

# The Value of Money

By

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*Inflation is an increase in the money supply. (The Bullion Report, 1810)*

Perth is a delightful place, especially in January if one lives in Chicago. The heat struck physically as I emerged from the Perth Mint in mid-afternoon. There is always something reassuring about a gold pour, even if conducted only for tourists. But, as any traveler knows, local currency is a requirement, so I set off in search of a bank.

Spotting the blue ANZ Bank logo, I quickened my step and took note of the flyer as I entered. It read: "Professional financial advice freely available." The woman behind the counter was courteous and quoted the daily exchange rate, asking how much I needed to change. However, upon seeing several \$100 bills, her expression changed. "I'm sorry, we no longer accept \$100 bills."

I must have reacted with surprise because she added, "The bank was losing too much with counterfeit notes." In vain I explained that, under Secretary of the Treasury Rubin, the hundred dollar bill had been changed from a design of symmetrical order to an off-center portrait with a patch that shifts from green to black. This elicited a look of patience mixed with wry amusement, but she was adamant. "No \$100 bills." I grabbed one of the handbills that promised "professional advice" and wrote on it: "1/9/01: 3:50 pm ANZ refused to take \$100 bills." The same scenario was then repeated at two more banks. Finally I found a local bank, a subsidiary of Westpac, which accepted my dollars and left me feeling more comfortable about my prospects for the weekend ahead.

But this did not diminish my curiosity regarding the hassle of exchanging the new \$100 bills. This new note owes its existence largely to a near perfect counterfeit dubbed the "Supernote" that came out of the Middle East, specifically the Bekaa Valley in Lebanon.

In a *New Yorker* article of October 23<sup>rd</sup> 1998, Frederic Dannen and Ira Silverman noted that:

"The Supernote remains one of the longest unsolved counterfeiting cases in the modern history of the Secret Service, and it has begun to undermine international confidence in the United States currency. Its rate of manufacture appears prodigious; in the Russian Federation, where the dollar has supplanted the unstable ruble as the primary currency, the Russian Central Bank estimates that the volume of Supernotes is as high as four billion dollars."

Dannen and Silverman further noted that, "The Treasury, taking its cue from the Federal Reserve, has a difficult time regarding counterfeiting, even on a very large scale, as a macroeconomic problem, because cash is a relatively small percentage of the total money supply. Wire transfers, checks and credit card transactions, after all, run into the trillions. Counterfeiting becomes significant to the Fed only if it undermines confidence in the dollar."

But all this was supposed to stop when the Treasury announced the first significant change in the design of United States currency since 1929. Treasury Secretary Rubin was emphatic in his insistence that the redesign did not stem from any problem with counterfeit notes, but rather by the "future and potential threat that the redesign was an example of anticipating a problem." In fact, the mood was one of levity with an actor

dressed as Ben Franklin providing the introduction. So here we were, or rather there I was, two and a half years later, confronting the same problem that was supposed to have been solved in 1998.

My second encounter with unacceptable \$100 bills took place in Florence. There, the local bank was equally blunt. While the teller looked like she would have been more at home on a Milan runway, the message was clear: “We do not accept \$100 bills.” But this time I was ready, and pulled out a stack of \$50 bills and completed the transaction.

Outside, in the clear light of a May morning, I wandered towards the Palazzo Vecchio and marveled that this city, with its countless treasures, would not have been possible without a stable monetary system to support it. And that of course was provided in the thirteenth century when Florence issued its famous gold Florins.

“The Florin weighed approximately 3.5 grams and was of such fineness that it won Florence universal fame and wide imitation... and became the most popular gold coin in the world for more than five centuries.” (Pierre Lassonde, *The Gold Book*, Penguin Books, 1994.)

This led me to wonder what it means when the world’s reserve currency is suspect. Not suspect in some remote wilderness, but in two major banks domiciled in staunch allies of the United States. Was this a minor detail, effluvia in the great river of financial transactions, or was it something greater, something that a Senate subcommittee staff member described as “an act of terrorism — monetary warfare, the Treasury won’t admit it?” (*New Yorker*, Oct 23, 1998.)

In the ensuing interval of almost two years, I have asked this question of fellow wanderers and received the reply that one should use ATM machines and credit cards; thereby proving that a problem does not exist if one ignores it. What does that say about the dollar that the public at large neither questions its value nor acceptance?

“Each accepts them (the pieces of paper) because he is confident others will. The pieces of green paper have value because everybody thinks they have value, and everybody thinks they have value because in his experience they have value.” (Milton Friedman and Anna Schwartz, *A Monetary History of the United States, 1867 - 1960*.)

Does history support such faith, or are the believers fat, content and clueless? This is certainly not a novel thought, as became apparent last week. I was surfing the Internet as a 21<sup>st</sup> century version of the “hunter-gatherer” for information, not food, when I came upon John Brimelow’s daily missive with a link to the ubiquitous Amazon that featured the new book *Greenback*, by Jason Goodwin, (Henry Holt & Co). The cover blurb reads:

“Money has always been at the heart of the American experience. Paper money itself, invented in Boston in 1691, was a classic example of American ingenuity — and American disregard for authority and tradition.”

More accurately, this front cover is a classic example of America’s disregard for history, as paper money was certainly not invented in Boston in 1691, something that even the most inexperienced fact checker could find out, if Henry Holt still employs any. The following quotes are from *The Story of Money* by Norman Angell, published in 1929, a year quite relevant to those seeking the reasons behind the delusion of mass psychology.

“Felted paper is said to have been invented in China, BC 177, and pasteboard notes were certainly used for money during the reign of Wu-ti, BC 140. The

ancient Egyptians made a sort of paper from the leaves of papyrus, but this was too flimsy to use as money.”

“In 1260 - 63 Kublai-Khan, then in command of the Mongol army of occupation, issued paper notes and introduced them into those parts of China which his forces had subdued. These issues soon became redundant and fell in purchasing power.”

“Between 1264 and 1290 a second series of notes was issued. Like their predecessors they were without specific limit as to numbers, and thus became in time depreciated below the level of the coins after which they were named, and for which the law compelled them to pass in the payment of debts.”

“The depreciation first became rapid in 1287, when the emissions were very extensive. Before this occurred the notes of the First issue of 1260 - 63 had been exchanged at the rate of five for one of those of the second (an early example of a reverse split).”

“During the last days of the Mongol dynasty, in 1351 an effort was made to reform the currency, but by this time the evil lay too deep for remedy; for many kinds of money paper were in circulation — government, provincial and private, besides many counterfeits; and therefore continued to depreciate, and were retired from circulation.”

The new Ming notes read: “This paper money shall have currency, and be used in all respects as if it were copper money.” (*History of Money in Ancient Countries*, A Del Mar London, 1885.)

Leather moneys were employed in Europe by Philip I, 1060 - 1108, the Doge Michieli, 1122, and Fredrick II, 1237. However, the first bank notes were known in England when they were acknowledgments made to private depositors by goldsmiths. These acknowledgments could pass freely from hand to hand, and as they were portable, and could easily be traced, and were usually of no value to highwaymen, were found to be convenient instruments for trade. Some goldsmiths issued notes far in excess of the money they held, and were able to carry on business by credit.

The “invention of paper money,” to which the blurb for *Greenback* refers, happened in 1686, when the colonial government of Massachusetts granted a charter to a private bank. The reason given was “the great decay of trade, obstructions to manufacturers and commerce in this country and multiplicity of debts and suits thereupon, principally occasioned by the present scarcity of coin.”

In 1690, the General Court of the colony issued, for the first time, government bills of credit to the value of 7,000 pounds, in denominations of between 5 shillings and 5 pounds, again giving as its reason: “the present poverty and calamities of this country, and through scarcity of money, the want of an adequate measure of commerce.” In 1692, these bills were made legal tender for all payments, and as a bonus 5% was given on them when they were paid into the public treasury. They remained at par with coin for about thirty years.

Paper money continued to be issued from time to time but, “No adequate provision for redemption was made, but, when they were thoroughly discredited, notes would be redeemed at a small percentage of their nominal value and new issues would be made, and as a result people were everywhere beginning to lose faith in paper currencies.” (*History of Money in the British Empire and the United States*, Agnes F. Dodd, London, 1911, p 235.)

It has been suggested that John Law acquired some of his financial ideas from residence in the American colonies. In 1705 he published *Money and Trade Considered* in Edinburgh. This work proposed that notes should be issued not on a reserve of coin, but on the possession of land. While his book had no immediate practical effect, it did attract notice and led to his “system” being adopted by the Regent, Orleans, and led France out of potential bankruptcy and shortly thereafter into financial chaos.

However, the experience of John Law’s paper money between 1716 and 1720 was soon forgotten, and in 1789 the French National assembly undertook a “limited” issue of four hundred million paper *livres*. These were backed by property seized from the Church. 1789 was also the year that a mob descended on Versailles and moved the Royal Family to the Tuileries Palace, where they remained as virtual prisoners.

After six months, the *assignats* were spent and Montesquieu, in a report of August 1790, recommended another issue of paper *assignats* stating, “We must save the country, and the increased money supply would revive France.” In words that echo through the centuries, he argued that “times are different,” and that France in 1790 was different from the France of John Law in 1716.

Echoing Law’s treatise, Chabroud argued that the *assignats* were backed by land:

“The earth is the source of value; you cannot distribute the earth in a circulating value, but this paper became representative of that value and it is evident that the creditors of the nation will not be injured by taking it.” (Andrew Dickson White, *Fiat Money Inflation in France*, Toronto, Canada, privately published 1914.)

This is very similar to the argument made today that the dollar is backed by the wealth, technology and military might of the United States.

“Unfortunately neither Chabroud nor his modern counterparts discuss the vital question that paper represents wealth as long as the recipients of paper money have confidence of a lasting valid claim on wealth, which they can pass on to others in exchange or hold as a reliable store of value.” (*The War on Gold*, Antony C. Sutton.)

Or as Ludwig von Mises wrote in *Human Action*: “It would be more correct to say that the money which the government’s decree has undervalued disappears from the market and the money which the decree has overvalued remains.” Or as per Gresham’s Law, bad money drives out good money, but only when the bad money is legal tender.

As the reader may suspect, this adventure in paper money ended badly for France in general and the monarchy in particular. On September 29, 1790, another 800 million *assignats* were authorized. By 1791 another 600 million were run off. In 1791, mobs stormed the Paris food shops looking for bread. The government imposed price controls with the threat of the guillotine for any merchant not in compliance. The French state decreed that any person selling gold or silver coins, or making a difference in a transaction between paper and gold, would be imprisoned in iron for six years. On January 21, 1793, Louis XVI was executed on the guillotine. On October 16, 1793, his Queen, Marie Antoinette was also executed.

By May 1794, any person who even *asked* if payment was to be made in gold or paper was subject to the death penalty. By 1796 the situation was in such chaos that the French burned all their paper money and the means of production: “on February 18<sup>th</sup>, 1796, at nine o’clock in the morning, in the presence of a great crowd, the machinery, plates and paper for printing *assignats* were brought to the Place Vendome and there, on the spot where the Napoleon Column now stands, these were solemnly broken and burned.”

(Andrew Dickson White, *Fiat Money Inflation in France*.) So the French turned to the gold Napoleon and for a century prospered on a full gold standard.

England had its own experiment with a paper pound between 1797 and 1821. The mini panic of 1792 was caused by anticipation of war with France. By 1796, gold in the vaults of the Bank of England had dropped to 400,000 pounds from 7 million in 1794. Alarmed by the drain, the Bank convinced the government led by Prime Minister Pitt to allow it to stop gold payments. In this manner, convertibility was suspended for the Bank of England, but not for other banks that issued notes. The *Bank Restriction Act of 1797* confirmed this suspension, and the law was extended annually for twenty-five years. Other banks, unable to issue their own notes, when presented with demands from their customers, turned to the Bank of England and exchanged their own notes. This had the effect of causing hoarding of gold and silver, and Britain effectively went on a paper money standard.

Fortunately, the Government was aware of the French *assignats* crisis, and, despite the war, restricted expenditures. Still, in 1809 the value of the pound fell from 123.25 grains of gold to 107. Parliament was sufficiently concerned to appoint the Bullion Committee to investigate the “high” price of bullion which, more correctly, should have read the “low” price of the pound. *The Bullion Report of 1801* was a major historical document whose arguments are relevant today.

*The Bullion Report* was critical of the directors of the Bank of England who “see the truth so little that they actually claim that their principle could work effectually with a much lower rate of discount,” and concluded that the issue of notes was large, was still increasing, and that the only guard against excess was convertibility into gold. *The Bullion Report* also stated: “Inflation is an increase in the money supply.” The increase leads to higher prices. The fact that the majority of the financial community does not have an accurate understanding of inflation may account for the convoluted quagmire of theories masquerading as financial analysis. The United States has had its own example of inflationary paper money.

While it was not the first paper fiat money to be issued in North America, the currency of the Continental Congress is well documented both in issue and subsequent depreciation. The continental currency of 1775 issued during the Revolutionary War competed with, and was convertible into, about \$10 million in gold and silver. Despite being convertible, depreciation was swift and severe. By 1779, it had fallen to 12 to 1, and the following year the ratio was 100 to 1. In May of 1781, continentals ceased to circulate as money and was changed only by speculators at anywhere between 400 - 1000 continentals for one dollar in gold or silver.

Within six years of the original issue, the phrase “Not worth a continental” had entered the lexicon. In answer to the obvious question of why the Congress issued fiat money, it is instructive to read the reasoning of one member of that Congress, a sentiment that has little changed in the ensuing two centuries.

“Do you think, gentlemen, that I will consent to load my constituents with taxes, when we can send to our printer, and get a wagon of money, one quire of which will pay for the whole?” (William M. Gouge, *A Short History of Paper Money and Banking in the United States*, T.W. Ustick, 1833.)

This is a sentiment that has little changed in the ensuing two centuries.

“The U.S. government has a technology, called a printing press (or today, its electronic equivalent), that allows it to produce as many U.S. dollars as it wishes at essentially no cost. By increasing the number of U.S. dollars in circulation, or

even by credibly threatening to do so, the U.S. government can also reduce the value of a dollar in terms of goods and services, which is equivalent to raising the prices in dollars of those goods and services.” (Federal Reserve Governor Bernanke, November 2002.)

Or as Theodore E. Allison, assistant to the Board of Governors of the Federal Reserve stated bluntly: “Issuing currency is about the best racket there is for a government.” (*New Yorker*, October 23, 1998.)

However, the bitter experience of the continental dollar was the principal reason that the *Constitution* specifically stated: “No State shall... make any Thing but gold and silver coin a tender in payment of Debts.” (U.S. *Constitution*, Article I, Section 10.)

As Alexander Hamilton wrote: “The emitting of paper money is wisely prohibited to the State Governments, and in the spirit of the prohibition ought not to be disregarded by the United States Government.” (Alexander del Mar, *The History of Money in America*.)

From 1792 to 2003, there has been no constitutional amendment that affects Article 1, Section 10. Indeed, there have been instances when the Supreme Court has held what applies to the States also applies to the federal government, thereby establishing Hamilton’s observation in case law. Yet, today the currency of the United States is wholly fiat paper.

The Federal Reserve System is based on paper debt and relies for its existence on confidence. In this it is identical to the rest of the money systems in the world today; the confidence that someone else will accept a piece of paper, backed by nothing, in exchange for tangible goods or services.

This debt money system is an enormous confidence game. As Marriner Eccles, Governor of the Federal Reserve testified to the House Committee on Banking and Currency on September 30, 1941, “That is what our money system is. If there were no debt in our money system, there wouldn’t be any money.” Simply put, the premise is that individuals will always accept another’s liabilities for their own goods or services.

At the end of the Second World War, the United States was in a unique monetary position. The world’s largest stock of gold was secure in the depths of Fort Knox and the Federal Reserve Banks. The American dollar was in universal demand. The American economy and lifestyle were objects of admiration and envy, and its military commanded universal respect. As we enter 2003, the United States still commands the world’s largest military, and dollar reserves still constitute the largest portion of global reserves.

As of the end of 2000, the Bank for International Settlements estimates world dollar reserves of \$1.450 trillion, or 76% of the total world reserves of \$1,909 trillion. This is a far greater percentage than the United States 21% share of the world economy or its 15% share of world trade. (Statistics courtesy Stephen Roach, Morgan Stanley.)

The United States now has the dubious distinction of being the world’s largest debtor nation and needs to attract fully 80% of the world’s free capital just to keep the dollar stable. During the 1990s, this was not a problem as strong financial markets led to increased foreign investment and consequently to further dollar denominated investments.

Foreign ownership of U.S. assets amounted to 33% of U.S. GDP in 1990. Today it is valued at over 70% of U.S. GDP. Foreigners own \$2 trillion (19% of U.S. GDP) more in U.S. assets than the U.S. holds of theirs. Foreign ownership of the U.S. Treasury market is over 30%, over 23% of the corporate bond market, and 13% of the U.S. equity market. (Statistics courtesy of Bridgewater, Dec 13, 2002.)

The fate of the dollar now boils down to a question of *confidence*. But not the confidence of its own citizens, but of foreigners. Their holdings are now such a large percentage of the total that, if confidence in the U.S. falters and foreigners become sellers, there is grave risk to U.S. financial markets.

On January 2, 2003, the dollar rallied on short covering. In the space of a few hours, the dollar rallied 1.2% vs. the euro. In calendar year 2002, it fell 14%. Market participants have become used to such volatility and fail to see it as a reflection of the disequilibrium that passes for normal in our financial system. The U.S. money supply has doubled in the last decade to \$8.5 trillion, and 25% of that increase came in the last eighteen months. Actual currency in circulation has also doubled in the same period to \$600 billion.

“The Fed is locked into an expansionism it dares not stop, a prisoner of its own expansionism.” The words of John Exter are as timely today as when he wrote them in 1988. For those unfamiliar with the man, John Exter served six years as Vice President of the Federal Reserve Bank of New York in charge of gold, silver and international operations. In November 1988, he presented a paper from which the following comments are taken.

“Most people today think the Fed, despite its running the printing presses at higher and higher speeds over the last three decades, has been doing a good job. I see it on the road to a far worse disaster than in the thirties.”

“The entire world’s monetary system is in serious disequilibrium. Since money runs like water, both within each currency and among them, market forces work every minute of every day trying to restore equilibrium, while central banks worldwide, especially our own Fed, intervene every minute of every day to prevent it. So uncertainty abounds. Markets do not like uncertainty.”

“Eventually markets will win, as they always have, so you should bet on markets. The problem is timing. Confidence erodes, but very slowly.”

“The safest and most liquid asset will be gold. It will be [by] far the biggest run out of paper money into gold money in history. I cannot say when, but it is now months, not years away.”

Markets of course make fools of wise men. The ability of the Fed to create credit, run the presses and still maintain confidence has been a triumph of improvisation over discipline. It has been years, and the time was bought in large part by central banks selling and lending their gold into the marketplace in a desperate attempt to mask inflation. The cost of that operation has yet to be determined, but central banks, their cover blown, will find it much more difficult to maintain confidence in this new era.

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