THE FREE MARKET

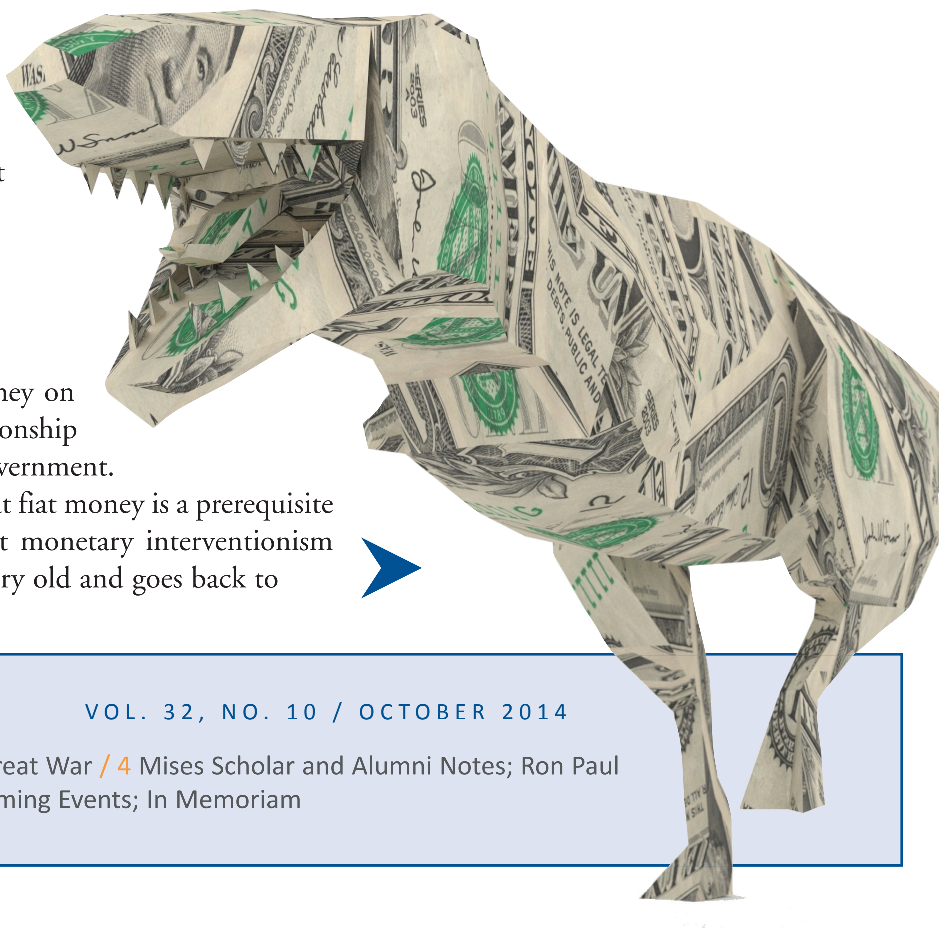
THE MONTHLY PUBLICATION OF THE MISES INSTITUTE

The Cultural and Political Consequences of Fiat Money

JÖRG GUIDO HÜLSMANN

It may seem unusual that an economist would talk about culture. Usually, we talk about prices and production, quantities produced, employment, the structure of production, scarce resources, and entrepreneurship.

But there are certain things that economists can say about the culture, and more precisely, that economists can say about the *transformation* of the culture. So what is culture? Well, to put it simply, it is the way we do things. This can include the way we eat — whether or not we dine with family members on a regular basis, for example — how we sleep, and how we use automobiles or other modes of transportation. And of course, the way we produce, consume, or accumulate capital are important aspects of the culture as well.



Limiting Budgets Is the Key to Limiting Governments

Now to understand the effects of fiat money on the culture, we must first look at the relationship between financial systems and the nature of government.

A number of economists have observed that fiat money is a prerequisite for tyrannical government, and the idea that monetary interventionism paves the way for tyrannical government is very old and goes back to

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Nicolas Oresme in the fourteenth century. It has not been emphasized in the twentieth century, but Ludwig von Mises is among the few who has stressed the importance of this relationship.

Mises said that when it comes to limiting government power, it is essential that the government is financially dependent on the citizens, and this addresses the fundamental political problem of controlling the people in office once they are there. We know that generally, once they are in office, elected politicians turn around and do very different things than they said they would do, with many acting contrary to the common good and interests of their constituents.

So how do we ensure that the people in power can be controlled?

Mises tells us the way we control government is through the budget, and this is necessary in a free society. In a democratic system, at least, we elect certain people to the government, and they often enter office believing that they have a mandate to do certain types of things while in office.

But it's not sufficient that the people tell government officials *what* they should be doing. It is equally important, if not more important, to dictate how *much* money the government will have to achieve those ends. So, it is not enough to tell the government that it will only protect private property. This mandate could be pursued with $100,000 or a billion dollars depending on what the people are willing to pay. So if the budget it not controlled, a limited mandate in itself offers no limitation on taxation or how much money is spent.

Mises believed that those who paid the taxes would then need to specifically limit the size of the government budget. The mission of the government does not by itself determine the amount of resources to be used in the mission.

In response, many will complain that if budgets are tightly controlled, then we'll *never* have an increase in government services because people hate taxes. That might be so, but, of course, that is the point.

Now, if we abandon a strict connection between what the citizens pay and what government spends, then we find that we move away from rule by the citizens who are being taxed, and toward greater rule by the elites.

The first way this shift can happen is by the government going into debt. The financial relationships then shift toward the new group that is funding the government, namely those who are extending credit to the government. This then weakens the relationship to the citizens who are being taxed, and it also allows the government to spend more money than would have been possible with taxation alone.

Now of course fiat money allows government to take out loans to an unlimited extent because fiat money by definition can be produced without limitation, without commercial limitation or technological limitation, and can be produced in whatever amount is desired. In this way, the government benefits from the support of a central bank, which is to be expected because the central bank itself depends on the legal framework of monopoly provided by the government.

Through these means of finding government revenues outside of directly taxing the population, we see then that fiat money allows for an extension of government activities unconnected to the willingness of the population to actually support revenue increases. In turn, the government's rule becomes rule by elites such as central bankers and financiers rather than rule by the

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How Wilson and the Fed Extended the Great War

BRENDAN BROWN

As the world reflects on the incomprehensible horror of the Great War which erupted 100 years ago there is a question which goes unasked in the media coverage. How was there no peace deal between the belligerents in 1915 or at latest 1916 once it became clear to all — especially after the Battle of the Somme — that the conflict had developed into a stalemate and holocaust of youth?

While there had been some early hopes for peace in 1916, they quickly evaporated as it became clear that the British government would not agree to a compromise deal. The political success of those who opposed compromise was based to a considerable degree on the argument that soon the US would enter the conflict on the Entente's (Britain and France) side.

Although the US had allowed the Entente (but not the Central Powers) to access Wall Street without restriction during the first two years of the war, the historical evidence shows that President Wilson had been inclined to threaten Britain with the ending of its access to vital US market financing for its war effort if it failed to negotiate seriously for peace. But Wilson was dissuaded from urging peace on the negotiators by his political adviser Colonel House.

A less well-known story is the role of the then-newly created Fed (which opened its doors in 1914) and its allies within the Wilson administration in facilitating Entente finance. Two prominent Fed members — Paul Warburg and Adolph Miller — had fought a rear-guard campaign seeking to restrict their new institution from discounting trade bills or buying acceptances (largely financing munitions) issued by the belligerents (in practice, the Entente Powers). But, they had been thwarted by the persistence of the New York Fed chief Benjamin Strong (closely allied to J.P. Morgan and others who were gaining tremendously from arranging loans to France and Britain) and the Treasury Secretary McAdoo, the son-in-law of President Wilson. (McAdoo, whose railroad company had been bailed out personally by J.P. Morgan, was also a voting member of the Federal Reserve Board).

Milton Friedman has argued that the creation of the Federal Reserve made no difference to the US monetary and economic outcomes during the period of neutrality (up until March 1917) or during the US participation in the war (to November 1918). The difference, Friedman contended, came afterward when the Fed allowed rapid monetary growth to continue for a further year. Under the pre-Fed regime, Friedman argues, the US would also have experienced huge inflows of gold during the period of neutrality and under existing procedures (for official US gold purchases), and these would have fueled rapid growth of high-powered money and hence inflation. In the period of war participation, the Treasury would have printed money with or without the Fed (as indeed had occurred during the Civil War).

There are two big caveats to consider about Friedman's "the Fed made no difference" case. The first is that the administration and Wall Street's ability to facilitate the flow of finance to the Entente would have been constricted in the absence of backdoor support (via trade acceptances and bills) by the new

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Mises Scholar and Alumni Notes

Senior Fellow **MARK THORNTON**'s article "Skyscrapers and Business Cycles," which was published in the *Quarterly Journal of Austrian Economics* (Spring 2005), will be translated into Portuguese and published in *Mises: Revista Interdisciplinar de Filosofia, Direito e Economia*, the scholarly journal of the Mises Institute of Brazil.

Associated Scholar **RICHARD EBELING** was appointed the BB&T Distinguished Professor of Ethics and Free Enterprise Leadership at The Citadel in Charleston, South Carolina. He will teach courses on "The Ethics and Economics of Capitalist Society" for both undergraduate and graduate students in the School of Business, and will be arranging programs and activities for Citadel students and the general public highlighting the moral foundations and the practical importance of free-market capitalism in modern society.

Two sessions of the APEE (Association of Private Enterprise Education) conference this year in Las Vegas were devoted to Associated Scholar **ROGER GARRISON**'s work, including his 2001 book, *Time and Money: The Macroeconomics of Capital Structure*.

Associated Scholar **PER BYLUND** was recently invited to serve (and accepted a three-year term) on the editorial board of the *Strategic Entrepreneurship Journal* (SEJ). The SEJ is an up-and-coming journal, published by the Strategic Management Society. Dr. Bylund also published the chapter "The Firm and the Authority Relation: Organization vs. Hierarchy," in the volume *Austrian Theory and Economic Organization: Reaching Beyond Free Market Boundaries*, edited by Guinevere Liberty Nell, published by Palgrave MacMillan.

Alumnus **BRUCE KOERBER** recently published *More Than Laissez-Faire*, an Austrian "macroeconomic textbook alternative." The book is available from Invisible Order publishers.

Associated Scholar **PAUL PRENTICE** taught "Constitutionomics" at the Constitution Camp in Colorado Springs this year.

Associated Scholar **JASON JEWELL** recently appeared on the *Tom Woods Show* to discuss essays contributed to *Christian Faith and Social Justice: Five Views*, Vic McCracken, editor. The book is now available from Bloomsbury Academic publishers.

Former Mises Fellow and Mises University Alumnus **JINGJING WANG** recently completed requirements to become an official PhD candidate at the University of Missouri. She is now on track to complete her PhD in May 2015.

Mises University Alumnus **DAVID RAPP** received his PhD from Saarland University in Saarbruecken, Germany in May 2014 (summa cum laude). He is now a visiting professor at Grove City College at the invitation of Senior Fellow **JEFFREY HERBENER**. He will be staying at Grove City College for the fall semester, conducting research, and teaching the course "Investment Theory and Business Valuation."

Faculty, Alumni, Members, and Donors: Send us your news at updates@mises.org.

Ron Paul Heads to Brazil

Ron Paul, Distinguished Counselor to the Mises Institute, recently travelled to Brazil at the invitation of long-time Mises Institute supporter Hélio Beltrão, founder and president of Mises Brasil. Jeff Deist writes, "Dr. Paul was received like a rock star at the 2014 Conferência De Escola Austríaca in Sao Paulo, with more than 400 people attending his keynote speech."

(Left) Hélio Beltrão holds up a recent interview with Ron Paul from the Brazilian magazine Veja.

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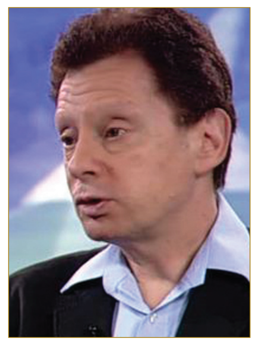
"creature of Jekyll Island" (the Fed). The second is that both camps within the Fed (Benjamin Strong on the one hand, and Paul Warburg and Adolph Miller on the other) were united in welcoming the accumulation of gold on their new institutions' balance sheet. They saw this as strengthening the metallic base of the currency (both were concerned that the Fed's creation should not be the start of a journey toward fiat money) and also as a key factor in their aims to make New York the number-one financial center in the world, displacing London in that role.

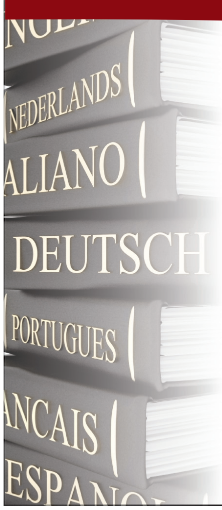
Without those hang-ups it is plausible that the US would have trodden the same path as Switzerland in dealing with the flood of gold from the belligerents and its inflationary potential. That path was the suspension of official gold purchases and effective temporary floating of the gold price. The latter might have slumped to say $10–14 per ounce from the then official level of $21 and correspondingly the dollar (like the Swiss franc) would have surged, while Sterling and the French franc come under intense downward pressure. In effect the Entente Powers would not have been able to finance their war expenditures by dumping gold in the US and having this monetized by the Fed and Treasury — a process which effectively levied an inflation tax on US citizens.

This suspension of gold purchases would have meant a better prospect of there being a gold-standard world being recreated in the ensuing peace. The exhaustion of British gold holdings during the war ruled out the resurrection of Sterling as gold money. Its so-called return to gold in 1925 was in fact a fixed exchange rate link to the US dollar. The US would have been spared much of the cumulative wartime inflation. The Fed would not have been so flush with gold that it could have tolerated the big monetary binge through 1919 before ultimately being forced by a decline in its free gold position to suddenly tighten policy sharply and induce the Great Recession of 1920–21. That episode led on to the Fed focusing during the 1920s on modern monetary management (counter-cyclical policy changes and price stabilization). The consequences of that focus, ultimately fatal to the gold order, were the Great Boom and the Great Depression.



Brendan Brown is Chief Economist and Head of Economic Research at Mitsubishi UFJ Securities International, and the author of *The Global Curse of the Federal Reserve* and *Euro Crash: The Route Back from Monetary Failure in Europe*.

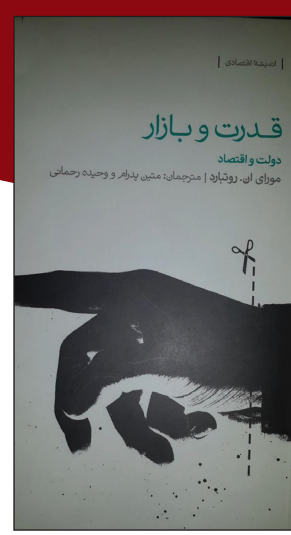
New Translations



Murray Rothbard's *Power and Market* is now available in Persian thanks to the efforts of translator Matin Pedram.

Thanks to Tyler Xiong Yue, numerous presentations are now available at the Mises Blog in video format with Chinese subtitles, featuring talks from Jeffrey Herbener, Robert Higgs, and Peter Klein, among others.

Yue, who reports that he will soon be studying Austrian economics under Senior Fellow Jesús Huerta de Soto in Spain, has also helped publish Philipp Bagus's *The Tragedy of the Euro* in Chinese.



Power and Market

taxpayers, and the government's ability to spend becomes more dependent on the ability to access fiat money than the ability to convince the citizens to accept a higher tax burden.

The Cultural Features of a Debt Economy

Now we come to the many ways through which a fiat money system affects the behavior of ordinary citizens.

One of the central features of a fiat money system is that it tends to produce near-permanent price inflation. This contrasts with the workings of an economy based on natural monies such as gold and silver. Here the price levels tend to stay flat over the long run or decline, especially in the presence of vigorous economic growth. We saw this throughout the nineteenth century in both Europe and the US, where deflationary growth has been the rule.

The reality of price inflation shapes culture in a variety of ways and much of this is deliberate, as it has long been an idea among government planners and ideologues of all sorts, even before Keynes, that ordinary people should be prevented from "hoarding" money at their homes.

In a free economy with a natural monetary system, there is a strong incentive to save money in the form of cash held under one's immediate control. Investments in savings accounts or other relatively safe investments also play a certain role, but cash hoarding is paramount, especially among low-income families.

By contrast, when there is constant price inflation, as in a fiat-money system, cash hoarding becomes suicidal. Other financial strategies now become more advisable. It becomes advisable to exchange one's cash for "financial products," thus offsetting the loss of purchasing power of money through the return on that financial investment. It also becomes advisable to go into debt and leverage one's investments. In a word, it becomes rational to pursue riskier investments in order to find a rate of return that can match or exceed the rate of price inflation. This is true across all sectors, including households and productive operations.

Before the twentieth century and widespread access to fiat money, debt was far less common and there were cultural imperatives against going into debt for consumption. Credit for households, for example, was virtually unknown before the twentieth century, and only very poor households fell back on debt to finance consumption.

But in a fiat money system, as price inflation diminishes the value of one's monetary savings, we are encouraged to adopt a short-term perspective. That is, we need to hurry up to obtain credit as soon as possible and obtain revenue from that debt as soon as possible, because savings lose value if we just hold on to cash.

It no longer makes sense to save up money for a decade to buy a house, for example. It is much more opportune to go into debt to buy a house immediately and to pay back the loan in devalued money. There is then a generalized rush into leverage in a fiat money system since debt-financed investment brings greater returns than savings in cash or equity-financed investments.

It needs to be stressed that this tendency has no natural stopping point. In other words, fiat-money systems tend to make people insatiable in their quest for ever higher monetary returns on their investments. In a natural monetary system, as savings increase, the return on investments of all sorts diminishes. It becomes ever less interesting to invest one's savings in order to earn a return, and thus other motivations shift into the foreground. Savings will be used increasingly to finance personal projects including the acquisition of durable consumers' goods, but also philanthropic activity. This is exactly what we saw in the West during the nineteenth century.

By contrast, in a fiat money society, you are more likely to increase your returns by remaining in debt and continuing to chase monetary revenue indefinitely by leveraging more and more funds.

You can imagine, then, how this inflation and debt-based system, over time, will begin to change the culture of a society and its behavior.

We become more materialistic than under a natural monetary system. We can't just sit on our savings anymore, and we have to watch our investments constantly, and think about revenue constantly, because if it is not earning enough, we are actively getting poorer.

The fact that the fiat money system pushes us into riskier investments also increases dependency on others because one must depend on the good behavior of those on whom the value of our investments depend.

Similarly, the stronger the level of debt the stronger is

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COMING EVENTS

Register online at mises.org or by phone at 800.636.4737.

November 8, 2014	WEST COAST REGIONAL MISES CIRCLE IN COSTA MESA, CALIFORNIA
January 24, 2015	SOUTHWEST REGIONAL MISES CIRCLE IN HOUSTON, TEXAS
March 12–14, 2015	AUSTRIAN ECONOMICS RESEARCH CONFERENCE • Mises Institute
June 7–12, 2015	ROTHBARD GRADUATE SEMINAR • Mises Institute
July 19–25, 2015	MISES UNIVERSITY • Mises Institute

IN MEMORIAM

We mourn the passing at age 100 of long-time Institute supporter ELLICE MCDONALD, CBE. He was dedicated to sound money, and promoted the work of his friend, the anti-Fed, gold-standard economist Elgin Groseclose.

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the selfish concern about the behavior of others who may owe us money. So fiat money creates an attempt to control others through the political system.

But at the same time, no household and no firm individually has an interest in abolishing the fiat system and putting in its place a natural monetary system. The short-term costs of such a transition would be immense. In this, we see that we are in a "rationality trap" in which one is motivated to maintain the fiat money system in spite of all its downsides, and because the culture at this point is so transformed by more than a century of easy access to fiat money.

Conclusion

We can apply economic analysis to explain cultural transformation, and a particularly important example is fiat money. It has a very important impact on our culture. This is something we would not see unless we step back and take a longer-term historical perspective. Of course, there are many other factors that come into play, but fiat money is an important factor, and the system is perpetuated by the fact that everyone stands to lose in the short run if the current system ceases to function. Moreover, given how our modern culture has been so shaped by fiat money systems, it runs against the very cultural foundations of our current society. In spite of the many short-term costs, we should nonetheless dare to change this system, and it is ultimately a question of courage, and insight, and of the will. ■

Jörg Guido Hülsmann is Senior Fellow at the Mises Institute and professor of economics at the University of Angers in France. He has edited six books and is the author of *The Ethics of Money Production* and of *Mises: The Last Knight of Liberalism*. Email jgh@guidohulsmann.com.

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