Ludwig von Mises on the Gold Standard and Free Banking

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George Selgin and Lawrence White have sought to tie their modern free banking school to the views of Ludwig von Mises.[1] In a recent article, Selgin has attempted to state, critique, and improve upon Mises's defense of the gold standard, while White, in a contribution to a *Festschrift* for Hans Sennholz in 1992, has attempted to demonstrate that Mises favored fractional-reserve free banking (Selgin 1999; White 1992). Whatever the validity of their own views on the gold standard and fractional-reserve free banking, their assessments of Mises's positions on these issues are dubious.

The Ideal Monetary System

Selgin begins by claiming that "contrary to the impressions conveyed by some of his followers, Mises did not defend the gold standard on ideological or moral grounds"; but instead "Mises defended the gold standard . . . because he was convinced that a managed fiat money would prove less stable than gold." Selgin then seeks to show "how Mises's argument involves a peculiar and unsatisfactory blend of consequentialism and strict a priori reasoning." On the consequentialist branch, Selgin claims that "his case for gold was based in large part upon his denial of the possibility of measuring, even approximately, money's purchasing power." And on the *a priori* branch, asserts that Mises failed "to make a convincing a priori case for the gold standard" by arguing "that disagreements concerning the direction and extent of changes in money's purchasing power must render a managed fiat money a

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[1]One example is their aptly entitled article, "In Defense of Fiduciary Media—or, We are Not Devo(lutionists), We are Misesians!" (1996).

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plaything of politics" and thus less stable than the gold standard (Selgin 1999, pp. 259–60).

According to Selgin, the ideal monetary system for Mises permits changes in money's purchasing power from the goods side, that is, from changes in demands for and supplies of goods, but not from the money side, that is, from changes in demands for and supplies of money. Quoting Mises, Selgin writes:

> While recognizing that the more popular ideal was that of a money "whose objective exchange value is not subject to any variation at all, *whether originating on the money side or on the commodity side*" (emphasis in original), Mises held "a money with an invariable exchange value, *so far as the monetary influences on its value are concerned*" (emphasis added) to be the ideal "of enlightened statesmen and economists." (1999, p. 262)

Selgin, however, is mistaken in asserting that Mises agreed with these enlightened statesmen and economists. To the contrary, Mises found fault in both the "popular" and the "enlightened" views. Concerning the latter, Mises wrote:

> The ideal of a money with an exchange value that is not subject to variations due to changes in the ratio between the supply of money and the need for it . . . demands the intervention of a regulating authority in the determination of the value of money; and its continued intervention. But here immediately most serious doubts arise from the circumstance, already referred to, that we have no useful knowledge of the quantitative significance of given measures intended to influence the value of money. More serious still is the circumstance that we are by no means in a position to determine with precision whether variations have occurred in the exchange value of money from any cause whatever, and if so to what extent, quite apart from the question of whether such changes have been effected by influences working from the monetary side. Attempts to stabilize the exchange value of money in this sense must therefore be frustrated at the outset by the fact that both their goal and the road to it are obscured by a darkness that human knowledge will never be able to penetrate. (1980, p. 269)[2]

Mises thought it impossible to distinguish the causal forces behind a change in prices merely from the knowledge of the price changes themselves. That these causal forces are inextricably intertwined is implied from the nature of a foundational concept in economics, namely, preference. Since preference in a market economy normally is manifested by an exchange of money for goods, any time a ranking changes, for example, a unit of good is now ranked above a sum of money instead of below it, one cannot distinguish

[2]It should be noted that contrary to Selgin and other proponents of modern free banking, Mises thought that a government-regulated money system was necessary to achieve the ideal "of enlightened statesmen and economists."

from this fact alone whether the change is an increased demand for the good or a decreased demand for money. In fact, they are two ways of looking at the same thing. (Mises 1980, pp. 146, 153).

Although the division of determinants of changes in the exchange value of money into goods-side factors and money-side factors plays an essential role in developing theory about particular issues of money's value, it has no observable manifestation. Therefore, one cannot infer from the fact of a changed rank order of goods, let alone from the effects of such a change—for example, a rising exchange ratio of one good in terms of another—whether the value of one good has risen or the value of the other has fallen. Preferences are always relative, that is, comparisons between two options. This fact directly applies to questions concerning the measurement of money's value. Mises wrote:

> There are two parts to the problem of measuring the objective exchange value of money. First we have to obtain numerical demonstration of the fact of variations in the objective exchange value of money; then the question must be decided whether it is possible to make a quantitative examination of the causes of particular price movements, with special reference to the question whether it would be possible to produce evidence of such variations in the purchasing power of money as lie on the monetary side of the ratio. (1980, pp. 216–17)

Mises discusses the issues raised by attempts to measure money's value in considering the monetary policy proposed to achieve the inflationists' goal of perpetually stimulating economic activity and expanding exports while contracting imports. Although it is easy to imagine a situation in which the value of money falls by a constant rate, Mises denied that anyone could put such a monetary system into effect. He wrote:

> But however clearly we may be able to imagine such a monetary system, it certainly does not lie in our power actually to create one like it. We know the determinants of the value of money, or think we know them. But we are not in a position to bend them to our will. For we lack the most important prerequisite for this; we do not so much as know the quantitative significance of variations in the quantity of money. We cannot calculate the intensity with which definite quantitative variations in the ratio of the supply of money and the demand for it operate upon the subjective valuations of individuals and through these indirectly upon the market. This remains a matter of very great uncertainty. In employing any means to influence the value of money we run the risk of giving the wrong dose. This is all the more important since in fact it is not possible even to *measure* variations in the purchasing power of money. Thus even though we can roughly tell the direction in which we should work in order to obtain the desired variation, we still have nothing to tell us how far we should go, and we can never find out where we are already, what effects our intervention has had, or how these are proportioned to the effects we desire. (1980, pp. 256–57; emphasis in original)[3]

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[3]Also, see, idem, pp. 218–19 and 270–71.

Even if it were possible to accurately measure changes in money's purchasing power, policies to keep it falling at a constant rate (or for that matter stable) cannot be practiced because effects on money's purchasing power from changes in the money supply are determined by the subjective valuations of individuals as they change their preferences in the new situation. The impossibility of measuring money's purchasing power compounds the difficulty of forming policy, but it is not the root problem. Moreover, what gives rise to the political pressure that Selgin mentions is precisely the uncertainty about the need to intervene and the proper extent of intervention to counteract any undesirable changes in money's purchasing power, not "measurement problems" (Mises 1980, p. 269). As discussed below, Mises thought that the problems of measuring changes in the purchasing power of money that Selgin refers to, although theoretically impossible to solve, do not obstruct the conduct of monetary policy.[4]

Because these political pressures to conduct monetary policy would be absent in a gold standard, Mises concluded that a gold standard eliminates any arbitrary influence on money's purchasing power from the money side. Without this source of "instability," the gold standard is in theory more "stable," than a fiat money standard. About the political influences, Mises concluded:

> These possibilities, and the remembrance of very recent experiments in public finance and inflation, have subordinated the unrealizable ideal of a money with an invariable exchange value to the demand that the state should at least refrain from exerting any sort of influence on the value of money. A metallic money, the augmentation or diminution of the quantity of metal available for which is independent of deliberate human intervention, is becoming the modern monetary ideal. (1980, p. 269–70)

Far from joining the "enlightened statesmen and economists" in advocating a managed fiat money as the monetary ideal, Mises claimed that they were coming over to his view of the monetary ideal, that is, a metallic standard not subject to policy discretion. He based his claim on the following logic: eminent statesmen and economists desire a monetary system in which money-side fluctuations are absent; this requires a government managed system; but such a system will introduce an arbitrary destabilizing money-side influence on money's purchasing power; therefore, a metallic standard, although not without money-side influences on money's purchasing power, will be more stable; to most nearly attain their goal, the eminent statesmen and economists should prefer a metallic standard (Mises 1998, chaps. 26 and 27). Mises wrote:

> The significance of adherence to a metallic-money system lies in the freedom of the value of money from state influence that such a system guarantees. . . . It is true that [money-side] effects, in the case of gold (and even in the case of silver), are not immoderately great, and these are the only

[4]Selgin (1999, p. 267) himself quotes Mises on this very point.

> two monetary metals that need be considered in modern times. But even if the effects were greater, such a money would still deserve preference over one subject to state intervention, since the latter sort of money would be subject to still greater fluctuations. (1980, p. 270)

Mises, then, was not asserting what Selgin (1999, p. 262) claims for him, that is, an "ideal of money with a constant inner objective exchange value (but with an *outer* exchange value that varied directly with changes in real output)." Instead, Mises was demonstrating why the advocates of such an ideal should prefer a gold standard. Mises's own reasons for favoring a gold standard, which are examined below, were much broader and deeper; in part ideological, in part theoretical, and in part historical.

The Proper Target for Monetary Policy

Selgin (1999, p. 262) also criticizes Mises for failing to recognize that the ideal he claims for Mises is "in essence, equivalent to the modern idea of a nominal income (GDP) target."[5] This equivalence, according to Selgin, obviates the need to construct a price index as a target for monetary policy and thus sidesteps Mises's criticisms of using a price index in conducting monetary policy—which, to reiterate, Selgin considers Mises's primary criticism of policy that targets money's purchasing power. He speculates (Selgin 1999, p. 267) that one reason "Mises himself . . . never recognized the equivalence of a stable inner objective exchange value of money and stable nominal income" was "his refusal to employ the equation of exchange as a tool of reasoning." It seems unnecessary to speculate on his reasons, however. As outlined above, Mises thought the fundamental problem in conducting monetary policy that targeted money's exchange value was the impossibility of bifurcating goods-side and money-side influences on the purchasing power of money. No one can detect from any particular change in price of something what the underlying causal force is, whether it is goods side or money side. Therefore, one cannot find an accurate quantitative division of the total change in price into goods-side and money-side influences. Absent this division, one cannot determine the correct dose of monetary expansion or contraction, or even whether the money supply should be increased or decreased to hit the target. Mises did argue, as Selgin claims, that there is no unique, correct way to construct a price index and thus, using some price index as a measure of changes in money's purchasing power is arbitrary and the selection of which one to use is then subject to political pressure. But this point is not his fundamental criticism of a monetary policy that aims at eliminating money-side influences on prices. Even if some price index did, with unique correctness, measure

[5]Selgin deduces this from the quantity equation, $MV=Py$, by rearranging terms to show that $1/P=y/MV$ and thus nominal income (which equals MV) is equivalent to the money-side influences and is separable from the goods-side influences (namely, y) on money's purchasing power (namely, $1/P$).

changes in the purchasing power of money (so that all parties would agree to adopt it), one could not use the knowledge it provided about changes in money's purchasing power to bifurcate the total change into goods-side and money-side influences (Mises 1980, p. 218). The problem Selgin cites is just another strike against a managed fiat-paper money system for Mises, but not the decisive blow.

Moreover, it is doubtful that Mises would agree with Selgin's claim that such bifurcation can be done based on the equivalence between a stable nominal income and a stable inner objective exchange value of money. His rejection of Selgin's claim can be inferred from his discussion of Wieser's proposal to use real and nominal income as a method of calculating a price index (Mises 1980, pp. 219–20). Although not identical to Selgin's constant nominal income target, Wieser's scheme elicited the following criticism from Mises that can be applied to Selgin's suggestion. Mises wrote:

> The technical difficulties in the way of employing this method, which is the most nearly perfect and the most deeply thought out of all methods of calculating index numbers, are apparently insurmountable. But even if it were possible to master them, this method could never fulfill the purpose that it is intended to serve. It could attain its end only under the same supposition that would justify all other methods; namely, the supposition that the exchange ratios between the individual economic goods excluding money are constant, and that only the exchange ratio between money and each of the other economic goods is liable to fluctuation. This would naturally involve an inertia of all social institutions, of population, of the distribution of wealth and income, and of the subjective valuations of individuals. Where every thing is in a state of flux the supposition breaks down completely. (1980, p. 220)

Only if one assumes that goods-side influences are unchanged can he identify, from any change in price, the money-side influence. But goods-side influences are in continual flux and indissolubly intermixed with money-side influences. And this is true whether nominal income is rising, staying the same, or declining. A constant nominal income does not ensure constancy of the underlying demands for and supplies of goods and money and thus is no guide to bifurcating goods-side and money-side influences and, by implication, no guide to monetary policy that targets money's value. Moreover, if nominal income could be kept constant only by a government policy of changing the money stock to offset any changes in money demand (thereby neutralizing any money-side influence) as Mises thought would be necessary to conduct such monetary policy, far from neutralizing the effect of the change in money demand, this would inject a second money-side influence into the economy on top of the (presumed) change in money demand.[6] Even if monetary policy could put the additional money directly and immediately into the

[6]This conclusion follows from Mises's concept of the nonneutrality of money. See Mises (1980, pp. 61–62 and 160–68; 1998, p. 414).

hands of those particular people whose money demands had changed and in an amount proportional to the changes in money demand for each person, a change in money supply would still fail to neutralize a change in money demand since the effects on prices of the two changes are determined by subjective valuations, which can be different in different circumstances (Mises 1980, pp. 218–19). What makes the managed monetary system less stable than the gold standard, according to Mises, is that it lacks this policy-induced money-side influence on money's purchasing power.

THEORY AND HISTORY

Selgin alleges another problem with Mises's arguments about a gold standard vis-à-vis a fiat-money standard: inconsistency between his two conclusions. On the one hand, Mises holds that "gold is to be preferred to managed (fiat) money because of the lack of a reliable measure of money's purchasing power," but, on the other hand, he holds that "gold is to be preferred to managed money because the gold standard is more stable in practice" (Selgin 1999, p. 265). Selgin's assessment of Mises's case for gold is wrong on both counts. As discussed above, his claim that Mises favored gold because of the impossibility of constructing a scientific, that is, non-arbitrary, measure of money's purchasing power ignores Mises's more fundamental argument about the impossibility of bifurcating money-side and good-side influences on money's purchasing power. Selgin's claim that Mises preferred the gold standard because of its superior stability is also wide of the mark. One of the distinguishing features of Mises's monetary theory is his position that monetary stability is a chimera. Mises was fully aware that no monetary system, the gold standard included, could be judged on this ground. "The purchasing power of gold is not stable," he wrote, "but the very notions of stability and unchangeability of purchasing power are absurd." Even so, what Mises claimed for the gold standard is that "nobody is in a position to tell us how something more satisfactory could be put in [its] place." Mises did not think that the gold standard was the best monetary system because it was the most stable. His defense of the gold standard on this point was that it fettered the inflationary impulse of government, not that it attained the utopia of stability. "The adversaries of the gold standard do not want to make money's purchasing power stable," he wrote, "they want rather to give to the government the power to manipulate purchasing power without being hindered by an 'external' factor, namely, the money relation of the gold standard" (Mises 1998, pp. 470–71).

But even if Selgin's assessment of Mises's arguments was correct, his own demonstration that Mises was inconsistent is faulty. Quoting Mises, Selgin writes:

> Ultimately Mises has no choice but to abandon his extreme position concerning the uselessness of index numbers. This allows him to suggest that gold has indeed performed better historically than irredeemable paper. It also serves to effectively undermine his claim that measurement problems

> alone must render a managed money standard impracticable: "The inadmissibility of the methods proposed for measuring variations in the value of money does not obtrude itself too much if we only want to use them for solving practical problems of economic policy." (1999, p. 267)

Selgin has here mischaracterized Mises's claims. Although Mises did demonstrate the impossibility of any price index to measure money's purchasing power with scientific accuracy (or to divide goods-side from money-side influences on money's purchasing power, as shown above), he did not claim that "measurement problems alone must render a managed money standard impracticable." Mises did not even hold that a price index was useless for every purpose. Continuing from the quotation Selgin cites above, Mises wrote:

> Even if index numbers cannot fulfill the demands that theory has to make, they can still, in spite of their fundamental shortcomings and the inexactness of the methods by which they are actually determined, perform useful workaday services for the politician.
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> If we have no other aim in view than the comparison of points of time that lie close to one another, then the errors that are involved in every method of calculating numbers may be so far ignored as to allow us to draw certain rough conclusions from them. . . . [W]e can follow statistically the progress of variations in purchasing power from month to month. (1980, p. 222)

Although Selgin denies the validity of Mises's approach, by which he holds simultaneously that a price index is useless in a theoretical task but useful in a practical task,[7] Mises (1985) grounded this position in his distinction between praxeology, the logic of action, which is the method of economic theory, and *verstehen*, the specific understanding of action, which is the method of history. Some claims impermissible in one realm are permissible—and, in some cases, indispensable—in the other. For example, praxeology says nothing about the particular concrete ends that action aims to attain or the particular means a person employs in action, instead treating ends and means in a purely conceptual manner, but *verstehen* must make statements about the particular ends that individuals aim to attain by employing particular means. Mises held that theory is the prism through which historical events are understood, but without investigation into the concrete circumstances of events, theory alone could not render historical understanding. Although one must take care in interpreting data, these data can serve the purpose of historical investigations even though they are suspect in theoretical purposes. Many types of data could fall into this category: national income, average wages, and per-capita capital stock, just to name a few. All of these may find a use in historical explanations while being deficient for theoretical purposes.

Instead of recognizing Mises's distinction between theory and history, Selgin asserts that Mises is making a strictly theoretical argument. He chides

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[7]For Selgin's position on this distinction, see Selgin (1999, p. 265).

Mises for noting, in defense of his pro-gold position, that the most extreme inflations have been with fiat paper money, such as in Germany after the First World War. Selgin (1999, p. 266) takes Mises to be making an "argument" from this observation that "fiat money is generally inferior to gold," which, if he was doing, Selgin would be correct in deeming it "far from adequate." But Mises was not trying to prove a theoretical point with this historical observation; he was simply illustrating that in fact fiat-paper standards have had more extreme episodes of price inflation than gold standards. The theoretical demonstration of why one should expect to find this result in history is his argument about the political impetus to inflate with a managed fiat-money system examined above.

Moreover, contra Selgin, Mises did not think it possible to construct an *a priori* argument for gold, much less the "public-choice style argument" Selgin assigns to him.[8] Mises (1998, p. 402) accepted Carl Menger's demonstration that money can only originate on the market and considered it "an irrefutable praxeological theory." Just as the pre-monetary barter market gave birth to a medium of exchange, as a widely salable commodity, money's development can be left to the market. The use of a medium of exchange becomes more widespread because traders see it in their interest to use a medium that is more widely traded. The more traders who use it the more attractive it becomes as a medium. Also, people will supplant commodities less able to perform the medium of exchange function with those better able to do so, and thus the precious-metal standard emerges. "Men have chosen the precious metals gold and silver for the money service," Mises (1998, p. 468) wrote, "on account of their mineralogical, physical, and chemical features." Although the use of money can be known praxeologically, the particular standard can only be known from the concrete facts of history. "The use of money in a market economy," (Mises 1980, p. 468) "is a praxeologically necessary fact. That gold—and not something else—is used as money is merely a historical fact and as such cannot be conceived by catallactics." Mises neither thought that any *a priori* case could be made for any particular precious metal, such as gold (but only an historical one), nor did he make any "public-choice-style arguments" in favor of gold. Contra Selgin, his argument for the gold standard had both ideological and historical elements.

The Ideological Battle Over the Monetary Standard

The use of the precious metals was historically the choice of the market. Without interference from governments, traders adopted the parallel standard

[8]Selgin claims that Mises "implicitly employs something like a Rawlsian 'veil of ignorance' argument" in defending the gold standard. He then goes on to criticize Mises on the grounds that this argument "confuses the ignorance induced by donning a Rawlsian veil with ignorance *tout court*" (1999, p. 269). The argument Mises actually made in defense of the gold standard is outlined below.

using gold and silver as money (Mises 1998, p. 419). During the nineteenth century, however, interventions on the part of various governments supplanted the parallel standard of gold and silver with the monometallic gold standard. Some governments intended to do so, and others did so as a secondary effect of pursuing other ends. "Once the economically most advanced nations had adopted the gold standard," Mises (1998, p. 469) wrote, "all other nations followed suit." Once in place, however, the gold standard provided an international money that permitted the development of a worldwide division of labor, which was the "greatest and most beneficial of all historical changes," Mises wrote. It increased welfare, spread liberty, and "accompanied the triumphal unprecedented progress of Western liberalism ready to unite all nations into a community of free nations peacefully cooperating with one another" (Mises 1998, p. 470).

The fly in the ointment of the classical gold standard was precisely that since it was created and maintained by governments, it could be abandoned and destroyed by them. As the ideological tide turned against laissez-faire in favor of statism, governments intent upon expanding the scope of their interference in and control of the market economy found it necessary to eliminate the gold standard. Nationalists wanted autarky, pressure groups sought higher wages, and, most important of all, demands were made for credit expansion by which everyone could be made prosperous and happy. "Only the gold standard," Mises (1998, p. 470) wrote, "that devilish contrivance of the wicked and stupid 'orthodox' economists, prevents mankind from attaining everlasting prosperity."

For Mises the political problem of the monetary standard did not revolve around a narrow rent-seeking cabal of special-interest groups haggling over which price index to target with monetary policy. It arose from ethnic and ideological forces, both political and economic. Selgin's (1999, pp. 259–60) focus on Mises's claim "that disagreements concerning the direction and extent of changes in money's purchasing power must render a managed fiat money a plaything of politics," is the proverbial tip of the iceberg. The impetus behind inflation and the destruction of the gold standard was much broader and squarely ideological. "[G]eneral acceptance [of the gold standard] requires the acknowledgement of the truth that one cannot make all people richer by printing money," Mises (1998, pp. 471–72) wrote, "the abhorrence of the gold standard is inspired by the superstition that omnipotent governments can create wealth out of little scraps of paper." Those who propagated this superstition "loathed the gold standard" because they were "intent upon sabotaging the evolution toward welfare, peace, freedom, and democracy," Mises wrote, "in their eyes the gold standard was the labarum, the symbol, of all those doctrines and policies they wanted to destroy. In the struggle against the gold standard much more was at stake than commodity prices and foreign exchange rates" (1998, p. 470). Mises wrote:

> The struggle against gold which is one of the main concerns of all contemporary governments must not be looked upon as an isolated phenomenon. It is but one item in the gigantic process of destruction which is the

> mark of our time. People fight the gold standard because they want to substitute national autarky for free trade, war for peace, totalitarian government omnipotence for liberty. (1998, p. 473)

What the advocates of inflation find objectionable about the gold standard is precisely that it constrains the government's ability to inflate, and by limiting this power, cripples its ability to attain the ends at which the advocates of inflation aim. "What the expansionists call the defects of the gold standard are indeed its very eminence and usefulness," Mises wrote, "it checks large-scale inflationary ventures on the part of governments." The "inflationists" destroyed the gold standard "because they were committed to the fallacies that credit expansion is an appropriate means of lowering the rate of interest and of 'improving' the balance of trade" (Mises 1998, pp. 471–72). By defending the gold standard, Mises was defending the world economy from its ideological enemies.

Costs and Benefits of the Gold Standard

The manner in which a supplier of gold coin, whether private enterprise or a government agency, is restrained from inflating the money stock under a gold standard is the market's imposition of gold's production costs on the profitability of its production. "The significance of the fact that the gold standard makes the increase in the supply of gold depend upon the profitability of producing gold is, of course," Mises wrote, "that it limits the government's power to resort to inflation." As a result, money's purchasing power is made independent of politics, which "is not a defect of the gold standard; it is its main excellence" (Mises 1998, p. 471). Moreover, Mises pointed out that the lower the costs of producing gold coin sink, the greater would be the incentive to produce and supply more. If, say through technological innovation, production costs became negligible, as with a fiat paper money, the incentive to inflate would be nearly unlimited. Then gold would no longer be useful as money and traders would need to replace gold with something else (1998, p. 473).

Far from recognizing Mises's argument that the cost of producing gold was a bulwark against inflation, Selgin's only mention of his views on the costs of gold production is as a "social cost of deflation." "Under a gold standard," Selgin (1999, p. 261) writes, "deflation becomes equivalent to a rising relative price of gold, which in turn means a greater diversion of resources to gold mining." But here again Mises is discussing this question in a historical context, namely, the "extension of the money economy," where he presumes that money's purchasing power would have risen in the absence of the "extension of money-economizing means of payment," such as the clearing system and fiduciary media (Mises 1980, p. 333). Mises's assessment of the force behind potential deflation as he looked back upon history in 1924 was the historical spread of the worldwide division of labor. He (Mises 1980, p. 359) is not discussing the growth of an existing monetary economy, but the extension

of the use of money and the money economy.[9] In that period of history when the money economy was spreading across the world, price deflation would have been observed had it not been for the extension of money-economizing means of payment, Mises presumes, and along with it the diversion of factors of production into producing the monetary metal and, thus, the social costs of deflation. But that period of history is over. The world economy became a reality, and with it the possibility of a disruptive type of deflation evaporated.

Moreover, Joseph Salerno has demonstrated that in completing his monetary theory during the years from 1912 to 1949, Mises abandoned the view he held earlier that "an increase in the purchasing power of money is somehow disadvantageous for the market economy." By the time Mises penned *Human Action*, he realized that when money demand increased as the result of economic growth—even with a constant money stock and, therefore, a rising purchasing power of money—it would not impair the process of pricing or economic calculation. Thus, economic growth would not be retarded (Salerno 1993, pp. 143–45).

White makes a much stronger claim than Selgin regarding Mises's position on the resource costs of a gold standard. In summarizing Mises's views, White (1992, p. 522) writes, "he viewed fractional-reserve banking as a natural and desirable development in a free society, most importantly because it reduced the resource costs associated with the payments system." White (1992, p. 520) notes Adam Smith's view, which Mises refers to in *The Theory of Money and Credit*, that replacing a metallic standard with paper substitutes an expensive medium of exchange with a less expensive one (Mises 1980, p. 332). But although Mises considered the classical view theoretically correct in 1924, his examination of the historical development of government intervention in money and banking led him to change his assessment of its importance in history by 1949.[10] He wrote:

> In examining the evolution which gave governments the power to manipulate their national currency systems, we must begin by mentioning one of the most serious shortcomings of the classical economists. Both Adam Smith and David Ricardo looked upon the costs involved in the preservation of a metallic currency as a waste. As they saw it, the substitution of paper money for metallic money would make it possible to employ capital and labor, required for the production of the quantity of gold and silver needed for monetary purposes, for the production of goods which could directly satisfy human wants. Starting from this assumption, Ricardo elaborated his famous *Proposals for an Economical and Secure*

[9]Contrary to White's assertion, Mises is not agreeing in this passage with the free bankers' position that in a growing economy an increase in fiduciary media is necessary to accommodate an increase in money demand. See White (1992, pp. 520–21, 523). Also, on this point see Selgin and White (1996, p. 98).

[10]Also on Mises's view of the resource costs of a gold standard, see Salerno (1993, p. 144). Mises had revised his more favorable assessment on Adam Smith's position, which he held in 1924, by the time he wrote his article "Monetary Stabilization and Cyclical Policy," in 1928. See, Mises (1978, pp. 72–74).

> *Currency*, first published in 1816. Ricardo's plan fell into oblivion. It was not until many decades after his death that several countries adopted its basic principles under the label *gold exchange standard* in order to reduce the alleged waste involved in the operation of the gold standard nowadays decried as "classical" or "orthodox." (Mises 1998, p. 780)[11]

Also, it should be kept in mind that the reason Mises gave for the resource cost advantage of a paper money during deflation was derived from Hume's argument showing that any stock of money can perform the entire medium-of-exchange function; a smaller stock would do so with lower prices, and a larger stock with higher prices (Mises 1980, pp. 165 and 333). Despite the greater regard he once held for Adam Smith's view, Mises's position was always much different from that of the modern free bankers who do believe there is an optimum amount of money and who do believe there is a social benefit to increasing the money stock in response to an increase in money demand.[12]

Also by 1949, Mises came to recognize that the resource costs associated with a gold standard pale in significance compared to the destruction wrought by inflation. "If one looks at the catastrophic consequences of the great paper money inflations," Mises (1998, p. 419) wrote, "one must admit that the expensiveness of gold production is the minor evil."

But whatever the reality and extent of diversion of resources into gold mining during deflation, it is clear that by 1949 Mises did not consider deflation a likely problem. Inflation, once government has monopolized the production of money, is the real danger. As long as there is a significant inflationary impulse (always strengthened by government intervention into money and credit), the cost of producing gold is its main advantage as a money since this is what restrains the inflationary impulse.

Gold and the State

Although governments did establish and rule over the classical gold standard, Mises did not think the market economy required such oversight. He recognized that the gold standard had come to transcend governments. International trade had created a worldwide division of labor based on gold, which "works without any action on the part of governments." Not only is there "no need for any government to interfere in order to make the gold standard work," Mises wrote, "no government is . . . powerful enough to abolish the gold standard." Because "gold is the money of international trade and of the super-national economic community of mankind," its preservation and

[11]That he came to realize the implications of the Smith-Ricardo view only after 1924 helps to explain his remark that "in dealing with the problems of the gold exchange standard all economists—including the author of this book—failed to realize the fact that it places in the hands of governments the power to manipulate their nations' currency easily" (Mises 1998, p. 780).

[12]On the free bankers' position, see White (1992, p. 523).

purification were necessary components of Mises's plan for the restoration of a liberal social order (1998, pp. 472–73).

Mises's defense of the gold standard, then, was part and parcel of his indefatigable drive for a liberal society. Such a society is put into place by the strictest limits on the power of the state. "Government means always coercion and compulsion and is by necessity the opposite of liberty," Mises (1998, p. 283) wrote, "[it] is a guarantor of liberty and is compatible with liberty only if its range is adequately restricted to the preservation of economic freedom." In short, the liberal society is achieved when state coercion is limited to defense of person and property (Mises 1998, p. 720).

Mises argued that money, like all other goods, is part of the private property order of the market, and thus, outside the realm of state power, which was to be restricted to defense of person and property. He wrote:

> Money is the commonly used medium of exchange. It is a market phenomenon. Its sphere is that of business transacted by individuals or groups of individuals within a society based on private ownership of the means of production and the division of labor. (Mises 1980, p. 478)

If the market would have been unhampered by government intervention into monetary affairs in the nineteenth century, the parallel standard, already developed in history, would have been maintained and no reform would be necessary. But governments did interfere and created the gold standard, which became the money of the world economy. Because the gold standard was the world's monetary system in 1949, Mises argued, reform projects must first seek to preserve it and second to purify it of its interventionist elements.[13]

Theory and History of Money Substitutes

If in a liberal social system money proper is to be left to the choice of the market and private enterprise, what about the monetary function of banks? As with other issues of monetary systems, Mises argued that there are praxeological and historical dimensions regarding the monetary function of banking. The praxeological function banks have performed is in producing money substitutes, which "render to the individual all the services money can render" Mises (1998, p. 429) wrote and thus, "they can fully replace money in an individual's or a firm's cash holdings." To do this, a money substitute must be a claim to a definite amount of money that is redeemable on demand against the issuer, for whom no doubt exists about his ability and willingness to pay and

> that all parties with whom he could possibly transact business are perfectly familiar with these essential qualities of the claims concerned. . . . The main thing is that *every owner* of a money-substitute, is perfectly certain that it can, at every instant and free of expense, be exchanged against money. (Mises 1998, pp. 429–30; emphasis added)

[13]This point is pursued below.

The legal claim that the money-substitute makes is part and parcel of the general legality of contract and must be upheld, and enforced if necessary, by the legal system. Contrary to Selgin (2000, p. 95), who asserts that the indefinite public knowledge that banks, in general, do not hold 100-percent reserves is sufficient to justify fiduciary media, according to Mises, to be a money-substitute all traders in the market must be fully informed of the legal character of the claim and the financial character of the institution that issues it. Then and only then will the banks have a clientele for their products and not merely customers; then and only then will the claims be money-substitutes, that is, be, like money itself, generally accepted as a medium of exchange. "People deal with money-substitutes as if they were money," Mises wrote, "because they are fully confident that it will be possible to exchange them at any time without delay and without cost against money." Only those who have this confidence, that is, deal with money-substitutes as if they were money, are clients of the issuer. The crucial factor determining confidence in a bank, or lack thereof, is the actual practice of redemption. "What counts," Mises wrote, "is whether the money-substitutes can really be exchanged against money without delay and cost" (Mises 1998, pp. 431–32).

Historically, banks have issued two types of money-substitutes: money-certificates, for which the bank "keeps against the whole amount of money-substitutes a reserve of money proper," and fiduciary media, which is "the amount of substitutes which exceeds the reserve" (Mises 1998, p. 430). Since the issue of either type of a money-substitute depends on clients who are "perfectly certain that it can, at every instant and free of expense," be redeemed for money, money-certificates are necessary for the existence of fiduciary media. Without a reserve held against some money substitutes, no fiduciary media could be issued at all. Fiduciary media, for Mises, are entirely dependent upon the existence of money certificates. The requirement for the legality and viability of money-substitute is the contractual obligation for the issuing bank to redeem the money-substitute for money at par on demand, and this requirement can only be met if the bank holds sufficient reserves of money. Mises wrote:

> It is very easy for a bank to increase the number of people who are ready to accept loans granted by credit expansion and paid out in an amount of money-substitutes. But it is very difficult for any bank to enlarge its clientele, that is, the number of people who are ready to consider these claims as money-substitutes and to keep them as such in their cash-holdings. To enlarge this clientele is a troublesome and slow process, as is the acquisition of any kind of good will. On the other hand, a bank can lose its clientele very quickly. If it wants to preserve it, it must never permit any doubt about its ability and readiness to discharge all its liabilities in due compliance with the terms of the contract. A reserve must be kept large enough to redeem all banknotes which a holder may submit for redemption. Therefore no bank can content itself with issuing fiduciary media only; it must keep a reserve against the total amount of money-substitutes issued and thus combine issuing fiduciary media and money-certificates. (1998, p. 436)

For Mises, free banking meant that banks have a legal obligation to redeem all money-substitutes, whether money-certificates or fiduciary media, into money at par on demand and must in practice never reveal any doubt as to their readiness and ability to do so. Banks do not have an inviolable right to issue fiduciary media itself, but only money-substitutes. Selgin and White, in contrast, wish to "defend the freedoms to issue and use fiduciary media of exchange," as a basic right of contract. "Outlawing voluntary contractual arrangements that permit fractional reserve-holding," they write, "is thus an intervention into the market, a restriction on the freedom of contract which is an essential aspect of private property rights" (Selgin and White 1996, pp. 83, 87).

The danger in issuing fiduciary media is that it makes the bank's legal obligation to redeem subject to the confidence that clients have in the bank. This fact, Mises thought, was an essential feature of issuing fiduciary media and granting circulating credit, the danger of which is ever present. The clients' confidence in the bank cannot be apportioned according to whether one holds money-certificates or fiduciary media. "As a rule," Mises (1998, p. 430) wrote, "it is not possible to ascertain whether a concrete specimen of money-substitute is a money-certificate or a fiduciary medium." Yet, confidence in the bank is indissoluble, Mises thought: "it is either present with all its clients or it vanishes entirely." For this reason, the purpose of holding reserves is not to redeem the banknotes of those who have lost confidence in the bank, but to hold a reserve large enough that the practice of redemption is never suspended and, thus, confidence is never lost. "A reserve must be kept large enough," Mises wrote, "to redeem all banknotes which a holder may submit for redemption." This all-or-nothing nature of the clientele's confidence in the bank "is an essential feature or weakness of the business of issuing fiduciary media and granting circulation credit. . . . No system of reserve policy and no reserve requirements as enforced by the laws, can remedy it" (Mises 1998, p. 436).

Disregarding these passages, Selgin and White cite Mises in favor of their position that because the issue of fiduciary media is a basic right of contract, redemption is merely a technical question whose dangers can be efficiently managed. Bankers must, by entrepreneurial judgment, determine a redemption policy that makes fiduciary media sustainable as a medium of exchange, which they characterize as a risk-management problem. Bank runs, according to Selgin and White, could be dealt with pragmatically with, for example, option clauses for suspension of specie redemption. Mises, as implied above, would not permit such suspension under any circumstances. The law must enforce the redemption of all money-substitutes under any conditions. Moreover, in the citation of Mises they attempt to use to bolster their position, he is explaining how a claim on money as property can be a medium of exchange and have par value with money, without being backed by money while a claim on consumer goods as property must be fully backed by the goods to have par value with the goods. As noted above, Mises argued that the viability of fiduciary media depended on the confidence holders have in their redemption. In the passage cited by Selgin and White, he merely adds that such confidence depends on the prudence of bankers in issuing fiduciary

media. Mises is not claiming what Selgin and White do, that because the issue of fiduciary media is a basic right of contract, their viability is a manifestation of satisfying the demand people have for them, as it would be for consumer goods. As shown above, according to Mises, people only demand money-substitutes, not fiduciary media, and their demand exists only when they have confidence in full redemption based on the issuers practice of full redemption. People could not demand fiduciary media because they cannot distinguish between a money-substitute that is a money-certificate and one that is a fiduciary medium. If they could make such a distinction, then fiduciary media would not be viable (Selgin and White 1996, pp. 90–92).[14]

Fiduciary Media and Credit Expansion

Although clients of a bank cannot distinguish between its money-certificates and fiduciary media, the effects of issuing the two types of money-substitutes are different. The issue of money-certificates neither changes the money stock nor expands bank credit. "A bank which does not issue fiduciary media," Mises wrote, "can only grant *commodity credit*, that is, it can only lend its own funds and the amount of money which its customers have entrusted to it." But issuing fiduciary media permits credit expansion. A bank, Mises wrote, "can now not only grant commodity credit, but also *circulation credit*, that is, credit granted out of the issue of fiduciary media." The result of an issue of fiduciary media is a reduction in money's purchasing power and the rate of interest (Mises 1998, pp. 430–31; emphasis in original).

Fiduciary media, then, is the source of credit expansion and credit expansion is an integral part of the trade cycle. "The term *credit expansion* has often been misinterpreted," Mises (p. 431, emphasis in original) wrote, "it is important to realize that commodity credit cannot be expanded. The only vehicle of credit expansion is circulation credit."[15] Mises wrote:

> The notion of "normal" credit expansion is absurd. Issuance of additional fiduciary media, no matter what its quantity may be, always sets in motion those changes in the price structure the description of which is the task of the theory of the trade cycle. Of course, if the additional amount issued is not large, neither are the inevitable effects of the expansion. (1998 p. 439, n. 17)

In contrast to Mises, Selgin argues that the additional issue of fiduciary media, and the consequent credit expansion, does not engender the trade

[14]The passage they cite is Mises (1980, pp. 299–300).

[15]Mises held that the major drawback of issuing fiduciary media was the resulting business cycle and, once his views were fully developed, he held that this drawback alone was sufficient to outweigh any advantages fiduciary media may have. See, Salerno (1993, pp. 139–41). Basing their position on Mises's underdeveloped view, Selgin and White (1996, p. 94) claim that Mises found the benefit of the saving of resource costs greater than the harm of cyclical instability.

cycle if the additional fiduciary media is accommodating an increase in money demand. Selgin writes:

> Anyone who finds even a grain of truth in the Austrian theory of the business cycle appreciates that excessive growth of the money stock can trigger or worsen industrial fluctuations. It does not follow, however, that fractional reserves are to blame for such fluctuations, or that an economy relying on one hundred percent reserve banks only would necessarily be cycle-free.
>
> In truth, whether an addition to the money stock will aggravate the business cycle depends entirely on whether or not the addition is warranted by a preexisting increase in the public's demand for money balances. . . . As far a business-cycle consequences are concerned, it makes no difference whether the new money is or is not backed by gold. (2000, p. 97)[16]

In Mises's view, any additional fiduciary media sets in motion the trade cycle. The only circumstances under which issuing fiduciary credit would not lead to credit expansion is if the new issue is replacing a retiring issue of fiduciary credit and thus no additional fiduciary media comes into existence. "Credit expansion is present only if credit is granted by the issue of an additional amount of fiduciary media," Mises (1998, p. 431) wrote, "not if banks lend anew fiduciary media paid back to them by the old debtors."

THEORY AND HISTORY OF FIDUCIARY MEDIA

Mises's earlier writings about fiduciary media must also be read in the context of the historical period that Mises is trying to explain. Thus, as with the claim by Selgin and White that Mises lends support to banks issuing fiduciary media today because he argued that such media once played an important role in preventing deflation, the claim by White (1992, p. 522) that Mises's assertion that the historical development of banking was aided by the issuing of fiduciary media lends no support to continuation of this practice. Mises wrote:

> In the early days of the modern banking system [fiduciary media] played a further part still by strengthening the credit-negotiating activities of the banks (which in those times could hardly have proved profitable if carried on for their own sake alone) and so brought the system safely past those obstacles which obstructed its beginnings. (1980, p. 359)

But now that the banking system is fully developed, this benefit no longer accrues to the continuing existence or further issuing of fiduciary media. Even Mises's claim in 1924 must be understood as a historical one. He wrote:

> Prohibition of the issue of all notes except those with a full backing and of the lending of the deposits which serve as the basis of the check-and-clearing

[16]See also Selgin and White (1996, pp. 102-03).

> business would mean almost completely suppressing the note issue and almost strangling the check-and-clearing system. (Mises 1980, pp. 359–60)

But following this quotation that White cites, Mises wrote:

> If notes are still to be issued and accounts opened in spite of such a prohibition, then somebody must be found who is prepared to bear unrecompensed the costs involved. Only very rarely will this be the issuer, although occasionally such a thing happens. (1980, p. 360)

So in any historical context where it is possible for the issuer to be compensated for fully backed money-substitutes, which Mises thought even before 1924 occasionally happened, this benefit of fiduciary credit disappears. He wrote:

> Issuing money-certificates is an expensive venture. . . . a ruinous business if not connected with issuing fiduciary media. In the early history of banking there were banks whose only operation consisted in issuing money-certificates. But these banks were indemnified by their clients for the costs incurred. (1998, p. 432)

This was possible because of people's preference for different forms of cash holdings. If people consider banknotes more convenient than coins, they "would be prepared to pay a premium," for them. Mises cites both "banknotes issued by banks of unquestionable solvency" and travelers' checks as examples of the public's greater demand for certain forms of media of exchange resulting in a premium high enough to cover the costs of their production (Mises 1998, p. 443).

Mises not only thought it possible for banks in a developed market system to be able to cover the costs of issuing only money-certificates, he claimed that the historical importance of fiduciary media was a result of government intervention. Mises did not think that fractional reserve banking was a "natural and desirable development in a free society," as White (1992, p. 522) claims for him. To the contrary, Mises thought that if banking had been unhampered by government intervention, fiduciary media would have never been an important factor in banks issuing money-substitutes. He wrote:

> The issue [of the public acceptance of banknotes] can still better be clarified by reviewing banking conditions in continental Europe. Here the commercial banks were free from any limitation concerning the amount of deposits subject to check. They would have been in a position to grant circulation credit and thus expand credit by adopting the methods applied by the banks of the Anglo-Saxon countries. However, the public was not ready to treat such bank deposits as money-substitutes. . . . Only a small group of big business treated deposits with the country's Central Bank of Issue (not those with the commercial banks) as money-substitutes. Although the Central Banks in most of these countries were not submitted to any legal restrictions with regard to their deposit business, they were prevented from using it as a vehicle of large-scale credit expansion because the clientele for deposit currency was too small. Banknotes were practically the sole

> instrument of circulation credit and credit expansion. Similar conditions prevailed and for the most part still prevail by and large in all countries of the world which are outside the pale of Anglo-Saxon banking methods. (Mises 1998, p. 442)

Not only did Mises claim that lack of public demand for deposits limited their use, whether money-certificates or fiduciary media, to a small cadre of traders, he also held that the widespread use of banknotes was unnecessary to the development of the market economy. "Banknotes are not indispensable," he wrote, "all the economic achievements of capitalism would have been accomplished if they had never existed" (Mises 1998, p. 444).

Moreover, the rise of banknotes was not the result of public demand, but government intervention.[17] "However, freedom in the issuance of banknotes," Mises (1998, p. 443) wrote, "would have narrowed down the use of banknotes considerably if it had not entirely suppressed it." It was not the market, but government, that gave rise to the widespread use of banknotes. Mises wrote:

> But this present state of banking is not the outcome of the operation of the unhampered market economy. It is a product of the various governments' attempts to bring about the conditions required for large-scale credit expansion. If the governments had never interfered, the use of banknotes and of deposit currency would be limited to those strata of the population who know very well how to distinguish between solvent and insolvent banks. No large-scale credit expansion would have been possible. (1998, p. 444)

Governments, according to Mises, were not aiming at developing the banking system or the market economy, but had only the goal of easing the burden of their own financing in mind when helping banknotes develop. "Governments did not foster the use of banknotes in order to avoid inconvenience to ladies shopping," Mises (1998, pp. 443–44) wrote, "their idea was to lower the rate of interest and to open a source of cheap credit to their treasuries."

In Mises's view, banknotes played a significant, and pernicious, role in history because governments interfered to bring about their widespread use and deposit currencies, even as late as 1949, played no significant widespread role in history because people did not desire them. Although White (1992, p. 526) agrees that Mises is claiming that money-substitutes would not have played a significant role in history absent government intervention, he fails to realize that without their widespread issue, free banks could not play the role of expanding the money stock to accommodate increases in money demand.

Today it can hardly be disputed that charges for checking accounts are commonplace and would not stifle the issue of money-certificates as the only form of money-substitutes. But even if banks could not profit from issuing money-substitutes, Mises would consider it a good thing, since it would restrict banknotes to a small fraction of commerce and thus discourage the development of fiduciary banknotes and "large-scale" credit expansion. In any case, whatever one's view of these historical issues, Mises clearly thought that

[17]Also, on this point, see Salerno (1993, p. 142).

the form of money substitute was not an issue that could be settled by catallactics. "At any rate, catallactics is not interested in the purely technical problems of banks not issuing fiduciary media," Mises (1998, p. 432) wrote, "the only interest that catallactics takes in money-certificates is the connection between issuing them and the issuing of fiduciary media."

This distinction between money-certificates and fiduciary media is important because issuing the latter results in credit expansion, the very force Mises was interested in curbing. "Hence the question of whether there are or are not limits to the increase in the quantity of fiduciary media," Mises (1998, p. 432) wrote, "has fundamental importance." This is why Mises (1998, pp. 432–36) took time to dwell on the consequences of different configurations of free banking. Three features of his analysis stand out vis-à-vis the modern Free Banking School. First, all of these configurations presume gold as money and differ only in the conditions under which banks issue money-substitutes. Modern advocates of free banking do not agree that free banking is a market monetary system only if it has gold as money (Rothbard 1992, p. 99).[18] Second, unlike the modern free bankers, Mises did not think that outlawing the issue of fiduciary media violated a basic right of contract. Instead, fractional reserve banking was one possible configuration of legally permissible bank activity, and not the one that attained his goal of restricting credit expansion as far as possible. Third, Mises demonstrated that free banking, with the legal right to issue fiduciary media, is a superior alternative to an interventionist system of government privilege, which permitted the suspension of specie redemption. By superior, he meant that this system would restrict credit expansion more than a system with one monopoly bank or a bank cartel (Mises 1998, pp. 433–34).

But, this configuration of free banking was not the one that most fully attained the goal Mises set for the ideal monetary system. The configuration that removed government most fully from monetary affairs and, thereby, restricted monetary inflation and credit expansion to the greatest degree begins with "the idea implied in the Currency Theory," Mises (1998, p. 439) wrote, "that all banks be forced by law to keep against the total amount of money-substitutes . . . a 100 per cent money reserve"[19] and then grounds money in gold and free banking in contract law. Mises wrote:

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[18]Selgin (2000, p. 93) agrees that money proper should be gold. White (1985, pp. 124–26), on the other hand, is ambiguous on this point.

[19]Mises also points out that the Peel Act of 1844 was defective because it did not go far enough in restraining inflationary forces:

> On the one hand, the system of government interference with banking was preserved. On the other hand, limits were placed only on the issuance of banknotes not covered by specie. The fiduciary media were suppressed only in the shape of banknotes. They could thrive as deposit currency. (Mises 1998, p. 439)

Also, on Mises's view of the Currency School, see Salerno (1993, pp. 141–42). White (1992, p. 524) has a different assessment of Mises's views on the Currency School.

> But even if the 100 per cent reserve plan were to be adopted on the basis of the unadulterated gold standard, it would not entirely remove the drawbacks inherent in every kind of government interference with banking. What is needed to prevent any further credit expansion is to place the banking business under the general rules of commercial and civil laws compelling every individual and firm to fulfill all obligations in full compliance with the terms of the contract. (1998, p. 440)

Free banking is one component of this monetary system. But the best system of free banking, Mises argued, is the one that has a prohibition on the issue of additional fiduciary media and thereby restricts additional money-substitutes to money-certificates. Mises conceded that while free banking with fractional reserves does permit credit expansion, and thus does not fully attain his goal, it would have been better historically than the system of government intervention which gave special legal privileges to banks, for example, suspension of specie redemption. Mises wrote:

> Free banking is the only method available for the prevention of the dangers inherent in credit expansion. It would, it is true, not hinder a slow credit expansion, kept within very narrow limits, on the part of cautious banks which provide the public with all information required about their financial status. But under free banking it would have been impossible for credit expansion with all its inevitable consequences to have developed into a regular—one is tempted to say normal—feature of the economic system. Only free banking would have rendered the market economy secure against crises and depressions. (1998, p. 440)[20]

But however history may have played out in the absence of government privileges given to banks, this possibility was no longer present in 1949. The market economy had experienced crises and depressions, and Mises proposed the monetary reform that restricted credit expansion most severely. He feared that any halfway measures, in any of the three features of the most-restrictive monetary system, would still leave room for government to regain its control and resume its inflationary ways. He wrote:

> If banks are preserved as privileged establishments subject to special legislative provisions, the tool remains that governments can use for fiscal purposes. Then every restriction imposed upon the issuance of fiduciary media depends upon the government's and the parliament's good intentions. They may limit the issuance for periods which are called normal. The restriction will be withdrawn whenever a government deems that an emergency justifies resorting to extraordinary measures. If an administration and the party backing it want to increase expenditure without jeopardizing their popularity through the imposition of higher taxes, they will always be ready to call their impasse an emergency. Recourse to the printing press and to the obsequiousness of bank managers, willing to oblige

[20]In contrast, Selgin and White (1996, p. 103) claim that in this passage Mises is making a theoretical claim about this type of free banking.

> the authorities regulating their conduct of affairs, is the foremost means of governments eager to spend money for purposes for which the taxpayers are not ready to pay higher taxes. (Mises 1998, p. 440)

MONETARY REFORM: THE GOLD STANDARD AND 100-PERCENT-RESERVE BANKING

Mises's concern with the changing historical conditions pushing ever harder for credit expansion was only one factor that led him to eventually adopt the view that banks should be prevented from issuing any new fiduciary media; thereby, cutting off the fuel for the boom-bust cycle. Salerno (1993, p. 139) has pointed out "significant developments in Mises's theory of money...occurred between the publication of the first German edition of *The Theory of Money and Credit* in 1912 and the publication of *Nationalökonomie* (the German language forerunner of *Human Action*) in 1940." As Salerno (1993, pp. 139 and 143) notes, Mises himself acknowledged that his monetary theory achieved completion only with the publication of his *magnum opus*, and that when his thought on "entrepreneurship, monetary calculation, and money" developed fully, Mises downgraded his former assessment of the benefits of issuing fiduciary media, especially the harm of increases in money's purchasing power, and upgraded his assessments of its drawbacks, especially credit expansion.

Mises advanced his proposal for a monetary system with zero credit expansion, that is, a gold standard with no issue of fiduciary media, as part of his program for monetary reform as early as 1944, and he repeated it in his 1952 essay on monetary reconstruction.[21] He wrote:

> The main thing is that the government should no longer be in a position to increase the quantity of money in circulation and the amount of checkbook money not fully—that is, 100 percent—covered by deposits paid in by the public. No backdoor must be left open where inflation can slip in. (Mises 1980, p. 481)

When applied to the United States, monetary reform must include restoration of the public's right to redeem the dollar for gold. "To enable the Conversion Agency to [buy gold against dollars at the legal parity]," Mises (1980, p. 492) wrote, "it is to be entitled to issue dollar bills against a 100-percent reserve in gold." Banks can only issue checkable deposits that are 100-percent backed and, therefore, can issue no additional fiduciary media. "This means a rigid 100-percent reserve for all future deposits," Mises (1980, p. 491) wrote. Barred from issuing additional fiduciary media, banks could play no role in generating a boom-bust cycle, even if they had existing fiduciary media outstanding. With the government impetus for inflation removed from the

[21]The 1944 essay is included in a volume of Mises's previously unpublished manuscripts (Ebeling, ed., 2000). The 1952 essay was made an addendum to the 1953 edition of *The Theory of Money and Credit*.

monetary system and 100 percent reserve banking, inflation, the main enemy in monetary affairs, is at last restricted as much as possible.

As noted above, Mises thought that if left to the free choice of the market, a parallel standard would emerge. But government intervention had given the world the gold standard, which in turn became the money of the world economy transcending the governments that created it. Given the historical reality of the gold standard, Mises (1998, p. 445) argued that monetary reform could not immediately throw the choice of money open to the market again, but must establish the ideal monetary system, that is, the one that permits no credit expansion, by reforming the existing monetary system.[22]

The reform measure of restoring dollar redemption for gold reestablished the actual historical metallic standard and thereby cut off the inflationary impulse acting on the stock of money. The 100-percent-reserve requirement cut off the inflationary impulse acting on money substitutes. The reason Mises (1998, p. 431) wanted to restrict only additional fiduciary media and not eliminate them all was the possibility of an artificial, and thus harmful, deflation from immediate retirement of all existing fiduciary media and his view that existing fiduciary media have already had their effects on the market economy and thus could not be a source of further credit expansion.[23]

It was the historical experience of the booms and busts and the propaganda that they were part and parcel of the market economy that did the most to discredit capitalism. Mises wrote:

> Looking backward upon the history of the last hundred years, one cannot help realizing that the blunders committed by liberalism in handling the problems of banking were a deadly blow to the market economy. . . . Nothing harmed the cause of liberalism more than the almost regular return of feverish booms and of the dramatic breakdown of bull markets followed by lingering slumps. Public opinion has become convinced that such happenings are inevitable in the unhampered market economy. People did not conceive that what they lamented was the necessary outcome of policies directed toward a lowering of the rate of interest by means of credit expansion. They stubbornly kept to these policies and tried in vain to fight their undesired consequences by more and more government interference. (1998, pp. 440–41)

It was of the utmost importance, for Mises, to set the record straight on this point and to inoculate the market economy from the boom-bust cycle by purging money and banking of their interventionist elements. In making his

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[22]On Mises's ideal monetary system being one without credit expansion, see Salerno (1993, pp. 139–42).

[23]Although both Selgin and White are eager to put distance between Mises's views on money and banking and those of Murray Rothbard, Mises's monetary reform has many affinities with that advocated by Rothbard. See Selgin (1999, p. 259) and White (1992, pp. 517–18). See Rothbard (1990, 1991, 1994) on a free market monetary system and monetary reform.

case for the gold standard and 100-percent-reserve banking, Mises was making his case for the market economy and, in so doing, striving to rescue Western civilization from its slide into socialism.

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