99% of All You Need to Know About

MONEY

And its Effect Upon the Economy

by Harry Browne

99% OF ALL YOU NEED TO KNOW ABOUT **MONEY**
AND ITS EFFECT UPON THE ECONOMY©

For information, contact: PLWBrowne@HarryBrowne.org
Website: www.HarryBrowne.org

Also by Harry Browne

How You Can Profit from the Coming Devaluation (1970)
How I Found Freedom in an Unfree World (1973, 1998, 2008)
You Can Profit from a Monetary Crisis (1974)
The Complete Guide to Swiss Banks (1976)
New Profits from a Monetary Crisis (1978)
Inflation-Proofing Your Investments - with Terry Coxon 1981)
Investment Rule #1 (1985)
Why the Best-Laid Investment Plans Usually Go Wrong (1987)
The Economic Time Bomb (1989)
Why Government Doesn't Work (1995, 2003)
Fail-Safe Investing (1995, 2003)
The Great Libertarian Offer (2000)
Liberty A to Z (2004)
2,000+ Libertarian Quotes (2007)
Investment Strategy in an Uncertain World (2008)
Freedom The American Way (2008)
The Secret of Selling Anything (2008)
The War Racket, Part I (2008)
The War Racket, Part II (2008)

Table of Contents

INTRODUCTION

October 1, 2008

Dear Reader:

Harry Browne was unknown in the investment world when his first book, *How You Can Profit from the Coming Devaluation*, was published in 1970. Recognizing the disastrous monetary policy of the U.S. government, he warned that the dollar would be devalued, inflation could be severe, and gold, silver, and foreign currencies should skyrocket in value. The book's theme clashed with the prevailing wisdom, but it struck a chord with tens of thousands of Americans, and the book made the *New York Times* bestseller list.

The first few chapters of the devaluation book are the clearest and most extensive explanation of how the government money system works and perverts the free market. Equally important, it's written in language that any reasonably intelligent layman can understand.

Fortunately, prior to Harry's death in 2006, he edited the following chapters in preparation for publication: *The Role of Money, What is Money?, What is Paper?, What is Inflation?, The Government and Money, How To Create Money, Mass Confusion, Inflation Starts to Gallop,* and *Who Will Protect You?*

In addition to the aforementioned chapters, this book includes a brief afterword that directs you to another short book by Harry Browne that can help you get started creating a bulletproof portfolio you can walk away from ~ while protecting you from inflation, deflation, or recession, while allowing you to profit from prosperous periods.

I sincerely hope you'll benefit from this book.

Best wishes,
Pamela Wolfe Browne
www.HarryBrowne.org

FORWARD

THE ROLE OF MONEY

It all has to do with the simple little word *money*. Everything flows from the way the money system is handled. It is the cause of inflation, of depressions, of any sudden changes in the economy.

Not one person in a thousand really understands what money is. And yet, there are few subjects in the world more fascinating than the study of money. A proper grasp of it will give you the key that unlocks the many puzzles of national economic events. Without that understanding, it's impossible to think for oneself; instead, you're forced to rely upon the superficial conclusions of people with conflicting opinions and credentials.

This book covers 99% of all you need to know about money and its effect upon the economy.

1
What Is Money?

Where do we begin?

Let's go back to the very basics, so there can be no misunderstanding between us as we proceed to the conclusions.

If you were to find yourself alone on an isolated island, you'd have no need for a medium of exchange. There would be no one with whom to exchange.

You would go to work, as necessary, to produce the things you needed for your survival. You'd produce some things that you would want to consume immediately, and you would probably produce other things to be stored for later use.

You might also produce some other things that would be called "capital goods" — things that make further production easier. But you would only produce when you believed it would lead ultimately to something you wanted.

Not hard to understand, is it?

Let's suppose now that there was one other person on the island with you. Each of you has his own area of the island and each of you is producing for himself.

Sooner or later, you'd probably begin exchanging things with each other. Perhaps you've produced more than you need of something he hasn't produced, and vice versa. You'd exchange your surplus with each other — and both of you would profit thereby.

Obviously, you won't trade your production for something you have no use for. Why bother working if your efforts don't eventually

bring you something you can use? You'll trade only for those things you want to use now or can store for use at a later date.

And here we have a very important rule at work, one that we should file mentally for reference later on: *You produce or exchange only when you believe it will lead ultimately to something you want.*

On such a simple basis, with only one or two people involved it's very easy to see and understand what's happening. You're producing and exchanging in order to acquire the things you'll eventually use to further your own well-being.

But now let's suppose there are 100 people on the island — each with his own area. You will still have to produce to survive; there's no way to avoid that.

But exchanges will probably take place on a much wider basis. In fact, it will be only a matter of time until a "specialization of labor" develops. That's where an individual no longer produces everything for himself. Instead, he concentrates on the production of only one or two items — and then trades his production with others for the products and services he wants.

You know that no one's going to exchange with you if you don't have something he wants. So you'll gear your production to those things that are in demand by others. In that way, you'll get the most possible in return.

These trades with others are called *direct exchange* — the trading of some of your property for another commodity you intend to use yourself. This is also called *barter* — trading without money.

The direct exchanges are a natural step in the development of a civilized society.

INDIRECT EXCHANGE

But, eventually, you find yourself in a position where you're willing to accept in exchange an item you don't intend to use. You accept it only to improve your trading position with someone else.

Suppose you have butter and you're looking for wheat. I have wheat, but I'm not looking for butter. Instead, I need corn. So you go find a third person who has corn and is looking for butter. You trade your butter for his corn. Then you come back to me and trade the corn for my wheat.

You have what you want; but it took two exchanges to get it.

This is the beginning of *indirect exchange* — the trading of one thing for something you *don't* intend to use yourself.

For example, one day Jones the nail-maker walks into the store of Smith the furniture-maker (whose store is conveniently located under a palm tree). Jones opens the conversation with, "Smith, I need a new workbench. I'll give you 2,000 nails to make one for me."

"Sorry," said Smith, "I have all the nails I'll need for awhile. Those you gave me for the bed I made for you will last me for another six months. Come back and see me then."

Determined not to be refused, Jones goes on, "But I need the workbench now! Look, you're bound to use those nails eventually. But, even in the meantime, you can probably trade them to someone else for something you need. I'm always getting offers of trades from people wanting nails. They're a lot easier to exchange than furniture."

"You have a point there," ponders Smith. "I do seem to have a lot of trouble exchanging king-size beds for clothes. This way, I'd use only as many nails as I need for each purchase . . . well, okay — I'll try anything once."

So he accepts the nails and makes the workbench for Jones. And then he goes out to find products for which he can exchange the nails.

And, lo and behold, it works! He finds that trades are much easier to make. As a result, he enjoys life a lot more with a few nails in his pocket. He can stop at a store and trade for anything he wants to — without having to exchange a king-size bed for a peanut-butter sandwich.

In fact, he merely points out to the merchant the advantages of nails as a trading medium in the same way that Jones pointed them out to him. And the final argument is that you can always use the nails *sometime* in the future; they won't lose their value. And if you don't use them, *someone* will.

The merchant realizes this; and so be accepts the nails, confident that he can use them or trade them for what he wants.

In the months to follow, Jones the nail-maker notices a slow, steady increase in the demand for his product. Why? Because individuals, *one at a time*, are coming to see that it's valuable to have a few extra nails on hand (in addition to those needed for construction purposes) to facilitate exchanges with others.

Nails seem to most people on the island to be an ideal trading medium. But once there are enough nails around for that purpose, the demand will level off. The nails are not free; they cost Jones his time to make them and he demands something in return when he trades them with others. So no one's going to pay for more nails than he'll find useful to have.

As a result, once there are enough nails in circulation to facilitate exchange, there'll be no additional value from more nails. In other words, like any other commodity, they seek their natural level of quantity, their market price.

Let's go back a moment to the point we recognized on page ten: *You produce or exchange only when you believe it will lead ultimately to something you want.*

Smith, the furniture-maker, didn't produce the workbench just for the sake of producing. In his eyes, his profit didn't come from the number of beds or workbenches produced.

Neither did his satisfaction come from the number he sold. To be able to say he sold a certain number of pieces of furniture was of no particular value to him.

To Smith, the object of it all was to obtain the things he wanted. He produced and sold furniture with only one purpose in mind — to trade it for the specific things *he* wanted. So he wouldn't make a workbench just to be making a workbench. Nor would he accept nails just so he could say he'd made a sale.

He agreed to Jones's offer only when he was convinced it was a step toward getting what he wanted.

And this is a vital point. Neither production volume nor sales volume is ever the object. It's only what you eventually receive for it that counts. You only produce and exchange when you believe it will lead ultimately to something you want.

We will have occasion to come back to this seemingly obvious point as we proceed. But, meanwhile, we see that this simple little trade has been the seed from which exchange is born on the island.

And as it naturally grows in use and acceptance, it opens up all kinds of new possibilities for residents of the community. Now it's possible for one man to employ another, paying him with nails instead of with fractions of a house. Now long-term capital investments can be made by trading one's production for nails, purchasing capital goods with the nails, making a new product, and finally selling it.

So nails have become money. And what is money?

Money is a commodity that is accepted in exchange by an individual who intends to trade it for something else.

Money is a commodity, just like everything else that's traded in the marketplace. What distinguishes a money commodity from other commodities is the intention of the recipient to keep it only until he trades it to someone else. It's only a means to a further exchange for that recipient.

Not *everyone* intends to trade it, however. Some people receive the money commodity, intending to use it for its own natural purpose (in this case, nails for construction purposes).

And this brings us to the key word in the definition of money: *accepted*. The commodity can become money only when an individual *accepts* it — when someone's willing to take it, confident that he can trade it ultimately for what *he* wants.

You only produce and exchange when you believe it'll lead ultimately to something you want. So you won't accept bamboo reeds — just because someone wants something you have.

The commodity to be used as money must already have established itself as being in demand — otherwise, you'd never be sure that you could trade it later for something you wanted.

Because of this, the money commodity is never chosen by a majority vote; it's never initially imposed upon a community by the government; it's never collectively nor arbitrarily selected. It *evolves* — *one exchange at a time* — as one individual and then another decide to accept it in exchange.

Governments can only choose to go along with what has naturally evolved in the marketplace. If they stray from that, they're doomed to destruction. For money only takes on value as individuals are willing to accept it. But we'll come back to governments later.

To summarize, the money commodity will emerge, one exchange at a time, as each individual sees the commodity, evaluates it, and agrees to accept it — believing this will further his ability to obtain eventually the items he wants.

In our island example, the individual accepted the nails because he knew how much they were worth in terms of other commodities; and he knew that, come what may, they'd always be of some value to him. He knew he'd never be "stuck" with nails (pardon the pun) because he could also use them himself.

As we've seen, the volume of nails would be determined by the number of nails that proved useful in exchange, together with the normal demand for nails in construction. Beyond that, any additional production of nails by Jones would be worthless to him; more nails would simply lessen the exchange value of each nail. So he'd be working harder (producing more nails) but getting no more in return.

If he tried to demand more for his nails than individuals were willing to give (the market value), he'd be inviting competition. For someone else could then offer nails at a lower exchange price; or possibly even offer a more useful commodity as a medium of exchange.

So Jones's success will still depend upon his technical ability and marketing sense; he has no special advantage just because he's the man who produces the money commodity.

WHY GOLD AND SILVER?

It's quite possible that more than one commodity might be used as money — either in the same or in neighboring communities. The only question that matters is: will an individual be willing to accept the commodity in an exchange?

But it is only natural that consumers will begin to rely upon the one or two commodities that best satisfy their needs and desires in exchanges. Despite the hundreds of different commodities that have been used as money at various times and places in history, two commodities have dominated the money markets for centuries. They are *gold* and *silver*.

But why gold and silver?

As we've seen, the development would have had to be purely natural — one exchange at a time — adding up to billions of trades. No one person or group ever decided that it would be so. But, in retrospect, we can look back and understand *why* gold and silver become supreme.

There are five main attributes of gold and silver that give individuals good reason to *accept* these commodities confidently:

1. Both commodities are *durable*. They can be stored for long periods of time, if necessary, without perishing. Obviously, bananas won't do. Imagine saving up for a new car, then going to the closet to take out your savings, only to find they were rotten.

2. The commodities are easily *divisible*. As we saw, it was easier to exchange nails than furniture because you could divide a supply of nails into small purchases. And gold and silver can be broken into smaller pieces or used as dust — without harming their inherent value in any way.

3. Gold and silver are relatively *convenient* to handle. Their naturally high market values make it possible to work with small quantities. Paper wouldn't do — because you'd need so much of it to be worth a desired item that it would be inconvenient to carry and exchange.

4. Gold and silver are each *consistent* in quality. Once it has been assayed and its fineness determined, one ounce of gold is as good as any other ounce of the same fineness. This simplifies exchange negotiations.

For short periods in history, each of these four rules has been violated by various commodities that still managed to serve adequately as money. But for a commodity to suffice as money, a fifth attribute is absolutely necessary. For we're talking about human beings whose futures and securities are at stake. And they won't produce and exchange unless they believe it will lead ultimately to something useful.

This means the individual must be confident that what he is receiving today will be exchangeable tomorrow. And how can he be sure of that?

5. The commodity must have *accepted value*. It must be usable and already accepted for a non-money purpose before it can serve as money. Only then can the recipient be sure he isn't receiving a white elephant.

Gold is a commodity — just like lettuce, nails, bricks, or toothpaste. Gold has its own uses. In fact, gold and silver are used for

such things as jewelry, dental work, electronics, art objects, ornamentation, soldering, photography, and other purposes. If gold weren't money, it would still circulate in the world because of its other uses. (We normally refer to the non-money uses as *commercial* or *industrial* uses.)

So you never have to worry about gold going out of style as a money item. Its continued value is based upon something sure and reliable. If your neighbor refuses to accept it in exchange from you, you can still take it to a jeweler or a dental supply company and receive something of value for it.

That previously determined value also tells you *how much* gold is worth in relationship to other commodities. If the money commodity didn't have that separate value, you couldn't confidently accept it in trade for what you have produced, for you wouldn't know the worth of what you received.

Gold, as either an industrial or monetary commodity, is subject to the same laws of supply and demand as is any other commodity. Overproduction will cause its market value to drop.

On the other hand, a *shortage* of gold would increase its value and thereby encourage prospecting and production. There has never really been a long-term shortage of gold in the world; and there certainly isn't one today. It is being produced at an ever increasing rate.

But we're getting ahead of ourselves. The evolution of our money system must continue.

Up to this point, we've recognized two important signposts that will have great significance when we get to the practical application of these principles of money:

1. You produce or exchange only when you believe it will lead ultimately to something you want.

2. Money is a commodity that is accepted in exchange by an individual who intends to trade it for something else.

Putting these two together, we find that you would not accept "money" in exchange if you didn't believe it would lead to the purchase of an item you really wanted.

That leads us to some further developments in money. In the next few pages, we'll see the transition from the primitive society (our island example, employed to isolate the purpose of each individual in an exchange) to the modern, complicated economy in which we live.

2
What Is Paper?

In any market the natural impulse of an ambitious individual is to look around for ways of making life easier for other people — knowing they will pay him a handsome profit for what he makes available to them.

Now that our little community has grown, and gold has replaced nails as the major money commodity, one enterprising fellow notices that individuals waste a lot of time measuring gold dust in exchange for their drinks at the bar.

So he opens a mint. He buys raw gold or silver from miners and converts the metal into coins. He stamps the coins with his name and the amount of gold inside the coin.

If an individual trusts the coin-maker, he will probably prefer to use the coin in exchange. Its recognizable weight makes it easier than measuring gold dust.

But since no one wants to trade for something that may be worthless, he must be sure there's really gold (in the amount indicated) inside the coin. Not only that, he has to know that *others* will accept the coin, too.

The coins must be stamped with the seal of someone who has gained widespread respect in the marketplace. For an individual will be willing to accept the coin only when he's sure of the value of the commodity in the coin.[1]

---

[1] In case you're wondering if this applies to copper-nickel "coins," we will come to them shortly.

Exchange is made easier as individuals trade coins instead of continually measuring gold dust.

But the evolution continues. another ambitious chap opens a warehouse. “Bring your gold to me,” he says. “I’ll store it for you in my theft-proof vault. I’ll give you a receipt for your gold, so you can claim it any time you want it. I charge only a small fee for the service of storing it for you.”

This means you can now keep your gold in a safe warehouse — rather than having it at home where it could be stolen.

You have the receipts in your possession; you can take them to the warehouse and get your gold whenever you need it.

And as the use of the warehouse becomes more widespread, and the integrity of the warehouseman becomes known, the receipts can serve an additional purpose. You can exchange the receipts themselves.

Why bother going to the warehouse to get your gold, only to trade it to someone who will probably take it back to the same warehouse for safekeeping? Instead, you simply hand over the receipt to him. In the process, title to the gold has passed from you to him.

Receipts add to the ease of exchange because it’s easier to transfer the paper than to transfer the gold itself. But at this important stage in the evolution of the money system, we must remind ourselves of an important point*: it is the gold that is the money; the paper receipts are not money*.

Gold is money because it’s a commodity with accepted value and is convenient to use in exchange. The use of warehouse receipts won’t change that. All you receive from the warehouse is a piece of paper, acknowledging that there is gold which belongs to you at the warehouse.

Paper could *not* be useful as money because the relative ease with which it’s produced makes it inexpensive by nature; you’d have to use tons of it to obtain the same result served by a few ounces of gold.

The paper takes on value only as it can be exchanged for gold. If the warehouse were to refuse to make gold available, the receipt would eventually be worthless.

It's similar to storing furniture. You can't sit on a furniture receipt; you can only exchange it for something to sit on.

The paper receipts are not money; they are *money substitutes*. They are receipts that can be readily exchanged for real money.[2]

It is obvious that no one is going to accept a piece of paper just because you want him to. He must be confident that it will eventually bring him what he wants. So there are three essential characteristics required of a worthwhile money substitute, if it's to retain its value:

1. *The warehouse must have a good reputation*. It isn't enough that the receipt holder trusts the warehouse. It must have general acceptance in the market. Otherwise, the holder of the receipt will be limited to exchanging it for gold; he won't be able to trade the receipt to someone else.

2. *The real money must be readily accessible*. If you couldn't exchange your receipt for gold any time you wanted to, what lasting value would the receipt have? And that means . . .

3. *The real money must be kept out of circulation*. If the warehouseman were to spend your gold or lend it to someone else, how could you expect it to be available when you wanted it?

If you hold a receipt, the gold in the warehouse actually belongs to you, not to the warehouse. It would be as preposterous for the warehouseman to use *your* gold as it would be for the Ajax Van & Storage Company to use your furniture while you had it stored there (unless it had your permission).

---

[2]Hereafter, I will use three terms interchangeably: *money substitutes*, *money receipts*, and *paper money* — each meaning receipts that are used in place of real money.

Imagine, for example, that you walked into a friend's house and found him lying on your sofa. When you expressed your shock, he told you that Ajax had rented your sofa to him because it figured you wouldn't be coming back to get it for a year or so.

Pieces of paper, as titles to commodities, aren't worth much unless you can exchange them at any time of *your* choosing for the commodity itself.

So to whatever extent any of the three requirements listed above is missing, the money substitute is bound to lose value.

You are paying the warehouseman a fee for a service — the storing of your money. And the gold must be there and accessible for the receipts to have much value.

Along with the normal paper receipts, it is possible to have *tokens*. A token is a money substitute in metallic form, rather than in paper. The present U. S. copper-nickel tokens are a good example.

These are not coins, since there is no significant inherent value (perhaps two cents worth of metal in a quarter). They are money substitutes. Like paper money, they can only have lasting, constant value if they can be readily exchanged for something of real value.

THE DEVELOPMENT OF CREDIT

If the warehouse shouldn't be lending out money that belongs to its customers, how can credit ever develop?

Easily. Suppose you own some gold that you don't intend to spend for awhile. You agree to lend it to your next-door neighbor in exchange for an extra payment (interest) when he returns the gold. Naturally, you know you won't be able to use the money while it is on loan to your neighbor.

The essential ingredient of *real* credit is that one person *gives up* the use of his money in order to allow someone else to use it. He is paid interest for temporarily getting along without the money.

Warehouses can play an important part in this. The warehouseman can be aware of who needs money and who has it to lend.

For example, you agree to leave a certain sum of gold in the warehouse for a definite period of time — one year, let us say. To compensate you, the warehouse will pay you interest of 3% on your money.

Now that the warehouseman knows you won't demand your money for a year, he can lend it to another customer at 6% interest — repayable within one year. You have agreed to *give up* the use of the money while the other person has it. You both can't have it to spend at the same time.

In this case, you will not receive a receipt for your gold; because you have no claim upon it for a year. Instead, you will receive a *note* that entitles you to pick up your gold plus the interest at the end of the year.

Here we have the difference between *demand deposits and time deposits*. A demand deposit is the storing of your money, for which you *pay* a fee — in exchange for the convenience of using receipts. You can demand your money at any time.

A time deposit is the *giving up* of your money for a specified length of time, for which you *receive* a fee — interest.

And, of course, the warehouse is merely the forerunner of the modern-day bank. The bank is the place where people store their money and where savings are lent out to obtain interest. So let's substitute the word bank for warehouse; although it won't change any of the principles involved.

No matter what we call the warehouse, you'll produce or exchange only when you believe it will lead ultimately to something you want. You aren't going to give up your production or your property in exchange for a piece of paper you think might be worthless. (It *is* possible, of course, to trade for a piece of paper that is becoming worthless without your knowing it.)

If, by now, you've thought to yourself: "My heavens, this is all so painfully obvious," then I'm glad you think so. If what we've seen so far is obvious, then it will be easier to see how distorted our present-day monetary structure has become when we examine it later on.

What we're reviewing now *is* obvious — but only in this simplified form. It's not as easy to see these principles amid the complexities of the modern economy, but they still exist.

THE SIZE OF THE MONEY SUPPLY

A number of fallacies have developed regarding the size of the money supply necessary to serve a community.

As with any other commodity, the overproduction of nails or gold or silver (or whatever is the money commodity) will just lessen the value of each unit of that commodity in exchange.

This identifies one element in the setting of prices. Suppose one horse and one cow are approximately equal in general market value. If prices are expressed in terms of gold, then the price of each might be five ounces of gold.

If the money supply were somehow doubled, one horse would still be equal to one cow; but both of them would soon be priced at *ten* ounces of gold. Consumers would have more gold to spend but there would have been no increase in the number of products on which to spend it.

They would inevitably bid more in order to obtain what they wanted from the limited supply available. And this would cause prices to rise to a level relative to the new, larger, money supply.

From this we can formulate an equation that shows how the *general price level* of the community is determined.

At any moment in history, there will be a fixed number of goods and services in the market, available for purchase. At the same time,

there will be a certain supply of money in the hands of prospective buyers, usable for purchases.

All the goods and services will compete against each other for the available money. And all the monies will compete for the available goods and services.

The general price level will be determined by dividing the available goods and services into the available money, creating a formula:

$$\frac{\text{Available Money Supply}}{\text{Available Goods \& Services}} = \text{General Price Level}$$

Or, expressed in a different way,

$$\text{General Price Level} = \text{Money} \div \text{Goods}$$

This is an abstract equation — meaning that its only purpose is to help us visualize what's happening. We could never hope to know the exact amount of money available for purchasing at any given moment; nor is there even any way to measure all the horses and cows and TV repair services in any uniform way.

But the equation serves to show us that *the greater the money supply, the higher prices will be*. Not because a larger money supply makes the products more valuable; but rather because the larger money supply makes the money less valuable. The prices of products are expressed in terms of money. The more money there is, the more will be bid on each item until the supply of available money is used up on the supply of available objects.

This isn't just probable; it's inevitable. If consumers suddenly received gold nuggets that had rained down from heaven, they wouldn't leave prices where they'd been previously. Each consumer would attempt to take advantage of his apparent new wealth to bid more for what be wanted, hoping to bid it away from others.

In the process, prices would invariably go up; the money supply would have increased, but not the available goods and services. No new wealth would have been created (except to whatever extent gold is in demand as a commercial or industrial commodity).

If the money supply decreased, prices would drop. There would not be enough money to buy up the available goods at the old general price level.

Within the general price level, there will be wide variations of prices among the commodities as consumers express their preferences. Some prices will even be dropping — while others are going up, as consumers change their minds and rearrange the values they have placed on various items.

But the general price index will necessarily result from the amount of money available for spending and the number of objects available for purchase.

3
What Is Inflation?

America is the land of opportunity. So I'm going to suggest that you and I go into business together (at least in your imagination, so I can pose my puzzle to you).

You and I form a partnership, a company that prints counterfeit money. We print 1,000 new $20 bills.

Then we go into San Diego where our affluence (or lack of it) is not known to anyone.

We start spending the bills and are immediately praised by the local merchants and the newspapers. They proclaim that it is a great thing for San Diego that we have come to town, for we're bringing prosperity to a city that perhaps was in a recession.

Two weeks later, we leave town with $20,000 worth of goods. The townspeople bid us grateful farewell for all the business we have brought to them.

It's obvious that *we* have benefited from the situation. We traded paper dollars with *no* real value for products that *have* real value.

Assuming that no one ever learns our little secret, has our gain actually hurt anyone else?

In other words*, does anyone ever pay for the benefits gained by counterfeiters*?

Set the book down for as long as it takes to think about that question. Did anyone lose in order for us to gain from our counterfeit spree? And, if so, who?

* * *

What's your answer?

The merchants who received the counterfeit bills didn't lose. They could pass the bills on to others for things they wanted. (Part of our assumption was that no one would discover the counterfeiting.)

We gained; the merchants didn't lose. Apparently, no one lost.

But we've overlooked a few people. Not just a few, in fact. *We've overlooked everyone else in the marketplace*. For everyone else will lose in order to make this gain possible.

We can see this easily as we imagine our car leaving San Diego — loaded with goods removed from San Diego's marketplace. We leave San Diego's residents with less property than they had before we came. There will be fewer goods available to divide up among the people there.

In exchange, they received additional paper money that will circulate in the community. But paper money isn't wealth. It simply means there is now *more* paper money to bid for *fewer* goods and services.

Referring back to our price level formula, we see that the general price level is determined by dividing the available goods and services into the available money supply. Since the money supply has gone up and the goods and services have decreased, the result can only be a *higher price level in San Diego*.

The price increase will be irregular. Those who get their hands on the counterfeit money first will gain from it; for they'll have extra spending money, and prices won't have gone up yet. But as that extra paper money passes through the community, it will bid prices upward.

The other people in the marketplace will be paying for our gain — and *they will do that through the higher prices they pay for each product*.

Let's carry the example a little further. Suppose our arrival and departure weren't noticed. In other words, no one was aware that an extra $20,000 was suddenly coming into circulation.

The individual merchants who received our $20 bills would have no reason to suppose there was anything unusual or temporary about the increase in business. They'd simply suppose that their long-standing promotional efforts were finally paying off — that success was on its way at last.

They would most likely hire extra clerks to handle the increased business, maybe order a new sign and a better paint job for the store. And they'd enlarge their inventories to meet the increased demand, of which we appeared to be an example.

But as soon as it became evident that the sudden dose of new business was purely temporary, they'd have to retract their expansion plans. They would lay off the extra clerks and cancel the orders for remodeling.

The painter who was to have done the remodeling would, in turn, have to fire his new helpers. And what would he do with all the extra paint he'd ordered?

The net result throughout the area would be a state of gloom. Everyone would have extra commitments to pay off and shelves full of undesired stock — all because an illusory boom caused businessmen to gear up to a demand that never really existed.

Would you call that a recession?

Had the businessmen understood the artificial nature of their sudden new business, they wouldn't have made their mistaken investments. Instead, they'd have recognized the situation for what it was — a sudden, temporary windfall. It was the inability to calculate the true nature of the situation that led to what we think of as a recession.

But let's not get ahead of ourselves. Instead, let me give you another puzzle to ponder, before we go on.

Suppose I've earned 100 ounces of gold by working in the marketplace. Now that I have it, I decide *not* to spend it. I won't even

lend it to someone else or put it in the bank. Instead, I go home and bury the 100 ounces of gold in the backyard.

I steadfastly refuse to spend it. Some of my friends (who are Harvard economists) come to me and plead with me to spend the money. "After all," they say, "if you spend it, it'll provide employment for others."

But I still refuse to spend the money. It remains in a hole in the backyard.

What happens as a result? Is anyone *hurt* by my action? If so, who? Does anyone *gain* from my action? If so, who?

Again, set down the book for as long as it takes to ponder the question.

* * *

What's your answer?

The only possible loser in such a case would be I — the one who has the money and refuses to spend it. Even then, if I have decided (for whatever reason) that I don't want to spend it, you could hardly say that I'm hurt.

But the fact is that I'm simply depriving myself. I've produced something in the marketplace that other people now enjoy. The gold I received was my claim to goods and services in the market. When I spend the gold, I'm claiming my reward for the things I've already given to others.

If I refuse to exercise that claim, I am the loser — for I'll have fewer goods and services to enjoy. And, in the process, I'll have left that many more goods and services in the market *for others to have*.

This highlights a very popular economic fallacy. Most people believe the market benefits from my *purchase*. But that isn't the case. The market as a whole benefits from my *production*, not my purchase.

When I produce, I add to the total number of goods and services available. When I purchase, I reduce that supply. My purchase is simply the claiming of my reward. If I don't claim it, only I suffer the consequences.

Well then, if I choose to forfeit my reward, who will gain? Everyone else will profit from my refusal to spend my money. There will be just that many more goods and services left for the others to split up — since I didn't take my share.

And how will that be reflected in practice?

Prices will be affected by the change in the money supply. As I remove 100 ounces of gold from circulation, prices will drop accordingly (see our price formula). So now everyone can buy *more* goods with the money he already has.

The larger the money supply, the higher prices are. The smaller the money supply, the lower prices are.

ORGANIZED COUNTERFEITING

In a free market, the gold stock would undoubtedly respond easily and quietly to changes in the volume of goods produced. If the available supply of products increased, prices would drop. That would make each ounce of gold more valuable than it was before, and this in turn would encourage greater production of gold.

On the other hand, if gold were overproduced temporarily, prices would rise and each ounce of gold would be less valuable in exchange. The gold miner would be getting less in return for his efforts. This would discourage production.

Remember: it's *not* the volume of production or the volume of sales that's important to you; it's what you eventually receive for what you've done that counts.

So if gold mining responds smoothly to changes in market needs, the market would seldom ever be disrupted by sudden changes in price levels.

However, an intricate economy (like the one in which we live) will use the money substitutes to a much greater degree than the real money. And there's plenty of room for manipulation of the money substitutes. It's possible for new paper money to come into circulation without increasing the production or storage of real money.

And this brings us to the next important element in understanding the money system: *inflation*.

Inflation is an increase in money substitutes above the stock of real money in storage.[3]

Inflation simply means there are more paper money receipts in circulation than there is real money with which to back them up. As we've seen, this will cause prices to go up. But rising prices are not inflation; they are an *effect* of inflation. Rising prices can result from several different causes (decreased production, for example); but only when they result from an overproduction of paper money do they cause seemingly mysterious changes in the economy.

It is possible for prices to remain stable or even drop during an inflationary period. This would happen if the production of goods and services increased faster than the increase in paper money (Prices = Money ÷ Goods). *But prices would still be higher than they would have been without the inflation.*

---

[3]The definitions used in this book have been created by the author. The purpose of a definition is to establish precise communication between author and reader, not to adhere to any authoritative concept. The worth of a definition comes from its ability to draw a sharp line between what is a certain thing and what isn't. There are several definitions of the word "inflation" in popular use; but this one isolates the one factor that has the greatest effect upon general economic conditions.

We should note also that the price formula will work in the same way whether the *money supply* element refers to real money (gold or silver) or to money substitutes. An increase in money substitutes will cause prices to go up, even if the stock of real money has remained constant; for the formula is affected by whatever is bid for the available goods and services in the market.

Let's return now to the development of our money system. Suppose you left your gold on demand deposit at the bank (warehouse) and received a receipt that you intended to spend in the marketplace. But the banker didn't store the gold; he lent it to someone else — in order to earn interest on money that isn't his. Or perhaps he just issued a second receipt to someone else.

In either case, two people would be trying to spend the same gold at the same time. You would have *inflation* — two receipts for the same supply of gold.

One consequence of this would be the well-known "run on the bank." As soon as anyone became suspicious that the banker was doing this, he'd get jittery about his own money.

"Heavens," he'd say, "if there isn't enough gold in the bank to cover every receipt, then someone will be out of luck if everyone decides to turn in his receipts for gold. That may not happen — but why take a chance? So, even though I'm a public-spirited citizen who doesn't want to undermine confidence in our institutions, I have too many humanitarian projects in mind for my gold. So I'd better run down to the bank and get my gold out while there's still some to get!"

If very many people became suspicious, you'd have a run on the bank. And those who arrived there last would be out of luck — if the bank really were cheating on the receipts. If it weren't, everyone would get his gold and the bank's honesty would be proven. This would probably result in increased business for the bank. An honest bank would not have to fear a run.

But if the banker *is* inflating, and can keep that fact hidden, what then? Obviously, he'll draw extra benefits from his ability to lend out gold that doesn't belong to him.

Who will pay for his benefits? The people in the community will pay the difference in higher prices, resulting from the increase of money substitutes in circulation.

The example is no different from our glorious success in San Diego. The paper money supply has been artificially increased and the people in the marketplace will pay higher prices as a result.

The banker has caused inflation in the same way our counterfeiting hit San Diego.

So let's coin another definition of inflation, one more to the point: *Inflation is the counterfeiting of paper money*.

Inflation is the printing of paper money substitutes that aren't backed by real money. And it doesn't matter *who* does the counterfeiting. *Any* increase in paper money — not backed by real money in storage — is going to cause the same reaction: prices will be higher than they would have been without the inflation.

Well, we've already come a long way in the development of our money system. We've seen banks or warehouses storing gold and silver, and issuing receipts for them. (They can even store money substitutes and issue checking accounts as a secondary money substitute.)

We've seen coins minted and circulated. Coins are a form of real money; while tokens are money substitutes.

Lending and borrowing take place as one individual gives up the use of his money for a period of time. This can be done through time deposits in banks.

Any bank that issued more receipts than its stock of real money justified would be constantly vulnerable to a "run" that could put it out of business.

Once those runs became common, individuals would probably become disenchanted with *all* banks; for how would you know which ones were honest and which weren't? That would put the burden of proof on the honest banks to *prove* their honesty to the satisfaction of their customers. There are many ways by which that could be done, but it isn't necessary to go into them here.

If the banks overprint the receipts and no bank runs take place (so that inflation continues unchecked), then, as we've seen, prices go up artificially and cause reactions in the marketplace.

We now have all the important elements of a money system at our disposal. So we can leave our island and our warehouses and proceed to modern-day conditions to see what is happening around us.

Our examination of the primitive beginnings of money has been useful to us, however. For it has isolated and identified the principles that exist in any economy. By concentrating on a few elements, we have been able to see them more clearly.

No matter how intricate the economy, no matter how sophisticated "modern economics" may become, some things do not change. For example, *you only produce or exchange when you believe it will lead ultimately to something you want*.

Because of that, actions in the marketplace have reactions, causes have effects, acts produce consequences.

4
The Government and Money

The government eventually becomes deeply involved in any economy. It's not our purpose here to examine the merits or demerits of governmental intervention in the economy. What is of immediate concern is the government's involvement in the money supply.

The government inevitably takes over the money system in any country. To understand why this control is so important to governments, we need to digress temporarily.

There are three ways for a government to raise the financial resources for its spending activities: taxing, borrowing, and printing.

1. When *taxation* is the method, it's not hard to see that one man's subsidy from the state is another man's tax. The total amount of property in the society hasn't increased; it has only, been redistributed according to the government's wishes.

2. If the government *borrows* the funds it spends, nothing changes. Eventually the funds will be due for repayment. That means the taxpayers will pay the bill; or else the loans will be repudiated — which means the lenders pay instead of the taxpayers in general.

We should also notice that, in the short term, the resources the government has borrowed could have been used in the private sector of the economy. These resources have been removed from private use as emphatically as if they'd been confiscated through taxation.

Private investment has been curtailed by the amount of the government's borrowings. Two people cannot use the same money at the same time.

3. This brings us to the most subtle method. It is inflation. The government, in effect, merely prints extra money substitutes and spends

them for what it wants.

We have already seen, however, that *these money substitutes only take on purchasing power at the expense of the other money substitutes which are thereby reduced in purchasing power*. Prices are invariably higher than they otherwise would have been.

Just as in our San Diego example, fewer goods and services are available to the rest of the population. The difference is what the government has confiscated through the use of its counterfeit paper money.

No matter how the government covers its spending bills, the end result is that the individuals in the marketplace have paid the cost. Whether government obtains its resources by taxing, borrowing, or printing, the people in general have lost purchasing power to the extent the government has been spending.

But the third method has a highly useful advantage: *few people realize what is going on*. In fact, as prices edge upward, people blame businessmen or the unions for causing what they call "inflation." Actually, it is the government that has taken their resources, but they don't know it. So inflation is the most subtle kind of taxation; it is always attractive to governments.

For example, the government can "benevolently" grant a "tax cut" periodically. But a look at the budget reveals that spending is continuing to increase. How can this be? All that happens, of course, is a shift in emphasis from method one to method three — from taxing to printing.

Whenever the government spends, the people must give up *something*. You can't create something out of nothing.

This brief digression demonstrates why controlling the money system is so important to any government. With this control, it can tax through inflation.

THE INEVITABLE TAKEOVER

Although the details will change from one country to another, we should be able to draw a composite picture of a government moving into a position of control over the money system. This takeover will be in six basic steps:

1. The first step is *for the government to go into the warehouse business*, issuing its own paper money. In no time at all, it succumbs to the temptation of step two:

2. *It prints more receipts than its gold stock justifies*. This, of course, is inflation.

In doing so, however, the government runs into our basic rule of money: you only produce or exchange when you believe it will lead ultimately to something you want.

This means that individuals aren't going to accept the government's inflationary money receipts — when they can get more valuable receipts from other sources.

3. Eventually this prompts *the government to declare itself to be the monopoly warehouse for gold*. That means no one else may issue receipts for gold. From this point onward, banks are merely storage houses for paper money receipts — since they can't issue their own receipts.

But our rule still applies; and individuals respond in their own self-interests by refusing to accept the government's depreciating currency, preferring to use gold and silver.

4. Seeing its receipts refused*, the government then passes a "legal tender" law* — which says you *must* accept the government's paper money; it's a crime to turn it down when someone offers it to you in payment of a debt or obligation.

If that's to be the case, then most individuals will accept the paper money; but then they're more prone to turn it in for gold as soon

as they get it. They hesitate to hold the paper money for any length of time, preferring to store the gold instead.

The government, however, labels such storing "hoarding." But the rush to turn in the legal tender for gold is simply the traditional run on the bank — only this time it's the *government's* bank.

5. And so, after creating sufficient rationalization for its action, *the government confiscates all the gold* — and declares that henceforth no private citizen may own gold (all this in the "public interest," of course).

The government will store all the gold (store it, not "hoard" it). And you are to use the paper receipts the government has decreed others must accept from you.

The government can't, however, guarantee what others will give you in return for that paper money — although it may try to do so by invoking price controls.

The confiscation of gold took place in America in 1933. Since then, we have thus been limited to the use of paper money, while the government uses the gold to settle international balances.

6. Along with this*, the government takes control of the banking system*.

The effect of the six-step program has been to confiscate the gold, outlaw all competition in money substitutes, and control the banking system. This is total monetary control.

THE FEDERAL RESERVE SYSTEM

The government's control of the banking system is most important. In modern economics, the banks provide the most effective engine of inflation. So let's turn our attention to the nature of the government's power.

The biggest single step forward in control of the banking system took place in 1913, with the passage of the Federal Reserve Act. All large banks in the nation are members of the Federal Reserve System. Nationally chartered banks are forced to join; state-chartered banks can choose.

The system consists of twelve Reserve Banks, located throughout the country. These twelve Reserve Banks are supervised by the Board of Governors of the Federal Reserve System, who are appointed by the President of the United States.

Some people claim that the Federal Reserve System is a private enterprise. Nothing could be further from the truth. It's as much a part of the government as the Internal Revenue Service, the Commodity Credit Corporation, or the Federal Trade Commission.

The error probably stems from the fact that commercial banks own "stock" in the Reserve Banks. This isn't by choice, however; each is forced to put up 6% of its own capital in the nearest Reserve Bank.

Dividends are paid on this; but the dividend is fixed. A commercial bank receives a straight 6% of its investment, not 6% of the Reserve Bank's profits. So the bankers actually only earn 6% on the investment they've been forced to make — not a very exciting return in the banking business.

The remaining profits are turned over to the federal Treasury; and that's where the "big profits" go. Over $7,000,000,000 have been turned over to the government since 1947.

Those profits are not the main interest of the government, however. It's more concerned with using the banks as a method of inflating the money supply. For there are actually three ways of inflating: (1) the printing of receipts, (2) the lending of demand deposits, and (3) the creation of demand deposits. Let's examine each of the three methods:

The first method is the most obvious. The government prints money receipts for which there is no real money as backing. It merely turns on the printing presses — simple counterfeiting.

The second method is only slightly more involved. That method is to take money in storage as demand deposits and lend it to someone else. In this way, two people believe they have the use of the same money at the same time. As we've seen, only time deposits can be legitimately lent; for then the owner of the money has agreed to give up his use of the money while it is out on loan.

Demand deposits have evolved into what we call checking accounts, where you withdraw your funds by making a written demand — a check. Time deposits have become savings accounts.

But, as you probably know, it's easy to remove your funds from your savings account (even though the bank reserves the right to refuse).

As it turns out, then, in both checking and savings accounts, banks are lending out funds that are there purely as storage. No one has agreed to give up the funds for a specified length of time, except in special types of accounts — such as certificates of deposit.

In order to understand the effect of this practice, let's suppose you decide to attend an auction. There's a group of vases there you like. They've been selling at past auctions for about $50 apiece. So you deposit $100 in your checking account, hoping to acquire two vases and pay for them with a check.

The bank, meanwhile, follows its normal practice and lends out $90 of your deposit to someone else.

You arrive at the auction and start bidding. When you bid $50, you expect to have won the first vase. But (surprise!) someone across the room bids $60; and so you have to bid higher.

The bidding continues until he bids $90 and you finally bid $100. At that point, he fails to respond and the vase is yours. But a vase you'd expected to buy for $50 has cost you $100. So you get only one vase with the money you'd expected would buy two.

After the auction, you walk across the room and talk with your adversary. In the process of the conversation, he tells you that he

borrowed the money he used to bid against you. In fact, he borrowed it that very morning at *your* bank.

You discover *that he's been bidding the price up against you with your own money*! The bank has taken your funds, lent them to someone else, and allowed your funds to bid up the price *you* have to pay.

That's a simplified example of how the lending of demand deposits causes inflation. In the same way, banks lend out deposits, causing prices in general to go up — to the disadvantage of those who deposited the money in the first place.

But there's a third way to inflate (a way that's even more incredible). We'll examine that method in the next chapter.

5
How to Create Money

Have you ever borrowed money at a bank? If so, think back to the occasion.

When the loan was approved did the banker go to the vault, count out the money, and hand you the loan in cash? Probably not. More likely, he handed you a deposit slip, showing that he had credited your checking account with the amount of the loan. If you didn't already have a checking account, he probably asked you to open one as a condition of the loan.

In either case, there was no requirement that currency be available to you. All that was necessary was for him to enter a figure in a ledger, crediting you with x number of dollars. In other words, he may not even have had the cash he lent to you.

But how could a banker do this?

To understand, we need to take a brief look at what is called the *fractional reserve banking system.*

The Federal Reserve System establishes reserve requirements for commercial banks. In recent years, city banks have been required to keep at least 16½% of their checking account deposits on reserve at the nearest Reserve Bank. Rural banks have a lower reserve requirement: 12½%. Savings account requirements are even smaller.

To simplify the explanation, we'll concentrate on the city banks. Any bank in a metropolitan area must keep approximately one-sixth (16½%) of its checking account deposits at the Reserve Bank. Suppose, for example, that the bank's records show that its customers have $100,000 deposited in checking accounts. The bank must then have at least $16,500 in cash on deposit at the Reserve Bank.

The superficial purpose of the reserve requirement is to prevent the bank from lending out so much of its deposits that it would be highly vulnerable to a run. But, in practice, the result works out to something quite different.

Since our partnership in the counterfeiting business was so successful, let's try another venture. This time let's open a bank.

On Monday morning, we open our doors for business for the first time. The local newspaper carries our advertisement for people to come in and deposit their funds. The result is that we receive $1,000 in deposits the first day.

On Tuesday, we advertise for people to come in and borrow money from us. After all, we intend to make our profits by lending out the deposits and earning interest.

Since our reserve requirement is 16½%, you'd expect that we'd send $165 of our new deposits to the Reserve Bank and lend out the remaining $835. (We'll assume that our operating expenses are paid out of our initial capital, to avoid complicating the essential matter involved.)

In that case, our statement would look something like this:

Deposits:	$1,000	Loans:	$835
		Cash Reserves:	165 (16½%)
Liabilities:	$1,000	Assets:	$1,000

Our reserve requirement has been met; and we've lent out $835. That's very simple and easy to understand; but it doesn't work that way.

For we have the ability to *inflate* — actually to *expand* our deposits through loans. So it's more likely that we'll proceed in *this* way: On Monday, we receive $1,000 in new deposits. On Tuesday, we send the *entire* $1,000 to the Reserve Bank as our reserve.

Instead of viewing the $1,000 as our total deposit structure, we'll use it as the reserve base and build a much larger deposit structure on top of it.

We then make new loans totaling $5,000 — by opening new checking accounts for the borrowers. Whenever anyone asks for a loan, we just add the amount of the loan to his checking account balance. Our statement would then look like this:

Deposits	$6,000	Loans:	$5,000
		Cash reserves:	1,000 (16½%)
Liabilities	$1,000	Assets:	$6,000

In other words, we'll grant loans by issuing deposit slips for money we don't actually have. No one usually asks for currency, anyway — at least not enough people to make a difference.

In the process, we expand our deposits by $5,000 to a total of $6,000. And we have a corresponding figure of $5,000 worth of loans on the other side of the ledger.

Our financial statement balances, our books are in order, and the reserve requirement is being met.

We've just done our bit to ease the tight money situation.

This is the third method of inflation — the *creation* of demand deposits. It's somewhat similar to the second method — the *lending* of demand deposits. Method three is much simpler and faster, however; we just create the new deposits *on top* of the reserves.

But there must be a flaw in all this somewhere. Aha! What happens when the borrowers go out and spend their new checking account deposits? After all, they're not seeking the loans just to have funds sitting idly in checking accounts. They have something in mind for those funds. They'll spend them by writing checks.

Eventually, the town's merchants are going to deposit these checks in their banks and those banks will come back to our bank and

say, "Give us cash for these checks issued on your bank." What happens then?

We don't have the cash to give them; we never did. And we'd be in real trouble at this point, except for one little thing*: the other banks have been doing the same thing we have*. They've been inflating their deposits and so we've collected a lot of their checks, too.

And so our checks are canceled out by their checks*, provided we're all inflating at the same rate*. Different-sized banks can coexist and inflate side by side, so long as the rate of inflation is the same.

That's the job of the Federal Reserve System — to assure that uniformity of inflation. It has several tools with which to do this, the most basic of which is the reserve requirement. With it, the system controls the volume of inflation in the nation.

CONTROLLING INFLATION

Suppose the reserve requirement were suddenly lowered to 14%, or about one-seventh. That would enable us to pyramid our original $1,000 on reserve at the Reserve Bank still further. We could now create an additional $1,000 in deposits and loans.

Deposits:	$7,000	Loans:	$6,000
		Cash reserves:	1,000 (14%)
Liabilities	$1,000	Assets:	$7,000

In other words, $1,000 in reserve will create $5,000 in loans when the reserve rate is 16½%. The same $1,000 in reserve can create $6,000 in loans if the reserve rate is 14%.

The result is a sudden addition to the nominal money supply of the nation. In this way, the Federal Reserve System has the ability to inflate or deflate the paper money supply of the nation, just by raising or lowering the bank reserve requirements.

The Reserve Banks also act as the clearing houses between banks, keeping track of the credits one has against the other. If any bank should temporarily be in higher debt than the others, the Reserve Bank can lend it the funds necessary to bail it out.

This process, just described, is *fractional reserve banking*. No matter how much discussion may take place over the raising or lowering of reserve requirements or the efficiency of the operators of the system, the process itself is never challenged publicly. It's become as much a part of the American way of life as high taxes.

The Reserve Banks also issue the currency we use, the green pieces of paper we call *dollars*. They're actually Federal Reserve Notes.

The greenbacks come into circulation as needed. If depositors at commercial banks desire to withdraw more currency, the banks call on the Reserve Banks for extra dollars to meet demands. The Reserve Banks print and issue the currency, as needed, to meet the demands created by a constantly expanding deposit structure.

In modern practice, then, the government doesn't print paper money to *cause* inflation. It prints the paper money *in response* to the inflation that takes place through the bank's deposit-loan expansion.

But the government is still running the show. For the Federal Reserve System determines the extent to which banks may inflate at any given time.

Because of that expansion, all banks are highly vulnerable to runs. So the government has created the Federal Deposit Insurance Corporation to reimburse you for your loss, up to $20,000 on any one account. With this insurance, you aren't supposed to see any reason for withdrawing your funds in shaky times. "After all, they're as safe as the United States Government."

In reality, the FDIC is really nothing but a confidence game. Its show of strength is intended to discourage depositors from withdrawing funds during shaky times.

When a tiny bank in New Jersey was caught in an apparent swindle in 1970, the FDIC swooped in with photographers and made a grand display of paying off all the depositors. The event was reported from coast to coast and served to reinforce the public impression that bank losses had died forever in the thirties.

What's overlooked is that the FDIC is only capable of dealing with small-time bank failures. Insured deposits in the U.S. in 1969 totaled $313 billion, while the FDIC fund to cover it amounted to only $4 billion. That amounts to slightly over 1¼% coverage.[4]

And virtually all of the insurance fund is used to finance the government's bonds. Only $6 million is kept in cash.

The FDIC has nowhere near the funds to cover any large-scale bank runs. It could make good only by creating new fictitious demand deposits in other banks or by having more paper money printed. In either case, the cure rivals the disease.

THE PAPER MONEY SUPPLY

Before reading this book, you may have assumed there were greenbacks in the bank vaults for every dollar credited to your checking account. If that were the case, the nation's paper money supply would simply be the amount of currency that had been printed and issued.

But, as we've seen, that *isn't* the case. There are far more purchasing media than just the greenbacks. People are writing checks for which there's no currency in the bank. The nation's paper money supply is larger than just the currency.

There are really three elements in the supply:

1. Currency outside of banks
2. Checking account deposits

---

[4]FDIC Annual Report, 1969.

3. Copper-nickel tokens

Any currency inside the bank is probably covered by what's already been credited to checking account deposits. In any event, it isn't out in the community bidding up prices. So the only currency we count is that which people hold at home, in their pockets, in cash registers, or elsewhere outside of banks.

The checking account deposits represent immediately spendable money substitutes. They're available to bid up the prices of goods and services in the marketplace.

Tokens that aren't silver or gold are not coins, but money substitutes.

The total of these three factors will be the *paper money supply*, the money substitutes that are supposedly backed by the government's gold supply. This also constitutes the *available money supply* in our *general price level* formula. Obviously, this isn't *real* money we're talking about. Instead, it's a great deal of inflated paper money, backed up by a small amount of real money.

There are conflicting opinions concerning which elements should be included in the paper money supply. Some economists include savings accounts; others include savings and loan deposits, etc. I'm keeping it as simple as possible here, since what we're looking for doesn't depend upon a precise figure.

We're also leaving out silver coins. There are so few in circulation that they don't affect prices much. Even the entire amount held by the public would amount to less than 1% of the available paper money supply.

Is there any limit to this paper money supply? The ultimate limits are, of course, the consequences of inflation that we'll examine in the next few pages. There used to be legal limits, also. The law stated that the Federal Reserve System could only issue $140 in currency for each ounce of gold in the Treasury. That law has been repealed.

There was also a law that the reserves of the commercial banks, on deposit at the Reserve Bank, could not exceed four times the Treasury's gold supply, figured at $35 per ounce. That law has been repealed, too.

It's interesting that those who say the 1929 depression couldn't happen again always cite increased "controls" as the reason for their views. But the "controls" are all on private individuals. There are far *fewer* controls on those who generate the inflation than there were in 1929.

And since all these controls have been taken off, it becomes vitally important to understand just what inflation does and where it leads, now that there are no longer any legal limitations upon it.

6
Mass Confusion

Ever wonder why your family budgets never seem to work out as planned? Have you ever wondered why the higher your income goes, the greater the problems you seem to have in just getting by? Oh sure, outwardly you're doing well; but behind the facade there's a constant problem meeting the monthly bills.

Whether or not these specific problems have plagued you, there are a number of somewhat chaotic factors in today's economy. And they make it very difficult to make rational long-term plans. To see things more clearly requires getting a broader perspective, standing back from the immediate problem.

We've seen that inflation, in the short term, pushes prices upward. Prices aren't necessarily higher than they were previously; but they're always higher than they'd be without the inflation.

And there will always be a sudden upsurge in demand at the specific points where the inflationary paper money is entering the community. The chief entry points in our economy today are (1) through government spending — defense contracts and subsidies; and (2) through bank loans to businesses and consumers.

The recipients are getting extra paper money that wouldn't have been theirs in the absence of inflation. They respond by gearing production up to a level that didn't exist before. Businessmen order new capital equipment and add workers to the payroll.

In the process, their purchases create new demands on other companies and industries, affecting them in much the same way the inflation recipients have been affected.

It might almost be called a law of nature that *no one ever gets new income without raising expenses accordingly*. Businessmen start

offering their suppliers more money to get deliveries faster; and they start bidding workers away from competing companies.

In fact, when a businessman gets a bank loan, he doesn't hire the unemployed. For in reality, there are only two kinds of unemployed: (1) those who don't want to work at prevailing wage levels; and (2) those who are legally prevented from working at prevailing wage levels by the various forms of minimum wage laws and union contracts.

So the businessman gets most of his new workers by bidding them away from other jobs, pushing wages upward.

In the process, the labor unions stage a gigantic show of strength to indicate that *they* are responsible for the higher wage levels, which isn't possible. All they can do is to move in and soak up the excess bidding power created by inflation.

If it weren't for inflation, any successful union wage hikes would result in unemployment. For the companies involved would be priced out of business by the increased costs. But in an inflationary economy, there's always more paper money in the hands of the company's customers; and that's what makes the so-called wage-price spiral possible.[5]

The two chief characteristics of the inflationary economy are (1) the unrealistic demands created for some companies and industries, and (1) the constantly rising price level. Our price formula is working, silently but irresistibly; and it applies to prices, wages, everything.

As the paper money flows through the market, it bids prices higher and higher. So those who receive the new inflationary money the

---

[5]It's true that inflation, by pushing prices and wages upward, creates the illusion of a higher wage level. That can then induce some of the unemployed to go back to work, thinking (erroneously) that the wage level is now more attractive. It can also push the prevailing levels above the legal minimum wage, freeing some other workers from involuntary unemployment.

soonest will benefit the most; they get to spend it while the lower prices are still in effect.

But as it passes from hand to hand, prices get higher. And some individuals receive it just in time to offset the rising price level and come out even.

Further back down the line are others who receive it too late to break even. And way in the back of the scene are those whose incomes are not bid up by inflation. Those are the retired, the pensioners — the individuals who are on fixed incomes that don't adjust upward to inflation, even though prices are going steadily upward.

These individuals in the back of the scene are the ones who are paying for the gains of those getting the handouts from the government and the banks. Every gain received by a handout recipient must be accompanied by a loss to someone else who must now pay more for everything.

Inflation amounts to nothing more than a redistribution of the wealth, a distortion of the purchasing pattern that would have taken place in the free market without inflation. Some people get greater purchasing power at the expense of others whose paper money will no longer buy as much.

And yet, in the short run, inflation *seems* to be producing a "boom." Prosperity *appears* to hit the economy when the government pumps new inflationary paper money into circulation. "After all, you have to admit we've never had it so good!"

This is just another example of the visible gain and the hidden loss. The so-called gains from inflation are always spectacular, while the losses are generally hidden from view. So let's go behind the scenes and see the actual sequence of events produced by inflation.

A DAY IN THE LIFE . . .

Each consumer is trying to satisfy his most urgent desires at any given time. He'll allocate his limited income on some basis, hoping to maximize his own objectives, whatever they may be.

Let's take a hypothetical engineer, working in an aerospace company. His take-home pay, after taxes, is $800 per month.

Here's an imaginary value scale for this consumer:

$800 Monthly Budget

1. Food	$ 100	
2. Housing	200	
3. Clothing	100	
4. Education	50	
5. Transportation	150	
6. Medical	50	
7. Entertainment	100	
8. Savings	50	
		$800 total
9. Swimming Pool	100	
		$900 total
10. Yacht	300	

. . . etc.

He has certain wants that must be satisfied: food for his family, a house with utilities and other things that go into it, clothing, education for his children, a car or two, medical expenses, and a certain amount of entertainment. With the $50 left over after taking care of these objectives, he feeds a savings account for the future.

Notice that there are numbers on this imaginary value scale. They are important, because the eight or ten items listed here aren't the *only* things he'd like to have. There are *hundreds* of other things in the world he'd love to have, if he only had the money.

As a matter of fact, we can see that he'd very much like a swimming pool — but it's just out of his reach. He's also wanted a yacht, but his $800 per month will only go so far. He gets down to item #8 and the budget is used up.

It isn't that he *can't* buy the swimming pool or the yacht. But he's not willing to give up more important things to get them. Instead,

he spends an hour or two a day at his desk dreaming of the swimming pool that he knows he can't afford.

But one day the boss calls him into his office to tell him some good news. "Bumstead," he says, "the company has just received a new government contract. That means we can now give you a raise. Your take-home pay is going up by $100 a month."

Naturally, our hypothetical hero isn't concerned with national questions of inflation and the like. All he knows is that someone has finally realized how talented he is and he's been rewarded with a long-overdue raise.

He rushes home, tells his wife, and they spend a good four minutes trying to decide what to do with the raise. They rush out and buy that swimming pool, probably by obligating themselves for the $100 per month the new raise is bringing him.

And the visible effects of his purchase (and the purchases of others like him) produce the appearance of a boom. "Look at all the swimming pools; and people are eating at more expensive restaurants, driving better cars. After all, wouldn't you really rather live in a society where people can afford swimming pools, in addition to the necessities of life?"

There's only one problem. Prices are rushing upward to meet the increased paper money supply caused by inflation — the same inflation that deceived him into thinking he'd received a raise.

And a few months after the raise, he finds that it now costs him $100 per month *more* to live in the same *old* routine than it did before he received the raise.

The raise has been completely absorbed by inflation, as the eight most important items on his value scale have gone up in price. It now costs $900 per month to do what previously cost only $800.

THE PINCH

The routine he once had has new price tags attached to it. It now looks like this:

$900 Monthly Budget

1. Food	$ 115	
2. Housing	225	
3. Clothing	115	
4. Education	60	
5. Transportation	165	
6. Medical	60	
7. Entertainment	110	
8. Savings	50	
		$900 total
9. Swimming Pool	100	
		$1,000 total
10. Yacht	325	

. . . etc.

His income covers the first eight items on the value scale, just as in the old routine.

There's only one problem*: he's not living in the same old routine*. He still has all the old expenses, *plus* a swimming pool that costs him $100 per month. And since no one has yet figured out a way to repossess swimming pools, he now has to eliminate $100 worth of purchases from his monthly budget.

$900 Monthly Budget

1. Food	$ ~~115~~	105	
2. Housing	225		
3. Clothing	~~115~~	100	
4. Education	60		
5. Transportation	165		
6. Medical	~~60~~	50	
7. Entertainment	~~110~~	60	
8. Savings	~~50~~	35	
9. Swimming Pool	100		
			$ 900 total
10. Yacht	325		

. . . etc.

This means he'll have to go without something he would ordinarily consider a necessity. Changes will have to be made in order to cram the pool into the budget — now that prices have gone up so much.

For as long as it takes to pay off the pool, he'll have to go without some of the things he'd always taken for granted. He's now purchasing what he used to, plus a swimming pool, *less* some things he considered more important than a swimming pool.

What, then, is the net effect of inflation on his life? He now purchases approximately *as much* as before; but the *distribution* of his purchases has been artificially altered by the curve he was thrown by inflation.

Had he been given a clear-cut choice, he'd never have bought the swimming pool. He'd have chosen his former routine as he did until inflation distorted his decisions. He was always in a position to buy a swimming pool before. All he had to do was to give up something else; but he didn't want to do that. Now his life is less enjoyable because he was temporarily deceived into thinking he could have more than was really possible.

And he was one of the first to get the inflationary paper money. Was his life improved by inflation?

THE MORNING AFTER

And, of course, what's happening to our hero is also happening to millions of others, in various positions along the handout line. Businessmen are gearing up to these new demands — swimming pools, expensive restaurants, better cars, etc.

But as soon as the inflationary currency has made one complete pass through the market, prices will begin to stabilize again at a new, higher level.

That's the point where the consumers realize that something has gone wrong with their calculations; and they attempt to reassert their

old routines. This brings about failures in the glamour industries — swimming pool companies, entertainment, expensive restaurants, etc. But, as we can see, it will also cause slowdowns in the more basic industries, such as food and clothing and housing.

The outward picture is that of the economy passing from a boom stage into a recession. "Too bad; it looked as though we really had all-out prosperity for awhile; but now this recession."

During the first stage, businessmen were gearing up to respond to the apparently upgraded tastes of the consumers. We seemed to be entering an era in which everyone would have more.

But the truth was that nothing had actually changed. We still had the same amount of resources to work with; we still had the same general level of technical competence. But inflation deceived us into redistributing our resources temporarily toward more glamorous industries.

And when the inflationary cycle is over, the businessmen are required to face the fact that they had geared up to a fairy-tale market. Now they must grit their teeth, accept their losses, and resolve not to be fooled again.

Mistakes will have to be liquidated, wasted man-hours written off.

This is a *recession*. Perhaps it's easier now to see what a recession really is. *It is the liquidation period following an inflationary cycle*.

But no government wants the embarrassment of that: and so the money managers look for a way of warding off the recession. And in thousands of years of recorded monetary history, only one temporary solution has ever been discovered. Governments know only *one* way of holding back a recession. What do you suppose it is?

(How did you know?)

Yes, the only solution they know is to *continue the inflation*. The "boom" is *re*generated with more bank credit and government subsidies. Companies appear to come to life again.

Prices go higher, but in such irregular patterns that businessmen and wage-earners are unable to make rational decisions from the distorted price structure.

Inefficient businessmen stay in business with more credit — at the expense of other companies that are offering to satisfy more basic consumer demands.

And, through all this, *the consumer is in a daze*. His concept of his buying power is totally distorted. He sits by his swimming pool, eating a can of beans for dinner. He drives to work in a new car, while his children go without dental care and his furniture falls apart.

Not surprisingly, many individuals begin to think less of themselves, feeling incapable of coping with life in an efficient manner.

The consumer finds himself turning more and more to credit as a means of keeping up with himself. He continually plans ahead, seeing the day when he'll be out of debt. But he never gets there; because his planning is always based upon today's prices and they keep going upward.

Inflation is mass confusion.

No one knows what he's doing. And every man thinks its <u>he</u> who's out of step with the general prosperity.

The businessman, seeing his sales volume larger than ever before, wonders why he isn't showing a profit. It's all he can do to keep his business propped up with bank credit. When he confides in his banker that he thinks he may be a failure, the banker reassures him and grants him a new loan.

The consumer wonders why everyone else is doing so well. He hopes that others won't see how badly he's doing behind the facade of a prosperity he's created.

If only he could stand back from his own life, view the entire economy and see what's happening, he'd be able to reassure himself of his own sanity. And he'd be able to begin taking steps to get out of his predicament.

It's also true that whenever an individual begins to allow for inflation in his calculations, inflation speeds up and manages to stay out in front of him.

7
Inflation Starts to Gallop

So the government's inflation didn't produce prosperity, after all. It simply distorted our choices temporarily.

Why, then, bother to pump inflation into the economy in the first place? Because those who control the inflation (the banks and the government) benefit so much from it. And, usually, those who are first in line at the subsidy window are the most vocal elements in the market.

The government invokes inflation as a way of appearing to create prosperity — as a way of financing, on a subtle basis, its own programs. Once underway, the inflationary program must be sustained in order to ward off the recession that will inevitably follow.

The additional inflation is simply postponing the day of reckoning. And it's covering up a greater and greater number of miscalculations that must come to light eventually. These mistakes can't be hidden forever; but the government hopes they can (or at least until another administration is in office).

And so the binge continues, guaranteeing an even *worse* readjustment period ahead. The longer the cycle lasts, the bigger the inflation, the greater number of miscalculations to be liquidated, the worse the recession to come.

But now another element enters the picture. As the money managers attempt to continue the cycle, they find that their doses of inflation don't have the effect they once had. Certainly our anti-hero, Joe Consumer, isn't going to be fooled again by another $100 raise; he's wise now.

But if the next one were to be $150? Ah, that's a different story. "Now I'm *really* getting ahead," he thinks.

It's not that the money managers are consciously aiming to throw our Dagwood Bumstead a curve. They just look at the business trends and become aware of the need for bigger and bigger doses of inflation.

So the subsidy programs get bigger and the bank credit expansion gets more feverish. But, as always, reactions are taking place that weren't anticipated.

For example, the government suffers from having to pay higher prices than expected, just as everyone does. Just like us, it plans its budget with today's prices in mind; but inflation is pushing those prices upward. So it, too, runs to the bank and borrows to meet a higher-than-expected deficit.

But the paper money won't be there to buy the government's bonds unless the reins on inflation are loosened a little more. So one feeds on the other and vice versa.

At the same time, individuals notice the paper money depreciating rapidly, and they become afraid to hold it. They try to spend it faster. Less savings are available for real credit, creating pressure for phony credit.

And when savings accounts go down, interest rates go up. The government tries to push the rates down by feeding more paper money into the system, hoping to make money more "plentiful."

What we're seeing here are the ways in which the fires of inflation are fanned: (1) bigger spending programs are needed to keep the "boom" from collapsing; (2) unexpectedly higher prices cause the government to borrow more, requiring more inflation to make it possible; and (3) savings accounts become less attractive and consumers spend more; so more inflation appears to be the way to hold interest rates down.

Each of these things encourages the expansion of inflation at an ever-increasing rate. It multiplies; it doesn't add. One thing feeds on another; and it becomes harder and harder to hold it in check.

When it gets going fast enough, you have *runaway inflation* (or *hyper-inflation*) — where the paper money is depreciating hourly. And within a short period of time, the entire monetary system collapses.

History is riddled with examples of runaway inflation. It reached such a critical stage during the French Revolution that the state decreed violations of its legal tender law to be guillotine offenses. Yet people *still* refused to accept the worthless currency.[6]

In 1923, Germans were paying a billion marks for a loaf of bread. And there was China at the end of the Second World War — and Brazil and Holland and Indonesia and on and on and on.

Naturally, in each case, the cry before the crisis was "You never had it so good!"

As Ludwig von Mises has pointed out, the government is the only agency that can take a useful commodity like paper, slap some ink on it, and make it totally worthless.

POISON OR HANGING?

Somewhere in this fool's paradise, the money managers reach a critical fork in the road. After having inflated steadily, they reach a point where all the many alternatives that were once available have disappeared. There are only two dismal alternatives left.

One choice is to continue inflating. But by this point, it's gone too far. Further inflation means they'll lose control completely and runaway inflation will take over.

But the only other alternative is to stop the inflation. And that will bring to light all the miscalculations of the past. It means an embarrassing liquidation period ahead. Only it won't be just a recession. Now inflation has gone so far that the readjustment period

---

[6]An excellent case history of runaway inflation is provided in Andrew Dickson White's *Fiat Money Inflation in France*.

will be a full-scale depression, with widespread business failures, unemployment, and bank closings.

In fact, at this point, it doesn't require a deflation (removal of paper money from circulation) in order to cause a recession. It doesn't even require an end to currency expansion. *Just slow down the rate of increase* and you bring on the depression.

So this is their choice now: runaway inflation or depression. The money managers may not even be aware that they've arrived at that juncture. They may go right on inflating, unaware of the consequences. But once they've reached that fork in the road, it's far too late to turn back and correct their mistakes.

THE GOLD DRAIN

While all this is going on, the money managers are also fighting on another front.

Inflation makes many people jittery about the future of the currency. And so those who can turn in their dollars for gold (mainly foreign banks and governments) do so, as they see the value of the dollar rapidly sliding downward.

The gap between the gold supply and the money substitute volume reaches a point where a run on the gold seems inevitable. And no one likes to be last in line at a run.

Preserving the remaining gold becomes a national problem. Such things as "balance of payments" become important issues. Attempts are made to keep American citizens from enhancing their lives by buying attractive foreign goods. Controls are often imposed that discourage, or totally prohibit, the sending of money to foreign countries.

It's interesting to note that, without inflation, there'd never be any such thing as a "balance of payments" problem. Every dollar that could be spent (and eventually turned in to the Treasury) would have

gold to back it up. Foreign trade would be encouraged as a way of widening our choices.

But with inflation, it's a big problem. And the government watches its gold supply getting smaller and smaller, until the situation becomes desperate. Here, too, a juncture is finally reached where there are only two alternatives left.

One obvious alternative is *deflation* — withdraw some of the excess paper money from circulation. That would close the gap between the gold supply and the volume of outstanding money substitutes, reducing the overwhelming demands on the gold stock.

But that means being prepared for the depression that would certainly follow. And if you wait too long to deflate, it can be too late. At that point, the run on the gold may have started. A short-term answer to the crisis is needed, and deflation wouldn't work fast enough.

The second alternative isn't widely understood. The government simply *defaults* on its agreement to redeem dollars with a stated amount of gold. Only it isn't called a default; it's called a *devaluation*.

The government has promised, in effect, to pay out one ounce of gold for every 35 dollars turned in at the Treasury. Surveying the situation, the government sees that outstanding claims against the gold stock are perhaps six times as great as the gold supply itself.

And perhaps it calculates that about half of those claims are in the hands of people in a position to exercise them. So the government finally decides it has no alternative but to change the rules in the middle of the game.

After having issued the dollars on the basis of a fixed rate of exchange, it now changes the rate. It says it will no longer redeem one ounce of gold for every 35 dollars turned in. Now it will pay out only *one-half ounce* for every 35 dollars. in other words, it will take 70 dollars, instead of 35, to claim one ounce.

This is a *devaluation*: *a repudiation of the government's promise to honor its money substitutes at the stated rate of exchange*.

It's important to recognize exactly what a devaluation is. It isn't a mere adjustment of exchange rates; it isn't a raising of the price of gold. *It is the act of defaulting on a debt*.

It's a bankrupt debtor deciding to pay off his debts at 50 cents on the dollar (or any other percentage chosen).

A 50% devaluation would mean changing the redemption rate from $35 per ounce to $70 per ounce, cutting the dollar's redemption value in half. A 67% devaluation would mean changing the redemption rate to $105 per ounce.

A 100% devaluation would mean refusing to redeem any gold at all. That's what American citizens suffered in 1933. Since then, no American has been legally permitted to own gold bullion or any gold coins dated later than 1933.

When a government devalues its currency, it seems to have solved the problem. For devaluation will seem to take the pressure off its gold supply for awhile. Inevitably, this encourages more inflation; the consequences *seem* to have been eliminated, at least temporarily.

Before the devaluation, there are many stop-gap measures a government may invoke, attempting to delay the inevitable. Most of these involve a false show of confidence in the future of the gold supply, hoping to dissuade foreign creditors from collecting their gold.

So the government ponders the dilemma of *deflation or devaluation* in trying to save its gold stock. And back on the other front, it's the dilemma of runaway *inflation or depression*.

Each of these problems becomes more and more aggravated, even while the government displays its most confident posture to the world.

The bureaucrats and economists talk more and more about the "new age" of monetary matters, the "archaic reliance on gold," the gold speculators who are pictured as the villains, and other fictions that are intended to draw attention away from the *real* problem — the problem no one wants to end: *inflation*.

All of the tricks up the government's sleeve have been tried before and have failed to avert the inevitable. But that won't stop it from trying again.

8
Who Will Protect You?

How many times have you heard a statement like this: "We could never have another great depression in this country; the government now has the power to intervene and prevent such things from happening"?

There was no shortage of governmental powers in 1929. Still, there was a depression. It's very instructive to review the events of the 1920s and 1930s. They represent the classic example of the inflation-depression cycle we've been examining in this book.

Anyone who believes that America of the 1920s was an example of unregulated free enterprise hasn't checked history very closely. As noted before, I recommend Murray Rothbard's outstanding book, *America's Great Depression*, as the most thorough economic history of the period 1921-1933.

In Rothbard's book, I counted 43 major federal activities in operation during the "Roaring Twenties." Here are some of those programs:

1. The Federal Reserve System launched a full-scale bank inflation during the twenties. By controlling the reserve requirements, it gave banks the lending power to create new paper money. In addition, in 1923, the Reserve Banks began purchasing government bonds in the open market to facilitate deficit spending and to add to the paper money supply.

Prices could have gone down during the twenties; it was a period of high production. But it became apparent that the Federal Reserve Board was following a policy aimed at stabilizing prices. Later, John Maynard Keynes hailed "the successful management of the dollar by the Federal Reserve Board from 1923 to 1928 . . ."

2. Meanwhile, the New York Federal Reserve extended credit directly to the Bank of England to offset the damage done by the British inflation (just as it did during the sixties). Similar credits were extended to the central banks of Belgium, Poland, and Italy.

3. In August 1921, Congress authorized one billion dollars in credits to the War Finance Corporation, to be lent directly to farmers' cooperatives and foreign importers of American farm goods. The purposes of the bill were to raise farm prices, provide cheap credit to farmers, and increase farm exports. There hasn't been a free market in agriculture since then.

4. During the First World War, the government seized the railroads. They were finally returned to their owners in 1920. But in 1926, the Railway Labor Act was passed. This imposed upon the railroads the same sort of regulation that the National Labor Relations Act later brought to the rest of American industry.

5. Federal taxing policies were used to influence activity in the stock market. In addition, the futures markets were regulated as a result of the Capper Grain Futures Act and the Futures Trading Act.

6. Business regulation started with the signing of the Constitution and its provisions for tariffs and interstate commerce laws. But it was greatly heightened by the anti-trust legislation passed at the turn of the century, plus the establishment of the Federal Trade Commission, the Interstate Commerce Commission, etc.

So please don't delude yourself by looking to the government to prevent the inevitable consequences of inflation. That's asking the problem to provide the solution.

There's never been any shortage of governmental intervention in the economy. But those who say, "We won't have a rerun of 1929 because the government has more power to intervene," are actually correct. The government *does* have more power; and so we won't have a rerun of 1929.

We'll have something more severe.

In general, American depressions have been getting steadily worse. As the government develops more "sophisticated" techniques for prolonging inflationary cycles, it causes more painful liquidation periods.

INFLATION IN THE TWENTIES

The seeds of the 1929 depression were planted in the First World War and the inflation that accompanied it. After the war, some of the paper money was cleared out, causing the recession of 1921.

Then the state embarked upon a full-scale inflationary cycle lasting through 1928, at which point money substitutes outnumbered the real money by a ratio of eight to one.

PAPER MONEY SUPPLY
(December 31, 1928)

Checking Account Deposits:	$23.1 billion
Currency in Circulation:	3.6 billion
Total Money Substitutes:	$26.7 billion
Gold Stock (real money):	$ 3.0 billion

The big problem facing the money managers in late 1928 was the heavy demand to redeem gold, coming from both Americans and foreigners. The Federal Reserve Board chose to meet the issue by deflation, rather than by devaluation. The inflationary cycle ended and the inevitable miscalculations started coming to light.

THE STOCK MARKET

It's important to realize that the stock market, like everything else in the economy, displays the effects of inflation. In fact, it's a particularly sensitive indicator of paper money in circulation because of its liquidity, its constantly changing price structure.

The stock market not only responds to inflation, it also benefits from it. It's like the swimming pool industry. It's an ideal investment receptacle for people who've been led to believe they have more money than they really do. In an inflationary cycle, many people who have no business investing think they have the funds to do so.

This pushes stock prices up faster than the general price rise. Other people, viewing the stock market from outside, see it as a way to beat the depreciation of the dollar. They withdraw their savings from banks and buy stocks instead.

The availability of margin credit adds to the number of people betting on higher stock prices. But margin credit isn't the culprit of the stock market orgies. The villain is inflation. Without inflation, there wouldn't be the feeling that higher prices are inevitable. People wouldn't be so anxious to use margin if they thought there was a good chance the stock price might drop; for losses are greater if the falling stock is margined.

In addition, the paper money needed for margin loans wouldn't be available without inflation.

The new paper money flowing into the stock market bids the prices of stocks well beyond the levels justified by any prosperity the companies involved are experiencing. So we see stocks selling at 30 to 100 times their earning values.

At that point, the stock market moves by *psychology* rather than fundamentals. It's no longer a question of what a particular *company* is likely to do in the future. The question is: what will *other speculators* think the stock of that company will do?

Chartists take over the market, looking for statistical trends, "break-outs," and other phenomena of *mass psychology*. The real fundamentals are ignored: supply and demand, company profits, markets, management, etc.

But when the inflation ends, the stock market begins to drop — *inevitably*. It *has* to drop because there's no longer enough paper money to support the higher price level.

All during 1929, people in the stock market fought to push the market to higher levels. They succeeded temporarily, despite the deflation beginning around them. But the break had to come. By October, the point had been reached where it was literally impossible to support the old price levels; the paper money just didn't exist any more.

The panic on October 29 wasn't the cause of the depression, nor even the beginning of it. It was simply the irrefutable signal that there was a depression in progress — that the dream world had ended. The price was about to be paid for years of tinkering with the money supply.

All speculative orgies are the result of inflation. Neither stock booms nor land booms could be sustained without inflation. There just aren't the resources available for people to buy-at-any-price unless inflation is pouring paper money into the economy. And the booms always collapse when the inflation ends.

THE DEPRESSION BEGINS

Surprisingly, once the inflationary cycle ends, there doesn't have to be widespread misery. The greatest losers will be the businessmen who have large sums of capital tied up in production facilities and inventories that aren't needed.

With the inflation over, prices and wages will drop to whatever realistic points are required to get things moving again. Unwanted inventories will move at *some* price; and workers can be employed at *some* wage. No matter what the state of the economy, there are an infinite number of unsatisfied human desires; thus, there's always a market for someone to work to satisfy them.

But what distinguishes a painful depression from a mild recession is the inability to get it over with. If the government has enough control over the economy, it usually will use that power to *prevent* wages and prices from falling to their natural levels. For some strange reason, high prices and high wages are assumed to be symptoms of a healthy economy — whereas they are only symptoms of inflation.

And so everything is done to hold the price level up, even though it isn't possible to trade at those higher prices. And, in the process, the economy comes to a dead stop. You can't have a world of high price levels when the paper money needed to support those levels is no longer there.

The 1929 depression evoked the ultimate in governmental interference. Herbert Hoover has been characterized so often as a "do nothing" President and the symbol of the "rugged individualist." But that isn't true. He reacted to the depression by calling for a fantastic program to keep wages and prices high, and to prevent the liquidation of mistakes.

He vowed to reverse all previous governmental policies in fighting this depression. And he did. In the process, he succeeded in keeping the economy immobilized.

When Franklin Roosevelt ran against Hoover in 1932, he castigated the President for his big-government techniques. He promised to cut the size of government and to let free enterprise make its way out of the depression unhampered.

Naturally, that never happened. Politicians only call for the reduction of powers they don't hold themselves. Governors, in general, are for states' "rights." Presidents are for federal "rights." If you want to change a governor's attitude toward federal power, make him President.

Roosevelt decided on a different policy from that pursued by Hoover, however. He was anxious to get the engine of inflation going again. But there was still that strain on the gold stock.

So he removed the pressure by prohibiting Americans from owning gold (a 100% devaluation), and then devalued the dollar by 41% for foreigners.

This gave him clear sailing to inflate with a vengeance. And he did.

But he continued to force wage and price levels as high as possible, and they managed to stay ahead of the inflationary push. So nothing happened. At the end of the thirties, there was still no improvement. And by that time, the economy was tied up in red tape.

Finally, the preparation for war created an all-out inflation that broke the price-fixing logjam, and things began to move.

Since then, we've been on one long inflationary spree. Each attempt to slow down the cycle has been met with a recession and a quick return to more inflation. The mistakes being piled up are enormous; and the problem has reached far greater dimensions than those that existed in 1929.

The next time you read that we're in the longest sustained "boom" in American history, you must remind yourself that, unfortunately, this means we're awaiting the worst depression yet.

The boom is unreal; but that doesn't mean that all the prosperity is. America's great productive strength has grown steadily since the industrial revolution. It's the growth in technical proficiency that has brought us prosperity. That growth is the only meaningful kind of progress in the real world. To whatever extent there is inflation, to that extent the prosperity is *diminished*.

How can one believe that the hundreds of billions of dollars spent on wars and foreign aid and welfare can possibly produce prosperity? That capital and energy and time could have gone into building things that actually improved our standard of living. Instead, the resources have been diverted into non-productive enterprises that reduced what we'd have had otherwise.

It staggers the mind to wonder what we'd be enjoying today if we hadn't lost so much of our productivity to wasteful endeavors encouraged by the inflationary cycle.

How far has that cycle gone? Here is the scorecard:

PAPER MONEY SUPPLY[7]

(December 30, 1970)

Checking Account Deposits:	$211.1 billion
Currency in Circulation:	48.9 billion
Total Money Substitutes:	260.0 billion
Gold Stock (real money):	$11.1 billion

The inflationary ratio was eight to one in 1928. Now it's 25 to one. The money substitutes are 25 times the gold stock backing them up.

These are mere figures and I know of no magic formula that attaches any particular significance to any particular ratio. But since 1966 the ratio has changed its direction. Even the slight decrease in the ratio in 1970 was due more than anything else to a slight increase in the gold supply.

WILL THE GOVERNMENT SAVE US?

We still hear over and over again that there could never be another depression because the government has the power to prevent it. But how can the government prevent it? In the first place, as we've seen, the government is the problem.

Depressions aren't caused by stock market speculation, by unregulated free enterprise, by gold speculators, by greedy profiteers, by shortages of demand, by capitalism, nor by lack of confidence. Depressions are caused by the government's inflationary printing of paper money.

---

[7]Source: Federal Reserve statistical release, *Assets & Liabilities of all Commercial Banks in the U.S.*, January 12, 1971. Figure for checking account deposits includes U.S. Government deposits and all other demand deposits (but not including deposits of other banks).

Secondly, even if the government did have the power to stop a depression, how could anyone be willing to put his faith in the government's ability to use it wisely?

This is the same government that has promised since 1964 to put an early end to the Vietnam war. This is the government that solved our financial problems by removing the gold reserve requirements for paper money and bank deposits.

This is the government that today, while the economy is already dizzy from deficit spending, is toying with more ambitious programs for outer space and free medical care for everyone.

Even if the government did have the power to prevent depressions, who could believe that every one of the two million bureaucrats who have anything to do with the problem will handle his role wisely? Is that where you want to put your faith?

How does the government plan to deal with runaway inflation? No one has suggested putting an end to the inflationary printing of paper money. Instead, all the discussions revolve around wage and price controls. That will just make matters worse. There's no way to control *every* wage and price. So, with the real inflation continuing unchecked, the prices of all *un*controlled products and services will continue to go up.

That makes it unprofitable for individuals whose income is controlled to continue selling their products and services at the controlled prices. So they quit producing and tremendous shortages result.

And I'm sure that while that's happening, there'll be plenty of spokesmen to tell us how capably the government can control the economy.

The fact is that the government *can't* control the economy. Such a thing is a literal impossibility. Whenever it tries, it only makes matters worse.

There's no way the government can repeal the natural law that you'll only produce or exchange when you believe it will lead to something you want. And yet, every governmental economic rule is an attempt to repeal that law — so every interference with the market fails to fulfill the "noble" purpose that was intended.

Some people believe that an end to the war in Vietnam would save the economy. I don't. It's true that giving those billions of war dollars back to the people to spend for themselves would help considerably — but even that wouldn't be enough to reverse the history of the past thirty years.

And it's foolish to think that the money actually would be returned to the people in the form of tax relief or an end to deficit spending. It's almost inevitable that the money would be kept in Washington to be spent on every conceivable scheme the frustrated politicians can dream up.

Big government always goes on unchecked. The end of the Korean war had no effect whatsoever upon the growth of government. Neither will an end to the war in Vietnam — if and when it ever happens.

And don't be naive enough to think that a change of administration would make any difference. Since the first world war, not one president has done anything to reverse the trend. Each one has been a slave to the merry-go-round he inherited.

So how could we possibly believe the government will be our salvation? It's the government that put us in this mess — and it's the government that aggravates it daily.

Economic cycles are a fact of life. And they'll continue to be so — as long as most people believe governments are capable of doing for them what they're unwilling to do for themselves.

And we're rapidly approaching the crisis point of this economic cycle. There's no way it can be prevented — although it may be delayed and aggravated by further governmental schemes. But there's no way the clichés we continually hear can solve the problem.

We're told that all we need is confidence. But confidence in what? Confidence that the immutable laws of economics have been repealed? Confidence that the world is going to start spinning in the opposite direction from now on? Confidence that acts no longer have consequences?

Can a man falling from a 30-story window, pulled toward the ground by gravity, solve his problem with confidence?

We're told that we don't need gold. "After all, the dollar is backed by the tremendous productive capacity of the nation." That has a nice ring to it — until you examine it a little more closely. For what's being said is that the government apparently has the right to confiscate *your* production to back up *its* currency.

The currency and the economy are two different things. The government is wholly responsible for the currency it issues. We, as individual human beings, are responsible for our own productivity. If you'd like to pledge your wealth, your resources, and your production as the backing for the government's currency, you're welcome to. But I find the idea less than appealing.

Money is a commodity that's accepted in exchange. It's not a hope, not an abstraction, not a measure of production, not a short-term note. It's a commodity that individual human beings are willing to hold while waiting to make purchases.

No one will produce or exchange unless he believes it will lead ultimately to something he wants.

You can't impose a valueless money system upon people and expect that there won't be reactions. Gold and silver evolved as money commodities out of billions and billions of human exchanges. They won't be superseded within our lifetimes. Governments can reject them, but individuals will continue to use them.

That won't stop government officials from looking for ways to replace gold, however. But there is no way out of their dilemma. Special Drawing Rights ("paper gold") aren't the answer. World

currencies aren't the answer. There isn't any answer, because the money managers don't even understand the question.

Governments don't like gold because it tells them when they do wrong things. Without the gold, they might be able to stretch their misdeeds a little further.

But it won't stop the consequences. They're inevitable.

You can't build a monetary system on sand and expect anything but dire consequences.

And that's exactly what we have today — a system that's based upon a commodity with no inherent value.

Advantages of Gold & Silver as Money:	Advantages of Paper as Money:
1. Durable	1.
2. Divisible	2.
3. Convenient	3.
4. Consistent	4.
5. Accepted Value	5.

AFTERWORD

Afterword

The investment world can seem to be a mysterious place - filled with moving averages, IPOs, reverse spreads, stochastics, a "Footsie" index, the Fed "injecting" and "draining" liquidity, and more ratios than you might care to hear about.

When Harry Browne entered the investment world in the 1960s he set out to understand it all. But the more he learned about sophisticated techniques, supposedly savvy strategies, and the secrets of the very rich, the more he came to understand that the real secret of investing is just this: **Keep it safe and simple**.

You don't have to become an investment expert to protect your savings. There are ways to assure that you won't be hurt - whatever may come.

The best way is to set up your own investment Permanent Portfolio. Within one day of doing so, you can have a safe portfolio that you'll never have to tinker with again. It's called a Permanent Portfolio because once you set it up, you don't have to continually reevaluate it, alter it, or even think about it. And it doesn't matter whether next year brings prosperity, inflation, recession, or even a depression; you'll know you're safe - no matter what.

Fail-Safe Investing, a short book by Harry Browne, shows you how to set up a Permanent Portfolio. It can be read in one to two hours. And it tells you everything you need to know to set up your own investment portfolio - including sources for obtaining the investments.

And no matter how much or little your investment experience, this book will show you how to handle your investments with minimum effort and no worry, and yet make sure your wealth (however large or small) is safe and growing. Written in Harry Browne's patented easy-to-follow style, sprinkled with his good humor, and with every detail covered, you'll never need another investment book.

Unlike most investment books, it won't teach you a secret theory of investing. Instead, it presents 17 simple rules that will remind you of what you already know and give you the confidence to act on that knowledge.

These rules will protect you against the unreality prevalent in so much writing and conversation about investing. The rules will assure that your investments will enhance your life and will grow into a safe and comfortable retirement. And they will make certain you don't lose your hard-earned money.

In Part I, you will look at the 17 rules. Since most of them are largely self-evident, they require very few words to explain. You can read through all the rules in 60 minutes or less.

Part II provides background information and some not-so-obvious examples of heeding or ignoring each rule.

While the rules are largely warnings to exercise prudence, they won't stop you from making profits. They even leave room for trying to strike it rich with part of your money, if that's what you want to do. But their first job is to keep you from making any mistake that could be financially fatal.

Investing doesn't have to be difficult, dangerous, complicated, or mysterious. It demands only that you relax and keep your head, that you approach the investment world in the same way you've handled the rest of your life - even if everyone you know chooses not to.

These rules are by far the most important truths Harry learned in his 35 years in the investment world. They made money for him, they kept his investments safe, and they made his investment life simple.

For over 30 years Harry Browne showed investors how to protect their assets from turbulent markets. Even during periods when inflation and recession buffeted the economy, people made money following his advice. For 27 years he published an investment newsletter, costing $225. His personal consultations cost hundreds of dollars.

Harry Browne's Permanent Portfolio approach has been adopted by wealthy and middle-class investors alike, by sophisticated speculators and by people who just want to be sure their savings are absolutely safe. You can learn how to construct a bulletproof investment portfolio for only $9.75.

To download *Fail-Safe Investing* go to: www.Trendsaction.com

or

To order a hardcover version visit the Harry Browne Store at:
www.HarryBrowne.org

ABOUT THE AUTHOR

Harry Browne was an American free-market Libertarian writer and the Libertarian Party's 1996 and 2000 candidate for President of the United States. He was also a well-known investment advisor for over thirty years, author of "Harry Browne's Special Report" – a financial newsletter published from 1974 - 1997, author of 18 books and thousands of articles, co-founder of the libertarian Downsize DC Foundation, host of two weekly network radio shows -- one a political and the other a financial show, host of an ETV (internet-based television) show called "This Week in Liberty with Harry Browne" on the Internet based Free Market News Network, a consultant to the Permanent Portfolio Family of Funds, and a popular public speaker.

He was a little known investment advisor when his first book, *How You Can Profit from the Coming Devaluation*, was published in 1970. Recognizing the disastrous monetary policy of the U.S. government, he warned that the dollar would be devalued, inflation could be severe, and gold, silver, and foreign currencies should skyrocket in value. The book's theme clashed with the prevailing wisdom, but it struck a chord with tens of thousands of Americans, and the book made the *New York Times* bestseller list.

In 1973 he published How I Found Freedom in an Unfree World, a self-help book that shows individuals how to take responsibility for their own lives. Many people consider the book to be a modern classic, and it remains in demand three decades after its first publication.

His 1974 book, *You Can Profit from a Monetary Crisis,* was an even greater success -- remaining on the *Times* bestseller list for 39 weeks and reaching #1. Its message amplified themes from his first book, and it allowed thousands of investors to hold their own and to profit during the turmoil of the late 1970s. He wrote six more big-selling investment books -- including one more *Times* bestseller. In 1999 he published his final investment book, Fail-Safe Investing.

His 1995 book, Why Government Doesn't Work, provided a provocative mix of ideas that spoke to hundreds of thousands of Americans who felt frustrated by big government. The Great

Libertarian Offer, was published in June, 2000. His 2004 book was Liberty A to Z: 872 Libertarian Soundbites You Can Use Right Now!

In Browne's presidential campaigns, he made appearances in almost every state, and he appeared on over a thousand radio and television programs. His pure approach to smaller government was praised in scores of newspaper editorials and political columns. He won numerous Internet preference polls and was endorsed for president by dozens of radio talk show hosts and journalists.

During his career he appeared on the *Today* show, *Hannity & Colmes*, *The O'Reilly Factor*, *Meet the Press*, *Politically Incorrect*, *Wall $treet Week*, *The Larry King Show*, and hundreds of other national and local radio and television shows.

Browne had a daughter, Autumn, and in 1985 married the former Pamela Lanier Wolfe. His main non-professional interests were classical music, fiction, opera and operettas, good food and wine, sports, and television. He was born in New York City, grew up in Los Angeles, and died from a motor neuron disease (e.g. ALS) at his home in Franklin, Tennessee on March 1, 2006 with his devoted wife, Pamela, beside him.