

# WHERE FRIEDMAN WENT WRONG

## *"Is a gold standard cum real bills an option"*

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"Dismal Monetary Science"

Date

I was in Chicago on November 17 to address the MBA class of 2007 at the University of Chicago Graduate School of Business. I had a prepared address on Milton Friedman's monetary theories concerning the adjustment mechanism of foreign trade under the floating exchange rate system. Before I could deliver it the announcement came that Friedman had died the previous day in San Francisco at the age of 94. Newspapers carried long obituaries calling him the man "who has changed economics, policy, and markets" and "made free markets popular again". My address was sharply critical of the Nobel laureate Chicago economist. It would have been a dissonant chord in the cacophony of eulogies, so I decided to deliver an extempore address instead. However, I did not tear up my script. A dollar crisis was brewing. As I see it, Friedman has sowed the wind and the world is going to reap the whirlwind. Soon. When it does, I may want to publish my critique of Friedman's monetary theories.

Here it is.

### **Keynes and Friedman**

Mr. Humphries, Graduating Class, Honored Guests, Ladies and Gentlemen:

You may call me reckless for daring to come here, the shrine of monetarism, to preach the anti-monetarist gospel. I must confess that I do it with some diffidence, given the enormous prestige of the father of monetarism.

Along with John Maynard Keynes (1883-1947) Milton Friedman was the *enfant terrible* of twentieth-century economics. Thirty-five years apart, the two of them were the great wreckers of the gold standard. George Schultz, a friend of Friedman's who served in the Nixon administration, says that in 1968 Friedman wrote a letter to president-elect Nixon suggesting that upon inauguration he should unilaterally take the United States off the gold standard (or whatever was left of it after president F. D. Roosevelt had wrecked it, on advice from Keynes, 35 years earlier in 1933).

In 1933 Keynes set out to persuade Roosevelt to default on the domestic gold obligations of the United States. He prevailed. In 1968 Friedman set out to persuade Nixon to default on the international gold obligations of the United States. He did not prevail. Not immediately, anyway. Thus the glory for dealing the *coup de grâce* to the gold standard eluded him.

Demonetization of gold was not the only option available to Nixon. He could have also devalued the dollar in terms of gold. As is known, Mises was in favor of the latter. A new official gold price of \$70 per oz, amounting to a 50 percent devaluation, was the figure being bandied about.

Friedman's unsolicited advice to Nixon tells us something about the character of the man. Rather than initiating a high-level debate among monetary economists on the disastrous monetary policies of the US government that has led to the 1968 crisis, Friedman preferred to work behind the scenes on his plan to plunge the nation headlong into irredeemable currency. He was determined to make the dollar an out-and-out fiat money, the worst type of currency known to man.

Friedman knew that people would be hooked on fiat money once it has been inflicted on them. Here is a quotation from monetary scientist Walter E. Spahr [1], the Head of Department of Economics at New York University from 1927 to 1956.

"The majority, when given a taste of it, embrace irredeemable currency. The arguments offered in its defense are many and various, and constitute a sad commentary on human intelligence and character. The dilemma whether to give it up is much like that of the drug addict whether to give up dope. Even if he wanted to heed the advice of his understanding and experienced physician, often he will decide not to kick the habit. The run-of-the-mill speeches and articles on 'inflation' in this country provide a typical example of the majority reaction: they either evade the issue in ignoring that inflation is caused by fiat money, or they distort pertinent evidence, or they preach virtue where there is none, or they utilize currently popular platitudes, or they treat superficiality as though it should be accepted as wisdom. Rarely does one see a statement that an irredeemable currency is preferable accompanied by an attempt to give reasons for such an untenable belief."

Friedman's is such a statement.

"A nation in due course pays severely for the use of irredeemable currency. The United States is in a position analogous to that of a drug addict administering a law liked by all other fellow drug addicts."

In this case the 'understanding' physician, Friedman, urges the addict to carry on with substance abuse.

### **Irredeemable currency is massive fraud**

The following quotation is also from Walter E. Spahr [2].

"Irredeemable currency means either fiscal or moral bankruptcy, or both. We are morally bankrupt now in so far as our monetary system is concerned. Both the U.S. government and the Federal Reserve have demonstrated that they wish to be free of pressure that people may put on them if our currency were redeemable. They are satisfied to hide behind irredeemable I.O.U.'s. Although a private citizen can expect imprisonment if he issues irredeemable bills of credit, our government and Federal Reserve banks have adopted as defensible a standard of morality that is not tolerated among honest people. They exercise power arbitrarily while refusing to accept the corresponding responsibility."

Friedman has never addressed the question of morality in issuing obligations that one has neither the means nor the intention to meet — as demonstrated by the check-kiting scheme between the U.S. Treasury and the Federal Reserve.

"A nation is in serious trouble when that state of affairs exists. The federal spending orgy since 1933, the depreciation in the purchasing power of our dollar, the mounting federal debt, the centralization of power in Washington, D.C., the steady march into the Death Valley of socialism, these are some of the manifestations of what tends to happen when a government steals the people's purse, having drugged them with the poison of irredeemable bills of credit."

This was written in 1958. Much happened since that would have surpassed even the worst fears of the author had he lived to see it, including the dismantling of America's once flourishing industries.

"Irredeemable currency is a massive fraud on the people. It is the chief and common means by which governments put shackles on free men."

In spite of all his free-market rhetoric, this point was lost on Friedman.

"A government loses its moral standing among men of integrity when it employs irredeemable I.O.U.'s. The regime of irredeemable currency is a monument to the dishonor of governments."

And, one might add, to the dishonor of advisors urging the government to carry on this abuse of power, in defiance of the Constitution.

"Irredeemable currency tends to expand and grow, and to carry abusers to their destruction. It is a potent contributor to international economic disintegration."

To this day Friedman could not see the signs of disintegration, be it the accelerating increase of the money supply, or the Babeldom of foreign exchange derivatives trading at the rate of \$ 500 *trillion* per annum, and rising exponentially, when the combined GNP's of all the nations on earth is a paltry \$ 40 trillion per annum.

"Irredeemable currency is a cesspool in which economic disease and human conflict are spawned. It is a wrecker of people, of families, and of nations. It is a road to the despotism of dictatorship."

It was, in Russia in 1917; in Germany in 1933; in China in 1949, to mention but three outstanding examples. Does Friedman really believe that it cannot happen here?

In most cases irredeemable currency led to war or civil war. Does Friedman really believe that it won't this time?

"Irredeemable currency is a symptom of a great national sickness. It 'engages all the hidden forces of economic law on the side of destruction which not one man in a million is able to diagnose' (according to Keynes, writing in 1919)."

Apparently, nor is Friedman the one in a million.

"What is the meaning of a gold standard and a redeemable currency? It represents integrity. It insures the people's control over the government's use of the public purse. It is the best guarantee against the socialization of a nation. It enables a people to keep the government and banks in check. It prevents currency expansion from getting ever farther out of bounds until it becomes worthless. It tends to force standards of honesty on government and bank officials. It is the symbol of a free society and an honorable government. It is a necessary prerequisite to economic health. It is the first economic bulwark of free men."

It is a great tragedy of our age that Friedman, the self-styled defender of the freedom of the individual and the free market, could not see this. Nor could he see the wisdom of Thomas Jefferson's warning: "*If the American people ever allow bankers to control the issuance of currency, first by inflation and then by deflation, corporations growing up around them will deprive people of all their prosperity until their children wake up homeless on the land that their fathers have gained for them.*"

## **Floating or sinking?**

In the 1950's Friedman concocted his pseudo-theory purporting to show how the floating system of foreign exchange rates would provide an automatic adjustment mechanism to balance the external accounts of trading nations. By implication, a gold standard was not a prerequisite of bringing about equilibrium in foreign trade. To say that Friedman is not a friend of the gold standard is an understatement. He maintains that it is a "price-fixing scheme" and as such a gold standard is anathema to the free market.

A monetary scientist should know better. Friedman puts the cart before the horse. A gold standard does not fix the price of gold any more than the tail wags the dog. What happens is that, once gold is in circulation, it is the price of bonds and notes that governments and banks are all too anxious to stabilize in terms of the gold coin of the realm. If they can, gold gives their obligations unmatched respectability. If they can't, then well-informed people will make their own conclusion about the quality of their paper.

According to Friedman's theory, under freely floating foreign exchanges a country in deficit would experience a loss in the exchange value of its national currency *vis-à-vis* a country in surplus which would, in turn, experience a gain. The former would be a more attractive market to buy from and less attractive to sell in. It could now export more and import less. The latter would be a less attractive market to buy from and more attractive to sell in. It would now export less and import more. The resulting changes in the export-import cocktail would restore trade balance. This is supposed to work as an automatic adjustment mechanism balancing foreign trade through the system of variable exchange rates.

This is an inept rationalization of the misfortune to have abandoned sound money. To say, as Friedman does, that debasement of the currency is a legitimate means of eliminating trade deficits, when carried *ad absurdum*, is saying that the worst currency is the best and the best the worst. Friedman's theory was actually put into practice by Nixon. The result judged from thirty-five years' of perspective was an unmitigated disaster. The monetary, financial, and economic stature of the United States is in shambles, thanks to Friedman's floating dollar. As a matter of fact, the euphemism 'floating' should be interpreted as 'sinking'. It was the sinking dollar that has turned the country from the greatest creditor into the greatest debtor the world ever knew. The dollar used to be a monetary giant, the envy of the rest of the world. Now, it is a dwarf treated with contempt abroad. And the worst is still to come. We are facing a credit collapse.

Floating did not solve problems that the United States was facing in 1968. It made them worse. The devaluation and the deliberate debasement of the dollar did not make American exporters stronger. It made them weaker. The weak dollar was a huge bonanza for the foreign competitors of America. They were able to buy more imported goods per unit of exports. By contrast, Americans were able to buy less. The deficit was financed by an unprecedented debt-pyramid spinning out of control. The terms of trade for America has deteriorated to such an extent that it necessitated the wholesale dismantling of once prosperous American industries. It is not just the foreign purchasing power of the dollar that is on skid row. So is its domestic purchasing power, official doctoring of statistics notwithstanding. The widely fluctuating value of U.S. Treasury bonds is a butt of some very unkind jokes by foreigners. True, the American people still appear to be well off. But this prosperity is resting on "thin ice" in the words of former Federal Reserve Board Chairman Paul A. Volcker.

## **What caused the great Depression?**

In their "Monetary History" published in 1963 Friedman and Anna Schwartz blamed the Great Depression of the 1930's on the 'Great Contraction' of the money supply in the United States during the period 1929 to 1933. *This is where Friedman went wrong.* He mixed up cause and

effect. In reality the contraction of the money supply was the effect of the Great Depression, not its cause. Businessmen declined to borrow in spite of the extraordinarily low interest rate available, because they could not see any profitable business opportunities around. The Federal Reserve can print all the dollars bills it wants; what's the use if there are no takers? The idea of putting crisp Federal Reserve notes into circulation through helicopter-drop, attributed to Friedman by Bernanke, is puerile. There is no synthetic substitute for the enterprising spirit of businessmen in search of entrepreneurial profits. You can't push dollar bills down the throat of lethargic businessmen.

The real cause of the Great Depression eluded Friedman, as it did Keynes before him. It was found by the German economist Heinrich Rittershausen who in looking for it went farther back in history than any other economist.

Unnoticed by Friedman and Schwartz, 1909 was a milestone in the history of money. That year, in preparation for the coming war, France and Germany decided to concentrate monetary gold in government coffers. They stopped paying civil servants in gold coin. To make this legally possible the notes of the Bank of France and the Reichsbank were made legal tender. Most people did not even notice the subtle change. Gold coins stayed in circulation for another five years. It was not the disappearance of gold coins from circulation that heralded the destruction of the world's monetary system. It was the making of bank notes irredeemable, even if they circulated side-by-side with gold coins for the time being. There was an early warning sign: the fact that finance and treasury bills were 'crowding out' real bills from the portfolio of central banks in consequence of the French and German governments' decision to make bank notes legal tender. Thus did the clearing system of the international gold standard fall victim to sabotage. It took twenty years before the chickens of 1909 came home to roost.

Well, come home they did with a vengeance. However, by 1929 the memory of the 1909 sabotage faded. No one suspected that a causal connection existed between the two events: making the bank notes legal tender and the wholesale destruction of jobs twenty years later. Permit me to elaborate.

### **Real Bills Doctrine**

Friedman calls himself a 'monetarist', meaning that he is a devotee of the Quantity Theory of Money. Like all quantity theorists, he is a sworn enemy of Adam Smith's Real Bills Doctrine. He has never understood completely the market in real bills as it existed before World War I, the function of which was to serve as the clearing system for the international gold standard.

When the victorious powers dictated their peace terms after the cessation of hostilities, they intentionally disallowed the international bill market to resume its former functions. They wanted foreign trade to follow a political rather than an economic agenda, in this case, to keep their former adversaries on short leash. At the same time, they wanted to retain the outward trappings of a gold standard. They failed to realize that sooner or later the gold standard would seize up without the support of its clearing system, the bill market. Worse still, they failed to see that world trade would contract severely as a consequence. Worst of all they were too obtuse to understand that the elimination of the bill market would be followed, albeit with some lag, by a horrendous and intractable unemployment problem confronting the entire world. This was correctly foreseen and predicted by Rittershausen in 1930. See [3] and [4].

Had the victors allowed the market in real bills to resume its proper functions after the signing of peace treaties, world trade would have recovered quickly and the international gold standard would have continued to hold sway over the world. On advice from upright economists sensible governments would have realized that legal tender laws were thoroughly bad and would have removed them from the books. The charters of central banks barring finance and treasury bills

from the portfolio could not have been violated with impunity. In that milieu there would have been no great depression. World trade wouldn't have vanished. The horrendous world-wide unemployment would have never occurred.

### **Destruction of the wage fund**

The fact of the matter is that prior to World War I wages of the majority of workers, namely all those engaged in the consumer goods sector, were financed by the international bill market. This is a point that eluded not only Milton Friedman but Ludwig von Mises as well. They missed the fact that the consumer was the ultimate paymaster and he would pay on the dot, provided that he had access to gold. It was his gold coin with which all wages were paid under the gold standard *cum* real bills. Tampering with the bill market, the clearing house of the gold standard, had an inevitable, if delayed, deleterious effect on employment.

Payment of wages is due long before the final sale of merchandise to the ultimate gold-paying consumer. In some cases the employer paying wages may have to wait as long as three months before he can collect his share of the proceeds from the sale of merchandise. Thus, then, there is the problem of financing wage payments. Unless this problem is solved satisfactorily, mass unemployment will ensue. The wage fund cannot be financed out of savings. Under the gold standard it was financed through the spontaneous circulation of real bills.

Whenever certain goods were in urgent demand, their movement through the channels of production and distribution was financed by self-liquidating credit. This also included all wages payable to workers handling consumer goods that were moving along on their way to the final consumer through the 'assembly line', as it were. The credit was liquidated out of the proceeds of the sale: the gold coin given up by the ultimate consumer when he removed the merchandise from the market. The system worked admirably well. Bills drawn on the retailer would circulate spontaneously. Real bills enjoyed ephemeral monetary privileges, which treasury bills and finance bills did not. Producers could buy supplies against this credit, and they could discount these bills at the bank to get gold coins with which to pay wages. Bills were the most liquid form of earning assets in existence. The competition of banks for them was keen.

*It is no exaggeration to say that the discovery of the spontaneous circulation of self-liquidating credit is one of the great achievements of the human intellect, on a par with the discovery of indirect exchange. Without it the great economic progress in the Modern Age would be unthinkable.*

After World War I the victorious powers, led by blind hatred for the vanquished, wanted to make foreign trade bilateral instead of multilateral. Exports and imports were made subject to political rather than economic considerations so that the victors could discriminate against their former adversaries. In this effort they unintentionally ruined the natural system of financing production and payment of wages. They dissipated the wage fund. They blocked the spontaneous circulation of self-liquidating credit in the world, the only safe and sound source from which wage payments could be financed. In doing so not only did they deal a mortal blow to the gold standard but, inadvertently; they brought upon the world the curse of massive and persistent unemployment.

This problem has been haunting the world ever since. There is still no satisfactory way of financing the wage fund of workers in the consumer goods sector in the absence of a gold standard *cum* real bills. There is no way bills could circulate under the regime of irredeemable currency. Not because real bills are anathema to Friedman; but because the idea of a real bill maturing into paper money is preposterous. A real bill is a *future good*. It must be maturing into a *present good* such as the gold coin in order to be able to circulate. It would just not circulate if it matured into another future good such as a bank note, redeemable or not.

The wage fund couldn't be financed out of savings. Apart from the problem that saving takes time, the sums involved are far too large. The idea that the working class can save the funds out of which it can pay wages to itself is no less preposterous than the idea that soldiers in the field can lift themselves up by their own bootstraps.

The only alternative to a gold standard *cum* real bills is the regime of irredeemable currency. But then the government has to assume the responsibility for paying the handouts of the welfare state: it has to pay workers for not working, and farmers for not farming. *Tertium non datur*: there is no third alternative. The regime of irredeemable currency and the so-called welfare state are Siamese twins. Here, in a nutshell, is Friedman on the horns of a dilemma. He likes irredeemable currency while he dislikes the welfare state. But if you like irredeemable currency, then you had better like its corollary, the welfare state as well. Nor does the problem end there, since fiat money cannot be a permanent arrangement of society. Unless it is stabilized by returning to a gold standard, it will collapse after having caused a lot of mischief in the economy, as convincingly demonstrated by monetary theory and history.

### **Optimal rate of increasing the stock of money**

Of course, Friedman says he has a panacea in mind for all the economic ills of the world. Just entrust the issuance of high-powered money at a steady optimal rate to the Federal Reserve. He was jubilant when his mentor Arthur Burns was named as chairman of the Federal Reserve Board. If anybody, he could do it! He could put the tenets of monetarism into practice. Well, he didn't. Neither could other chairmen, Bernanke's 'apology' on Friedman's 90<sup>th</sup> birthday notwithstanding. Central bankers consider Friedman's prescriptions "impractical" and they have said so. Friedman retaliated by quipping that "even a clever horse can thrash out grain at a steady rate, so why can't the dummies at the Fed?" There is neither inflation nor deflation in the never-never land of Friedman.

The idea that there is an 'optimal rate' of increasing the stock of money, and it could be determined scientifically, is chimerical. Creditors would challenge the 'optimal rate' saying it is too high; debtors would fight it saying it is too low. The federal government, being the greatest debtor of them all, would apply pressure on the Fed in support of the latter.

If the power to increase the money supply is delegated to an agency dressed in scientific garb, then this agency is a front behind which impostors hell-bent to usurp unlimited power under false pretenses hide. No matter how you look at it, the power to issue the currency *is* unlimited power. Unlimited power means unlimited corruption.

### **Mene Tekel Upharsin**

In so far as Friedman has any coherent theory of money at all, it is the tenet that, even though the creation of wealth must be trusted to private hands and to the free play of the market, the creation of money must not — notwithstanding the monetary provisions of the U.S. Constitution. Money creation must be put squarely into the hands of the government — never mind the Constitution which is, after all, 'just a piece of paper' (with apologies to George W. Bush).

Naturally, the U.S. government and the Federal Reserve were all too eager to embrace unlimited power assigned to them by Friedman, in spite of the fact that this power was not 'enumerated' in, nay, it was explicitly denied by the Constitution of the United States. Friedman's defense of a floating currency is pseudo-scientific claptrap, modernistic stuff designed to impress the mind untrained in monetary science (as opposed to 'dismal monetary science'). The unfortunate part is that permanent damage has been inflicted to the social science faculties of our colleges and universities where so many have abandoned true science for the dismal kind, in pursuit of the scent of money.

When Friedman's monetary theory is put on a scale against the U.S. Constitution, the verdict is: *Mene tekel upharsin* (you have been weighed and found wanting). Why the theory in the citation for Nobel Prize not was worth to merit a constitutional amendment is an interesting story. The credentials of Friedman were not strong enough to withstand public furor that would erupt if the paper dollar, hardly worth one constitutional gold cent, was supposed to be carved into the stone of the U.S. Constitution. The powers-that-be don't want to rock the boat. It is too risky. 'Let the sleeping dog lie'. Policy-makers could not muster the necessary moral courage to initiate a constitutional amendment. They would rather live with the odium of running a blatantly unconstitutional monetary regime. Be that as it may, the next dollar crisis will force the issue.

In "Two Lucky People", written together with his wife Rose, Friedman said: "We do not influence the course of events by persuading people that we are right when we make what they regard as radical proposals. Rather, we exert influence by keeping options available when something has to be done at a time of crisis".

*Well, Mr. Friedman, crisis is knocking on our door right now. It is a dollar crisis dwarfing that of 1968, or any monetary crisis in all the history of money. Do you mean to say that the option to rehabilitate the gold standard cum real bills is open still?*

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