

THE GOLD CRISIS

THE EVOLUTION OF COMMERCIAL BANKING

AT FIRST thought, one might believe that commercial banking and money-credit matters generally are too complicated for all but a few exceptional individuals to understand. However, knowing that only simple relationships are involved we are convinced that the difficulty lies elsewhere.

Our conclusion is that the difficulty is traceable to two factors. First, commercial banking is the outcome of an evolutionary process that is simplicity itself when viewed one step at a time as it must have occurred but that is not so readily understood when one looks only at the result to date. Second, many of the technical words have been in common use so long that those attempting to understand are confronted by the difficulty of remembering the technical uses of words that have become familiar in somewhat different uses.

In the following paragraphs, the evolution of commercial banking is described step by step. No attempt is made to date each successive step in the evolutionary process, although some dates are given. Many of the original dates for successive steps are lost in the haze of man's unwritten history; and some of the successive steps have recurred in recent decades and may be expected to recur again wherever formerly well-developed money-credit processes are destroyed, as in Germany after World War II for example, and in primitive societies beginning the long climb upward to a more advanced civilization.

Primitive Markets

We begin with a primitive society where exchanges were simple barter. The grower of wheat exchanged it directly for skins obtained by the tribal hunters, for meat obtained both by the hunters and by those who had cattle, and for gold obtained in crude form by some members of the tribe from alluvial deposits. Why gold was generally desired, other than for the fact that it was used for ornaments and because it

You can help to promote correct understanding and wise decisions in the present crisis by distributing this bulletin; extra copies, 5 for one dollar (\$1).

Application to mail at second-class postage rates is pending at Great Barrington, Mass.

ECONOMIC EDUCATION BULLETIN
A.L.E.R., Great Barrington, Massachusetts

Economic Education Bulletin is published four times a year by American Institute for Economic Research (a scientific and educational organization) at Great Barrington, Massachusetts.

To mail *Economic Education Bulletin* without an envelope, put a 4-cent stamp over the line referring to second-class postage rates and mark it "First Class Mail."

Use This Convenient Check-list to Order

**PUBLICATIONS of AMERICAN INSTITUTE for
ECONOMIC RESEARCH**

(Include your mailing address above and your check or cash. You may send currency at our risk.)
AMERICAN INSTITUTE for ECONOMIC RESEARCH, GREAT BARRINGTON, MASSACHUSETTS

Enclosed is \$. . . for the items checked. If not completely satisfied, I understand that I may return the books, and my money will be refunded.

- How to Avoid Financial Tangles**, Kenneth C. Masteller. \$1.00
- Life Insurance and Annuities From the Buyer's Point of View**, William J. Matteson. \$1.00
- What Will Social Security Mean to You?** William J. Matteson. \$1.00
- How to Invest Wisely**, C. Russell Doane and E. C. Harwood. \$1.00
- Investment Trusts and Funds From the Investor's Point of View**, C. Russell Doane and Edward J. Hills. \$1.00
- What Will Deflation or More Inflation Mean to You?** by the Editorial Staff. \$1.00
- How to Make Your Budget Balance**, Helen Fowle and Margaret Blodgett. \$1.00
- The Rubber Budget Account Book**. 25 cents
- Current Economic Trends**, by the Editorial Staff. \$1.00
- Cause and Control of the Business Cycle**, E. C. Harwood. \$2.00
- Useful Economics**, E. C. Harwood. \$1.00
- Twentieth Century Common Sense and the American Crisis of the 1960's**, the Editorial Staff. \$1 each (three copies for \$2, ten copies for \$5)
- Reconstruction of Economics**, E. C. Harwood. \$1.00
- Economic Tides and Trends, Their Effects on Your Lifetime Plans**, the Editorial Staff. \$1.00
- The First Quarter Century and Plans for the Future**. A report of the Institute's activities. Free on request
- Economic News**. Published nine times a year. \$1 per year, \$2 for 3 years, \$3 for 5 years
- Research Reports**. Weekly reviews of economic developments. \$6.50 per quarter, \$25 per year
- Investment Bulletin**. Issued twice monthly. Includes recommendations for the three basic plans. \$10 per year
- Annual Sustaining Membership**. Sustaining members receive all Institute publications including new or revised editions as published. \$9 per quarter, \$35 per year

Additional copies of *Economic Education Bulletin*: 5 for one dollar (\$1)

could be exchanged again for other things desired, need not concern us. We simply observe a fact and report it.

As the tribe increased in number and the exchanges to be made increased greatly, a time came when the bartering was concentrated, for the most part, at a convenient meeting place. Today we should call that meeting place a market or shopping center.

Of course, many other things than those already mentioned were exchanged in the markets. However, the principles we are seeking to understand can be illustrated by discussing initially only a few of the many. We choose to focus attention on wheat, beaver skins, and gold.

As market activity increased, the time came when some individuals became specialists in marketing. One chose to deal in wheat, another in beaver skins, and another in gold. Once these specialists had established themselves, many of those bringing in things to barter discovered a process more convenient than carrying on their backs the things they wished to offer in exchange. The processor of wheat delivered wheat to the warehouse and took in exchange a claim check or warehouse receipt for his wheat. Similarly the processors of skins and gold took warehouse receipts from the merchants specializing in skins and gold respectively.

Claim Checks

Those who thus had obtained claim checks on wheat, skins, and gold then exchanged the claim checks among themselves until they had claims on the things they wanted. When each had claim checks for whatever he wanted, he went to the appropriate merchant warehouses and obtained wheat, or skins, or gold in exchange for the respective claim checks.

At this point, brief consideration of the wording on the claim checks is advisable. The earlier ones for wheat read as follows:

This certifies that John Doe has placed in my warehouse
35 bushels of wheat, which I promise to deliver to the
bearer of this claim check on demand.

Arthur Smith, Wheat Merchant.

Similar warehouse receipts or claim checks were written by the merchants handling skins and gold. In some instances the claim checks were not redeemable by the bearer unless the claim check had been endorsed or signed over to him by the original depositor of the wheat, but these details need not concern us at this point.

Gold as the Medium of Exchange

As the market increased in size and activity the individuals concerned found, to an increasing extent, that gold or claim checks on gold were a convenient medium of exchange. On more and more occasions the men who had gold or claim checks on gold found that they could obtain what

they wanted with the least difficulty in persuading others to accept what they had to offer. Soon, anyone who had gold or claim checks on gold found all others willing to accept gold in exchange, because each seller saw for himself how readily he could buy other things he might want with the gold and how conveniently he could hold gold until he might wish to buy other things.

As a result of the increasing use of gold and claims on gold in effecting exchanges, men developed the habit of estimating the exchange value of other things in amounts of gold. Thus prices, instead of being thought of and talked about in such ways as, "two bushels of wheat equals in exchange value one beaver skin," came to be thought of and talked about in such ways as, "one bushel of wheat equals one thirty-fifth of an ounce of gold, and one beaver skin equals two thirty-fifths of an ounce of gold (also the exchange value of two bushels of wheat)."

The Goldsmiths

At about this stage of development, the gold merchants, or goldsmiths as they were called, saw the possibility of greatly simplifying the marketing and exchange processes. A goldsmith suggested to a wheat merchant that more growers of wheat would bring their wheat to his warehouse if he would give them in exchange claim checks on gold instead of claim checks on wheat. When the merchant replied that he had neither gold nor claim checks on gold to offer, the goldsmith explained that claim checks on gold could be borrowed until such time as the merchant might sell the wheat.

The wheat merchant decided to experiment as suggested. When the next wheat grower arrived with a load of wheat, the merchant offered him a choice between claim checks on wheat and claim checks on gold. When the wheat grower said he preferred the claim checks on gold, the merchant stepped next door and gave to the goldsmith the claim checks on wheat accompanied by a promissory note for gold. Whereupon the goldsmith gave the merchant claim checks on gold, which were delivered to the wheat grower in exchange for the wheat he had delivered. The wheat merchant's promissory note read like this:

This is to certify that I have received and now offer for sale in my warehouse 100 bushels of wheat for which this note is a claim check. Received this date from the goldsmith 100 claim checks for 1/35 ounce of gold each. As the wheat is sold I promise to return to the goldsmith corresponding claim checks on gold with interest at 6 percent, and if I fail to return all the claim checks within 30 days the goldsmith may claim the wheat not yet sold.

And each of the 100 claim checks on gold issued by the goldsmith read like this:

I promise to pay to the bearer on demand one thirty-fifth of an ounce of gold.

William James, Goldsmith.

Shortly thereafter, the goldsmith made an interesting discovery. At first he had issued claim checks on gold totaling no more than the gold in his possession. His discovery was that few people who obtained his claim checks ever demanded gold. Most of them used the claim checks on gold as purchasing media to buy other things, and the sellers returned the claim checks thus obtained to the goldsmith as agreed in order to repay their borrowings. Occasionally, some individual demanded gold, but even that gold usually returned to the goldsmith, for safekeeping if for no other reason, within a short time.

Commercial Banking

The much greater convenience to all concerned provided by the claim checks, especially those on gold, facilitated great increases in trade. Soon the goldsmith was being urged to issue claim checks on gold for greater amounts than the gold he had. But by that time, he knew from experience that few who had claim checks would want gold if other things were available for purchase in the markets. Consequently, the goldsmith reasoned thus:

a. If I am prudent in judging the gold exchange value of the things the merchants have to sell, and if I am sure that they are offering those things on the markets, I can issue more claim checks on gold than the amount of gold in my possession. Few of the people who get my claim checks will want gold; most of them will use the claim checks to buy other things.

b. If I make sure that the merchants repay their loans promptly by returning to me the claim checks on gold that they receive when they sell wheat, skins, etc., I shall be sure that there are no more claim checks outstanding than the total value of things left in the market place plus my gold. Obviously, I must lend my claim checks only for short periods and must insist that a merchant promptly repay me whenever he sells the wheat or other thing that serves as security for his promissory note.

c. If, for any reason I cannot foresee, many individuals suddenly decide to demand gold for their claim checks on gold, I can refuse to lend any more and insist that the merchants repay past loans. This will force the merchants to reduce prices on what they have for sale; the lower prices will attract purchasers who have claim checks on gold; thus people who have such claims no longer will demand gold from me but will exchange their claim checks for other things such as wheat. Then the wheat merchants, in order to repay their borrowings, will return to me

the claim checks on gold they had borrowed. In a short time, there will be no claim checks on gold outstanding, or at least no more than I can readily redeem with gold if necessary.

Once the goldsmith initiated operations as just described, sound commercial banking was under way. Soon, more of the goldsmiths in the first market and then in other markets undertook the new business of commercial banking. However, for a long time they were known as goldsmiths.

Intermarket Trading

Shortly thereafter some interesting relationships were discovered. In a market area not far from the first, the cost of producing wheat was less because the alluvial valley land was richer. On the other hand, beaver skins were available in larger quantity with less effort in the first market area because of the many hillside waterways where beaver could be trapped. In the second market area the exchange value of wheat for gold decreased (the price of wheat declined), and in the first market area the price of beaver skins was lower than it was in the second market.

Even in the days of simple barter, there had been differences in the exchange values of wheat and skins in the two markets. But with the regular use of gold or claims on gold as purchasing media, the price differences became more apparent and the advantages of regular trade between the two areas became obvious. Thus inter-area commerce increased to the mutual advantage of all concerned.

At first the goldsmiths wondered whether or not the supply of gold would be adequate for the increasing number of exchanges and growing volume of commercial banking for which many more claim checks on gold were needed. However, as the goldsmiths became better known, more gold was brought to them for safekeeping. In addition, the gold producers took advantage of the new inventions stimulated by the general advance of a trading civilization to increase the effectiveness of their operations. Crude pumps were developed to provide water for hydraulic washing of gravel, and the new wheeled carts lessened costs of hauling supplies, etc., as the costs of other industries were similarly lessened. Thus gold production was stimulated.

In addition to the lending to merchants originally undertaken and still continued, the goldsmiths finally were creating and lending claim checks on gold to traders shipping from one market to another and to processors of wheat and skins such as the millers and furriers. In each instance the goldsmiths were at first careful to apply the basic principle of commercial banking, i.e., that each new issue of claim checks on gold created for a borrower should, in effect, represent either additional gold received or other things being offered in the markets.

Savings Deposits

Soon the goldsmiths developed a new aspect of their business. Some of the individuals employed by manufacturers, merchants, and traders found that their wages and salaries would buy more than their immediate needs for consumption. Consequently, they began to save and invest part of their incomes. At first, these individuals invested the claim checks on gold they had saved directly in new houses to rent and other things, but some of them realized that the goldsmiths were in a position to make such investments, safeguard the documents concerned in their vaults, and exercise continuing supervision. By mutual arrangement the goldsmiths then undertook to receive such savings and invest them. For example, a salaried executive would bring part of his salary each month in the form of claim checks on gold to the goldsmith. A record of this deposit was made by the latter; this record was known as a savings account or time deposit.

Of course, the purchasing media in the form of claim checks received by the goldsmiths from savers were already in existence; those claim checks had been created and issued originally by the goldsmiths as commercial loans were made; some individuals who had received the claim checks from the merchants and other borrowers chose not to buy some of the things in the market but to deposit some of their claim checks at the goldsmiths; consequently, things that those claim checks represented still were for sale in the markets, and those claim checks, although the same in all outward appearance as other claim checks, could be loaned or invested by the goldsmiths in other than commercial loans. As far as those claim checks were concerned, the goldsmiths could safely disregard the commercial-loan principle, because those claim checks had been issued in the first place to represent things being offered and still available in the markets. Of course the goldsmiths promptly invested or loaned those claim checks, and anyone who borrowed those claim checks from the goldsmiths would find things of equivalent value already in the markets for him to buy.

At first thought, readers may wonder whether the goldsmiths might not become confused by making two types of loans with similar claim checks. However, the goldsmiths had an exact record of the savings deposited with them. Consequently, they always knew precisely how much they could invest in bonds, mortgages, or other loans that did *not* involve simultaneous offerings of things in the markets.

Inflation

Then, during a period of peace and general prosperity when markets were functioning well and the goldsmiths were actively conducting their

usual businesses of both commercial and noncommercial lending, an unusual event occurred. A would-be borrower who had nothing to offer on the market desired one of the new chariots then becoming fashionable. He asked his goldsmith friend for a loan, but was at first told, "I am sorry to disappoint you, but my records show that all the savings deposited with me already have been invested. As you can understand, a loan to you for the purpose you have indicated would not be a commercial loan because you would not be simultaneously offering anything on the market from which the proceeds of sale would repay the loan. Therefore, I should not create and issue new claim checks on gold in order to lend them to you."

The would-be borrower, a long-established customer of the goldsmith's, had his reply ready. "I realize that what I am asking is unusual, but what harm can result? If you fear for the safety of the loan, I can give you a chattel mortgage on the chariot I buy; it will serve as security for the loan. If I fail to repay when the note falls due, you can repossess the chariot and reoffer it on the market yourself. Moreover, I am willing to pay an unusually high rate of interest. You will be well protected and can profit by the arrangement."

Now the goldsmith in this instance, although by no means stupid, was not well informed on the principles of sound commercial banking. He had fallen into the habit of thinking more about the security for his loans than of their purpose. Finally, he had had no experience with and could not foresee the consequences of departing from the basic principle of sound commercial banking. He therefore created some additional claim checks on gold and loaned them to the persistent borrower. Thus was inflation begun.

As soon as the borrower had the claim checks in his hands he rushed to the market and bought one of the few chariots then available. Within the next several days, other individuals who in the usual course of events would have purchased chariots likewise sought to buy. The chariot merchant realized that demand for his product was exceeding the supply; his haggling over prices altered in tone with the result that chariots soon commanded higher prices.

The chariot merchant then dispatched a letter by mounted messenger to the manufacturer of chariots ordering an additional number for early delivery. The manufacturer was so pleased with the increasing evidence that his products were finding favor in the seemingly more affluent society that he decided to push ahead with plans long under consideration for expansion of his manufacturing facilities. He went to the goldsmith and proposed to borrow on a large scale either by giving his note or bond (another form of promissory note) in which the goldsmith could invest savings at his disposal.

More Inflation

The goldsmith's reply was, "I can see how advantageous your early expansion seems to be; but, unfortunately, I have already invested all the savings at my disposal. In fact, my noncommercial, investment-type assets (holdings of bonds, mortgage notes, etc.) already exceed the savings heretofore deposited with me plus my capital funds. You will have to wait until additional savings are brought to me for investment."

But the chariot manufacturer was eager to proceed; consequently he urged, "Your loan will be well secured. Within a year at most, I shall be producing additional chariots from the new plant, and in 8 or 10 years your loan can be repaid in full. Surely, what I am proposing is a sound loan."

Thus the goldsmith was finally persuaded to create more claim checks on gold and lend them to the chariot manufacturer. The latter then started bidding for labor and construction materials in order to construct his new plant. Of course, the new purchasing media thus made available for purchases of things in the markets were in excess of the value of things then being offered in the markets for sale. Inevitably, competitive bidding forced prices and wages up. In this community a period of boom prosperity began. All makers of things found demand in the market place suddenly increased; all tried to increase their plants, all bid for scarce materials and labor at higher and higher prices. The goldsmiths were urged to make more and more noncommercial loans at higher and higher rates of interest, and the more they disregarded the "old-fogey" principles of sound commercial banking the more their new-found "wisdom" seemed justified by the turn of events.

At least, such were the effects at first. Then subtle changes in past procedures began to appear. Merchants in this market area discovered that they could buy at lower prices in other market areas. First wheat, then skins, and finally even chariots were being brought in from adjacent market areas in large quantities. The local merchants of course had to pay for the things thus brought in, and they gave the claim checks on gold issued by the local goldsmiths.

Then the goldsmiths made an important discovery. Formerly, few of the claim checks they issued were presented as demands for gold. Most claim checks had returned to the goldsmiths as merchants repaid loans and then were reissued for new commercial loans. Almost no one in the local market had seemed to want gold. However, the goldsmiths in other markets (communities B, C, etc.) had no use for the claim checks issued by goldsmiths in the market where prices (exchange values of other things for gold) had increased so greatly; consequently, the claim checks were presented as demand claims for the gold held by goldsmiths in community A.

At first, the goldsmiths in community A were not concerned about the outflow of gold from their vaults. Occasionally in the past, claim checks had been presented for their gold, and they had encountered no difficulty in satisfying the desires of those who, for one reason or another, wished to hold gold. In this instance however, the demand for the goldsmiths' gold persisted. Soon the gold left in their vaults was far below the amounts that they formerly had considered reasonable in relation to claim checks outstanding.

Deflation

At this stage, the goldsmiths in community A became alarmed. Unless some way could be found to alleviate their situation, they soon would be bankrupt. First, they turned to the borrowers who were building new factories or who had bought new chariots and urged them to repay their borrowings. But the manufacturers told the goldsmiths, "Surely, you remember that we have bought bricks and mortar with the claim checks you loaned to us. Someone else has those claim checks now, and we shall not be able to repay for a few more years." And those who had borrowed to buy chariots said, "We simply cannot repay the claim checks we borrowed until our future earnings are received in the months ahead."

Finally, in desperation, the goldsmiths turned to the merchants and said, "We cannot loan you more claim checks to buy more goods; we must have repayment of your outstanding loans. Then the rush to liquidate began. Merchants marked down prices in order to persuade more shoppers to buy with claim checks that could be used to repay loans. Merchants canceled orders for things from manufacturers in order to avoid becoming obligated for incoming goods. Manufacturers reduced production, and the number of unemployed in community A greatly increased.

As prices generally fell, prices of secondhand chariots declined rapidly. Soon some of the goldsmiths in community A realized that their loans secured by chariots were "frozen" because the borrowers were unemployed and the chariots involved were worth much less than the unpaid loans. These goldsmiths repossessed chariots and sold them at auction, but the proceeds of such sales were insufficient to cover the unpaid loans. Some of the goldsmiths then realized that their own capital, and more, had been lost; they too were bankrupt and were forced to close their doors to the dismay of many savings depositors and of others who still held the claim checks on gold issued by those particular goldsmiths.

Gold Production

One of the interesting developments during the days of boom prosperity and afterward was the trend of gold production. When businessmen generally were frantically bidding for raw materials and labor at

rising prices and wages, gold production markedly decreased. The reason was not difficult to ascertain. From the viewpoint of the gold producers, the prices of everything they had to buy and the wages they had to offer in order to attract labor rose rapidly. The gold producers thus were forced to discontinue producing in all but the richer gravel deposits and mines. Labor and new machinery that might ordinarily have been used in producing gold were diverted to other activities.

Later, after prices generally and wages had fallen extensively and many were unemployed, gold miners found that old abandoned mine shafts and gravel deposits could be worked again. Even placer mining by individuals became popular.

Some of the economic theorists in this society had become concerned during the early days of the depression and developed learned theories about the "shortage" of gold, blaming that for the depression difficulties. However, their books hardly were published before gold production was stimulated again as described above and increased to levels never before reached.

With our understanding of the entire situation in community A, we can see that the decrease in gold production was desirable. It tended to discourage continued issuance of claim checks by the goldsmiths when they already had issued too many. Moreover, the subsequent increase in gold production during the depression had a reverse effect in that it made more gold available to the goldsmiths and encouraged them to create more claim checks on gold. For all new gold delivered to the goldsmiths they gave claim checks that were purchasing media, which made possible increased demand for other things. In addition, as their gold holdings increased once more, the goldsmiths were in a better position to resume commercial lending.

England's Experience

As it happened, one national economy where the goldsmiths functioned most effectively was England of the 19th century. In the early 1800's the English goldsmiths, who by then were called bankers, developed a modification of the claim-check procedures described above. English merchants found that handling claim checks was awkward and that a simpler procedure would be to have the banker hold the claim checks and permit the borrowing merchant to transfer them from his account to others in whatever amount he wished by written order directing such transfers.

When merchants or others brought gold or claim checks on gold to the bank, the English bankers wrote a credit on their books, which they called the depositor's "checking account." A depositor who held title to such a demand deposit or checking account then could write checks (written instructions to the bankers) transferring any portion or all of the gold thus represented to others.

In applying the commercial banking principle, the bankers accepted borrowers' promissory notes, but instead of creating claim checks on gold for the borrowers to use, the banks authorized the borrowers to write checks not only for the amounts already in their checking accounts but also for the additional amount of the loan. The excess checking account purchasing media thus authorized were called "overdrafts." An English commercial banker thus had a record showing him continuously the total of overdrafts on accounts in his bank. As the total of overdrafts increased, an English banker tended to be more cautious about making loans. Moreover, the bookkeeping record of overdrafts was a continuous reminder to him that his loans resulting in overdrafts should be short-term strictly commercial loans based on goods being offered in the markets.

Somewhat complicating the situation was the fact that many exchanges in the markets still involved the use of claim checks on gold instead of checks drawn on checking accounts. The claim checks on gold issued by a bank finally were given the name "banknotes," because they were the bank's promises to pay gold on demand.

Experience in the United States

Although the basic principles of sound commercial banking were being applied with increasing success in England during the 1800's, these principles were not so widely understood in the United States. Hundreds of banks were started in the several States of the Union by individuals who knew nothing of banking beyond the fact that they wanted to participate in that mysteriously profitable business. These amateur goldsmiths were easily induced to provide claim checks on gold (their banknotes) to borrowers who wished to speculate in land, then in the railroads, sometimes in almost anything. Moreover, unlike the English bankers who differentiated between overdrafts and the original deposits of gold and claim checks on gold by their customers, the American bankers used the same name, "demand deposits," for both. When they accepted a borrower's promissory note and created claims on gold for him, they either issued new claim checks called banknotes, or added the amount to his previously existing checking account as the borrower desired. Except for technical legal requirements as to banknotes, which need not concern us although important to students of money and banking, the American bankers lacked the constant reminder to be cautious and adhere to sound commercial banking that the English bankers had in their records of overdrafts.

The inevitable result of such banking was a long series of minor booms and recessions, with occasional great booms (whenever all or most of the goldsmiths became especially optimistic) followed by severe depressions. Efforts were made by the State governments and by the Federal Government to remedy the situation. Almost every conceivable

remedy apparently was tried, even the adoption of sound commercial banking for a brief period. A review of the principal remedies adopted is enlightening.

One of the first methods chosen for improving the functioning of the goldsmiths (or commercial bankers as we shall call them from this point on) was to limit the amount of claim checks on gold that they could legally issue in relation to their actual holdings of gold. Thus were initiated the legal reserve requirements that have become characteristic of American banking.

The reason for adopting such a crude, rule-of-thumb procedure is not difficult to understand. Evidently, the hundreds of banks that failed (many thousands as the decades passed) had overexpanded; therefore, why not limit the creation of claim checks (whether banknotes or checking accounts) to a smaller multiple of a bank's gold? This procedure did work, in a manner of speaking; at least, it tended to prevent every major boom from getting as completely out of control as had the tulip speculation in Holland, or John Law's Mississippi Bubble inflation in France, or the French inflation of the assignats, or the Rhode Island paper-money inflation, or the Continental currency "shinplaster" inflation of the late 1700's.

Another means by which better banking was sought was the organization of the National banks in 1861. By establishing certain safeguards, such as requiring deposits of Government bonds in relation to note issues, the credit "rope" with which the Nation's bankers periodically "hanged" themselves and nearly everyone else was somewhat shortened.

At long last, after a particularly disastrous experience with an inflationary boom and bust resulting from ignoring the principles of sound commercial banking, a Monetary Commission was formed. In the course of an investigation extending over 5 years early in the 1900's, the Commission rediscovered the principles of commercial banking that had been applied in England for nearly a century.

Following the recommendations of the Monetary Commission, the United States established in 1914 a Federal Reserve System including 12 Federal Reserve banks and thousands of member banks. Although the resulting money-credit arrangements included many "hangovers" from earlier procedures, the new system at least recognized and attempted to apply the principles of sound commercial banking. In the 3 years from 1914 until the United States entered World War I, the banks of the Nation came as near as they ever have to an understanding and application of sound commercial banking.

Wartime Inflation

During World War I, the governments of the warring nations including England chose inflation as the expedient means of financing

their war efforts. In England, the long-established principles of commercial banking were put aside as the goldsmiths or commercial banks were persuaded to create claims on gold for the national Treasury in the forms of both banknotes and checking accounts in exchange for Government bonds. The resulting great increase in the purchasing media had the usual effects on prices, wages, and business activity.

In the United States during the years of World War I after 1916 similar procedures were followed. The new Federal Reserve System was used as an "engine of inflation" by inducing the commercial banks including the 12 Reserve banks to accept Government bonds in exchange for additions to the Treasury's checking accounts.

Shortly after the war, the Federal Reserve Board sold Government bonds from the Federal Reserve banks and forced deflation. Thus most of the inflationary purchasing media were removed from circulation, and sound commercial banking might have been resumed.

The "New Era" and 1929 Panic

Unfortunately, the wartime practice of having the 12 Federal Reserve banks create new purchasing media (additions to Treasury checking accounts) in exchange for Government bonds soon was resumed. The reasons were complex. They included a misguided and in the end unsuccessful effort to help England restore the gold standard as well as efforts to stimulate business in the United States by means of an "easy-money" policy. The results was another great inflation, the effects of which, and in part the means, were found in unbridled stock market speculation. The speculators who borrowed to buy more stocks obtained newly created purchasing media that became the profits of those who sold at higher prices; and when successful speculators bought new cars, new homes, etc., with their gains, the boom in business was augmented until, for a time, increasing business profits seemed to justify the rise in stock prices.

The outcome, when the great speculative bubble burst, was drastic deflation and accompanying depression. By mid-1932 the process of liquidating prior inflationary borrowings was completed. Hundreds of banks had failed as had thousands of others during the earlier similar periods, but the remaining banks had liquidated inflationary loans and were back to a sound basis. Also as on past occasions, a recovery of business began as soon as the necessary deflation with accompanying reductions in prices and wages was accomplished. By the fall of 1932, the recovery was well under way.

As it happened, however, a presidential election was held in that year. Although the President-elect had espoused sound money and had ridiculed assertions concerning threats to the gold standard, he permitted some close advisers to learn in December 1932 that he favored managed-

money panaceas and that he intended to do something about the seeming shortage of gold.

The Banks Close

Soon rumors spread, and a run on the banks was begun by many depositors who feared that claims on gold would not be honored after the new Administration came into office. The run reached startling proportions during February 1933 as the President-elect declined to join with his predecessor in reassuring the public as to the new Administration's intentions. By early March every bank in the Nation was forced to close its doors, although nearly all were soon found to be in excellent condition and were reopened. (Most of the few that failed at that time subsequently paid depositors every dollar owed to them.)

In 1934 by newly-enacted laws all existing claim checks on gold were, in effect, reworded so that they became claims for about 40 percent less gold (i.e., only 60 percent of the original amount).

But the devaluation of the dollar failed to raise prices immediately and restore prosperity as some naive advisers had predicted. Another experiment, planned inflation as specifically recommended in detail by Lord Keynes, was undertaken. By again persuading the commercial banks to accept Government bonds in exchange for newly created additions to Treasury checking accounts, the Government's deficits were "monetized" in substantial part. The initial result was a short-lived boom that still left 7,500,000 unemployed; and the aftermath was one of the most extensive and most rapid business contractions in the Nation's history. By 1939 nearly 10,000,000 were unemployed.

World War II

Then came World War II with the repetition on a larger scale of the inflationary wartime financing of World War I. In fact, so great an amount of inflationary purchasing media was created and issued in monetizing Treasury deficits that the early recipients could not find the things they wanted to buy. New cars and new homes desired by individuals simply were not available, and businesses could not obtain new plant and equipment except for wartime needs. Consequently, a large portion of the inflationary purchasing media in the forms of both currency and checking accounts was hoarded or held idle until the postwar years.

Postwar Inflation

Instead of forcing deflation, as was done shortly after World War I, the Federal Reserve Board (the money-credit policy agency in the United States) continued its easy-money program, apparently influenced greatly by an Administration fearful of a great depression. (Many

Keynesian economists then were predicting a relapse into depression with millions of unemployed.) Without describing the postwar experience in detail, we simply note that inflation continued with only minor cyclical interruptions, each of which was cut short primarily by the continuing flow of hoarded inflationary purchasing media into circulation and secondarily by further monetizing of public and private debt.

By 1958 the economy of the United States, in relation to other leading industrial nations, had become like economy A in relation to economies B, C, etc., as described earlier in this discussion. Foreign claims on U. S. gold and foreign withdrawals of gold from the Nation's monetary system increased rapidly. Although some understanding of the situation was evidenced by the Federal Reserve Board when it pursued its tighter money policy throughout 1959, this policy was abandoned by mid-1960, apparently because a business recession was developing.

The Situation, November 1960

At this writing, we do not know whether the recession will become a depression or whether renewed inflation will be undertaken in an attempt to revive the business boom. That the latter action obviously would make an already bad situation worse may, or it may not, have a decisive influence on Federal Reserve Board policy and fiscal policies of the Federal Government.

In any event, another Monetary Commission now is at work attempting to analyze the Nation's money-credit problem and propose solutions. It seems safe to predict that, unless the basic principles of sound commercial banking are rediscovered and suitable measures for the transition to sound money and sound banking are adopted, satisfactory solutions of the Nation's money-credit problems will be indefinitely postponed. In the meantime the question whether the United States will become one more victim of money-credit follies, whether it may even be destroyed as inflation has destroyed many other nations, hangs in the balance.

Correct understanding is a prerequisite to wise action. You can help to promote correct understanding in the present crisis by distributing this bulletin. Extra copies: 5 for one dollar (\$1).
