

Paper-Thin Prosperity

by

Lawrence Parks

1/31/2001

As Daniel Webster noted, "Of all the contrivances for cheating the laboring classes of mankind, none has been more effective than that which deludes them with paper money."

Under America's current monetary regime, which has been in place since 1913, there is a big difference between money and wealth. A *big* difference. It takes work to create wealth. Under our monetary system, however, *dollars* are created without work—no more is involved in printing a \$100 bill than a \$1 bill. The ability to create money out of thin air—"fiat money"—results in monetary instability of the sort that was endemic throughout the past century, which leads in turn to the "boom and bust" business cycles that politicians and citizens both hate and fear. Already, monetary systems modeled after our own have wiped out the savings, pensions, and jobs of hundreds of millions of people all over the world—in Mexico, Russia, Malaysia, Indonesia, the Philippines, South Korea, and many other countries.

In a prosperous society, people save for future needs, but under a fiat-money system, when they attempt to exchange their savings for real wealth, it costs more to pay for these things than it would have when they put their money into the savings account or some other financial instrument. Their money has melted because inflation has decreased its purchasing power. In fact, while people are saving potential *claims* on wealth, those who receive the interest and transaction fees for creating fiat dollars are spending them and *consuming* the real wealth those claims represent.

Since the eighteenth century, U.S. banks have been allowed to create money by extending loans greater than the amount of gold they have on hand—a process known as *fractional reserve lending*. They were allowed to issue promissory notes, a.k.a. bank notes, that bore the legend "payable to the bearer on demand in gold," when they did not, in fact, have enough gold to redeem all of the bank notes they issued. The customers, rather than remaining the owners of their gold, thus became *unsecured* creditors of the bank. Of course, most people did not understand this, and the banks were not eager to tell them about it. Consequently, banks were able to engage in more leverage and more risky behavior than would have been tolerated if they had fully disclosed these factors. The excessive leverage that banks were thereby able to engage in resulted in numerous "bank panics" and booms and busts throughout the nineteenth century.

The Federal Reserve System was meant to prevent systemic busts, but its presence as a "lender of last resort" tempted banks to engage in even more leverage and take even greater risks than they could when their own capital was on the line. This eventually engendered an even bigger bust: the Great Depression. Debasement of the currency has continued since then, though the effects have tended to be more gradual. Far less well-known than the economic consequences, however, are the political inequities and corruption a fiat-money system breeds. Both of these deleterious effects are currently at work in the United States. They are also an important reason why, when given the chance, people have chosen to have their money in the form of gold or silver.

It is important to note that the Constitution does not empower the U.S. government to create legal-tender fiat currency. (It gives Congress the power to coin money, not to print it.) Congress has therefore delegated to the banking system a power that itself does not have. The courts have declined to entertain a challenge to this power, but for ordinary people the obvious question is, if America's fiat dollar is good money, and people really prefer it, why do we need legal-tender laws?

The reason, of course, is that people prefer the security of money in the form of gold or silver. And as the sixteenth-century British economist Sir Thomas Gresham noted, when bad money is designated as legal tender—when people are *forced* to accept it in exchange for their goods and services—"bad money drives out good." Note that Gresham's Law operates *only when the bad money has been designated legal tender*. In the absence of this coercion, people would be inclined to include a gold clause in their contracts for future payments, as they did until 1933.

Shattering Faith

The problem with America's current fiat-money system is the inherent temptation it sets up for its creators and administrators—bankers, central bankers, and politicians—to manipulate it for their own benefit, transferring wealth to themselves through government coercion and the aforementioned private-sector misrepresentation and nondisclosure (fractional reserve lending and failure to notify depositors of risk levels). The lender-of-last-resort bailout facility at the Federal Reserve guarantees the banks' assets, and the Federal Deposit Insurance Corporation guarantees their liabilities. Furthermore, banks have been empowered to value a significant portion of their investments at what they originally paid for them rather than at market value, a policy that encourages nondisclosure and underassessment of risk. No other segment of society enjoys these kinds of guarantees or exemptions from disclosure. It should not surprise us that such temptation has typically proven impossible to resist. In fact, the essence of any fiat-monetary system is that it enables an

ongoing transfer of wealth from those who produce it—mostly working people—to those who churn out and have easy access to fiat money: bankers who charge interest and fees for generating it, Wall Street firms that garner transaction fees for moving it around, and large, creditworthy borrowers who receive the most credit and the best borrowing terms.

Fiat money, remember, is not wealth; it is merely a potential claim on wealth. That is where the economic danger lies. Once people begin to realize that the real wealth on which their money has a potential claim does not exist, the money can quickly melt, as in Asia and Russia during the late 1990s. When fiat money melts, the purchasing power of savings, pensions, and all forms of future payments denominated in the fiat money is greatly reduced; interest rates increase; business relationships predicated on lower interest rates unravel; companies go out of business; and people lose their jobs—all through no fault of their own. The suffering of ordinary people becomes obvious. This economic meltdown naturally discredits the government, upon which people relied to regulate the generation of the fiat money, and people many times have responded by changing their form of government. The people generally rely on politicians to oversee the bankers and the central bank so that the latter do not generate too much excess money and bring on the adverse consequences of monetary instability. A government that fails to fulfill this trust, as the American regime failed to do before and during the Great Depression, risks not only its own credibility but that of the nation's entire economic and social system, as William Greider noted in his book *Secrets of the Temple* (1987):

Year after year, as the social misery deepened and massive unemployment stretched on for more than a decade, the popular faith in free markets was shattered. . . . The New Deal advanced a new creed: an activist national government must intervene to overcome the shortcomings and weaknesses of private enterprise. This new idea—government's obligation to manage the economy—was legitimized by the national trauma of Depression, embraced both in public opinion and in scholarly theory.

During the late 1990s, fiat currencies all over the world lost credibility, bringing on economic chaos in South Korea, Russia, Brazil, Mexico, Indonesia, Malaysia, the Philippines, and elsewhere. The baneful consequences included loss of jobs, loss of savings, and rioting. In each case, analysts completely ignored the role of fiat money and blamed alternative scapegoats—"crony capitalism" in East Asia, currency speculators in Indonesia, "the Jews" in Malaysia, etc.

Before each of these discontinuities occurred, however, there were

numerous warning signs of potential monetary disaster. This usually happens when fiat money begins to lose credibility: governments grow large, real wages decrease, debt levels grow, working people's standard of living stagnates or declines, and the financial sector and large corporations prosper inordinately. People get the feeling that the rich are getting richer and that the middle class is working harder than ever. As citizens begin to realize that their money is melting, interest rates, as noted earlier, begin to increase. This shortens the time horizon for investments and causes a shift from manufacturing—which generally requires a longer investment—time horizon—to services. As a result, higher-paying manufacturing jobs give way to lower-paying service jobs.

The United States, of course, has exhibited most of these symptoms during the current eight-year economic expansion. Here, too, the causality should be clear. In the United States, the creation of nearly \$7 trillion in new dollars since 1950 has already depreciated the purchasing power of our fiat dollar by approximately 90 percent. (In 1950, the Consumer Price Index for urban areas was at 24, and today it is at 173, denoting an 87 percent loss of purchasing power.) Current Fed chairman Alan Greenspan receives much credit for the past decade of relative monetary stability, and Americans and the rest of the world now place great faith in the U.S. dollar, but no fiat currency is really trustworthy.

It is important to heed the economic warning signs as early as possible, because fiat currencies do not always lose purchasing power slowly. When it becomes apparent that a currency is in trouble, the decline in purchasing power, rise in interest rates, and subversion of commercial relationships can be very swift. Promises of future payment, such as pensions, are broken, and the economy implodes. This is exactly what occurred in Indonesia and in Russia during 1998-1999.

Corrupting the Political Process

Given the obvious shortcomings of such a system, one might well wonder why the public puts up with it. A key factor keeping the current monetary system in place is the extensive political contributions by those who benefit from it. As *The Wall Street Journal* reported, "Since last year, when the latest reform bill [for repeal of the 1933 Glass-Steagall Act that separated commercial and investment banking] started moving through the House, the coffers of Democratic and Republican lawmakers and their national committees have been enriched by \$7.4 million from securities firms, \$6.8 million from insurers, and \$5.5 million from banks." (See Michael Schroeder, "Law That Separates Banks, Brokers Always Seems to Find Patron in Time," April 10, 1998.)

This example of nearly \$20 million in donations associated with just one

particular piece of legislation is minimal, of course, compared with what is contributed to political campaigns overall. In the last general election, at the national level only, politicians collected \$2.4 billion, according to the Center for Responsive Politics, which tabulated it from data submitted to the Federal Election Commission. Most campaign finance money comes from large contributors, mostly from the financial sector, large companies, and other entities for whom banks create most of the new dollars. In 1998 alone, U.S. banks created roughly \$600 billion in new dollars, most of which were generated as a result of credit creation on behalf of large, creditworthy borrowers such as multinational corporations. The social and political inequity of the fiat-money system lies in the fact that the banking system, Wall Street firms, and large corporations have easy access to dollars created out of nothing, whereas ordinary people must work for their dollars. Thus, those who are first in line for our fiat currency have a decided advantage in influencing politicians.

The politicians, in turn, are in a tight spot. As a practical matter, they need the campaign contributions. Those who fail to raise the necessary money will not be reelected. In this way, the fiat dollar contributes to the corruption of the entire political process, by reducing the political influence of ordinary people, those who produce the nation's wealth, and increasing that of a relatively few citizens (and foreigners) who benefit from the fiat-money system.

Gold Bugs

Given all these problems and inequities, and for other compelling reasons, it should not surprise us that gold and silver have been the people's money of choice in open markets from antiquity. Furthermore, *every time* Americans have had the opportunity, they have chosen gold or silver or both as their coin of the realm. The creators of fiat money—banks and central banks—despite their vastly inferior product, have succeeded because of government coercion and their own legally permitted practices of misrepresentation and nondisclosure, and also in part because proponents of honest monetary weights and measures have left the playing field. At the time of the American Revolution, the colonials were repulsed by their experience with the fiat money of the day, continentals. There was even a derogatory saying, "not worth a continental." As a result, the Constitution did not empower the government to create fiat money. When Andrew Jackson successfully ran for president in 1832, he opposed paper money and the Bank of the United States. His rallying cry was, "Gold is the friend of the farmer." When President Grant signed the Resumption Legislation in 1874, he did away with the Civil War greenbacks and returned to gold as money. When President McKinley (pro-gold) ran against William Jennings Bryan (pro-silver) in 1896, gold won again. And when President Roosevelt seized the nation's (and the citizens') gold in

1933, he reassured the country that the currency would not be fiat money: "This currency is not fiat currency," he said. "It is issued only on adequate security—and every good bank has an abundance of such security."

It is fair to conclude that the monetary system we have now was *not* the choice of the people. A few politicians, most notably Jack Kemp, support a return to the gold standard, but the issue is seldom debated or addressed by the national media. Our fiat-money system, however, has a long history of economic distortions and problems. To ignore the warning signs of potential trouble is to invite an American version of the Asian financial crisis—one that would be much greater because of the preeminent size and importance of the U.S. economy.

Lawrence Parks (Lparks@fame.org) is the executive director of the Foundation for the Advancement of Monetary Education (www.fame.org) and a member of the National Writers' Union, UAW 1981, AFL-CIO.

CONTACT INFORMATION

Larry Parks, Executive Director
FAME,501(c)(3)
Box 625, FDR Station,
New York, NY 10150-0625

Phone:212-818-1206
Fax: 212-754-6543
Lparks@FAME.ORG
www.fame.org

Copyright © 2000 by Lawrence Parks 1/31/2001

FAME

Foundation for the Advancement of Monetary Education, 501(c)(3)
Box 625, FDR Station, New York, NY 10150-0625
Phone (212) 818-1206 • Fax (212) 754-6543
E-mail Join@FAME.org
www.FAME.org

NEW
Credit card donors can
now fax their support

YES! I Want to Join the Fight for Honest Monetary Weights & Measures

JOIN THE FIGHT FOR HONEST MONETARY WEIGHTS & MEASURES

My fully tax-deductible contribution is:

\$2,500 \$1,000 \$500 \$250 \$100 \$50 \$25 other _____

Please charge my:

check enclosed Visa Mastercard American Express

Credit Card Number

Expiration

Signature

DONOR INFORMATION

Name

Company

Address

Address cont'

Phone Fax

E-mail

Your support goes farther when we can reach others who think as you do. Please attach the name of an associate or colleague to whom we should send literature and it will be sent with your compliments.

Name

Company

Address

Address continued

Phone Fax

E-mail

OTHER OPTIONS

Please call me to discuss:

- a bequest a sustaining gift
 my employer's matching gift program – (if your employer has a matching gift program, you may be able to double your tax-deductible contribution to FAME).

The best time to reach me is approximately _____
am/pm at telephone number: _____

COMMENTS

Please feel free to offer any comments or suggestions, e.g., how did you hear about us?

FAME is an independent, unaffiliated, 501(c)(3) not-for-profit public charity devoted to educating people about the importance of honest money and the harm cause by its absence. A copy of the organization's last financial statement is available upon request.