraction
1. No wiping out of business profitability, since nothing is present to reduce aggregate business sales revenue. Indeed, a modest increase in aggregate sales revenue and profit to the extent that the increase in production and supply includes an increase in the production and supply of commodity money, which results in rising aggregate spending.	1. Wiping out of business profitability due to immediate decline in sales revenues in the face of costs that fall only with a more-or-less significant time lag.
2. No greater difficulty of repaying debt, but greater ease, to the extent of the increase in the quantity of money and volume of spending.	2. Greater difficulty of repaying debt including widespread insolvencies and bankruptcies.
3. A rise in the real incomes of virtually all members of the economic system, who can take advantage of the lower prices with the same aggregate money incomes; or who can take advantage of a lesser decline in prices accompanied by greater aggregate money incomes.	3. Mass unemployment until such time as wage rates and prices fall, to correspond to the reduced quantity of money and volume of spending for goods and labor.

already discussed, but also with respect to the effects on real income and unemployment.

Falling prices caused by increases in production and supply are part of the process of raising real incomes throughout the economic system and do not cause unemployment. They make possible the sale of the increasing quantities of goods, and serve to raise the buying power of money incomes, which, under a system of commodity money, not only do not decrease, but almost certainly increase because of the accompanying increase in the quantity of gold. An

increase in the quantity of gold is normally a part of general increases in production and supply.[16]

In sharpest contrast, falling prices caused by monetary contraction are not accompanied by any general rise in real incomes, but only by the gains of some groups, accompanied by the vastly greater losses of other groups. Creditors gain, but not even all creditors—only those able to collect the debts owed to them. And not only do debtors lose what those creditors gain, but on top of their loss and the loss of creditors who are unable to collect, is the loss of all those who are thrown into unemployment by the monetary contraction. Their unemployment and loss continues until such time as the fall in wage rates and prices becomes sufficient to enable the smaller quantity of money and/or volume of spending to purchase as much as the previously larger quantity of money and/or volume of spending had purchased.

And even here, it should be noted, the problem is not the fall in prices but the monetary contraction. The fall in prices (and, of course, wages) serves to mitigate the damage done by the monetary contraction. It is what enables the volume of employment and production to recover in the aftermath of the monetary contraction.

The leading conclusion of this discussion is that there could not be any greater error than to confuse deflation with falling prices. Doing so confuses two radically different phenomena, one economically good, and one economically evil, and treats them as though they were the same. Such a procedure is comparable to developing a concept that would treat all sweet things as the same—sweet-tasting foods and sweet-tasting poisons.

The concept "deflation" should be reserved for monetary contraction, *not* for falling prices. Indeed, it should not even be used to mean falling prices caused by monetary contraction, though that would represent a considerable improvement. For, as we have seen, all the negative effects of monetary contraction would persist even if, because of sufficient decreases in production and supply, prices did not fall but even rose. Furthermore, as we have also seen, the fall in prices is what mitigates the effects of monetary contraction.

The notion that deflation is falling prices and can be caused by increases in production is the old overproduction doctrine. It claims that we are thrown

---

[16]The increase in the production and supply of gold can come about as part of the process of increases in production and supply even in countries that have no gold mines—to the extent that such increases serve to increase access to gold deposits and to reduce the costs of extracting gold anywhere in the world. In addition, increases in production and supply in countries that have no domestic sources of gold serve, other things being equal, to increase the fraction of the world's economy that is represented by the country in question and thus the fraction of the world's money supply that circulates in its territory.

into depressions because we produce too much—that we are impoverished by the process of growing richer. It claims that in depressions, when people cannot afford to buy a home or rent an apartment, or even buy clothing or food, the cause of their poverty is that there are *too many* homes and apartments and *too much* clothing and food—i.e., that people are poor because they are rich. This doctrine belongs with such notions as the sound of one hand clapping.

THE 100-PERCENT-RESERVE GOLD STANDARD AS THE GUARANTEE AGAINST DEFLATION

Once deflation is properly understood, namely, as a monetary contraction, i.e., a decline in the quantity of money and/or volume of spending in the economic system, it becomes clear that a 100-percent-reserve gold standard would not only *not* be deflationary by virtue of the fall in prices that would be likely to accompany it, but would actually be the best possible guarantee *against* deflation. As I explain in my book:

> There are two basic reasons why the 100-percent-reserve gold standard would be a guarantee against deflation. First, under a 100-percent-reserve gold standard, nothing could happen that would suddenly reduce the quantity of money in the economic system. Once gold money comes into existence, it *stays* in existence. It is not wiped out by the failure of debtors, as are fiduciary media. Second, nothing could happen that would suddenly increase the need or desire of people to hold money rather than spend it, because none of the artificial inducements to a lower demand for money for holding would exist that set the stage for such an increase. It must be recalled that what creates the potential for a sudden increase in the need and desire to hold money is that first, people are misled into experiencing an artificial decrease in their need and desire to hold money. All the inducements that mislead them into this decrease are caused by the prior undue increase in the quantity of money, especially in the form of credit expansion. A 100-percent-reserve gold standard would thus be a system in which the quantity of money would not decrease and the demand for money for holding would not suddenly increase. As a result, it would be a system in which total spending in the economy would virtually never contract. Thus . . . it would be a system that was deflation proof as well as inflation proof.

> Under the 100-percent-reserve gold standard, the desire to hold money would be substantially greater than it is today and also greater than it would be under a fractional-reserve gold standard. Money would be something for which people would have great respect and would want to own in abundance. And they would succeed in owning it in abundance. However paradoxical it may seem, the 100-percent-reserve gold standard would be a system of *enormous financial liquidity*. It would be a system in which the quantity of money measured in terms of its absolute buying power and relative to such things as current liabilities, would be far greater than under any other system. It is precisely for this reason that there would be no basis for any

sudden increase in the need or desire of people to own money. They would *already own* all the money they needed to.[17]

<div align="center">SUMMARY AND CONCLUSION</div>

I have shown that a 100-percent-reserve gold standard would do much more than safeguard against inflation, by virtue of the relatively modest rates of increase in the quantity of money and volume of spending it would impose. I have shown that in addition the falling prices that would be likely to accompany it, and which underscore the protection it affords against inflation, would not constitute deflation in any rational usage of that term.

Falling prices under a 100-percent-reserve gold standard would not be accompanied by any wiping out of business profitability but rather by an addition to the general rate of profit and interest corresponding to the rate of increase in the quantity of money and volume of spending going on at the same time that prices fell. By the same token, the increase in the quantity of money and volume of spending that would occur at the same time that prices fell would serve to make the earning of money and thus the repayment of debt somewhat easier, not more difficult, as would be the case under deflation and depression.

Deflation and depression, I have shown, are phenomena operating from the side of money and spending, not production and supply. Specifically, they represent less money and spending, not more production and supply. More production and supply are always causes of prosperity. And, under a 100-percent-reserve gold standard, in which the monetary unit is itself a physical product whose supply can be increased like that of other products, more aggregate production and supply are typically accompanied by more money and spending as well.

Finally, I have shown that not only are the falling prices that would take place under a 100-percent-reserve gold standard not deflation but that such a gold standard offers the best possible guarantees against deflation properly understood—i.e., in the sense of monetary contraction. This is because decreases in the quantity of money would be virtually impossible under it—to the contrary, the quantity of money would almost always increase to some extent. And in the absence of the artificial inducements to reduce cash holdings that other monetary systems provide, no basis would exist for any sudden subsequent need to build up cash holdings and thus cause a contraction of spending.

This is what I believe I have demonstrated.

---

[17]Reisman (1996, pp. 955–56). Concerning how a greater demand for money for holding increases the real stock of money and, indeed, is the only thing that can do so, see Rothbard (1974, pp. 15–16).

I have not attempted to deal with the question of how one might go about actually achieving the establishment of a 100-percent-reserve gold standard. I have also not dealt with the major implications a 100-percent-reserve gold standard has for the monetary role of silver.[18] My concern has been only to establish the 100-percent-reserve gold standard as the ultimate proper objective of monetary reform.

REFERENCES

Mises, Ludwig von. 1966. *Human Action*. 3rd ed. rev. Chicago: Henry Regnery.

Reisman, George. 1996. *Capitalism: A Treatise on Economics.* Ottawa, Ill.: Jameson Books.

Rothbard, Murray N. 1962. *Man, Economy, and State*. 2 vols. New York: D. Van Nostrand.

———. 1974. *What Has Government Done to Our Money?* Novato, Calif.: Libertarian Publishers.

Selgin, George. 1997. *Less Than Zero.* London: Institute of Economic Affairs.

---

[18]On this subject, see Reisman (1996, pp. 958–59).