Gold Standard: Net Costs or Net Benefits for Modern Economies?¹

Cristian Păun
Academy of Economic Studies, Bucharest, Romania
cpaun@ase.ro

Vladimir Topan
Academy of Economic Studies, Bucharest, Romania
topan_vlad@yahoo.com

Abstract

The current financial crisis reopened the discussions around the sound reforms that should be addressed to the modern economies. The actions that should be taken in order to create a more stable global system are based on the concept of sound money, the existence of central banks and the characteristics and objectives of monetary policies. One of the most sensitive problems of modern economies and source of economic cycles is the fiat money used as medium of exchange and administrated by central banks without having an objective criterion to establish the necessary quantity of money. This paper will discuss the characteristics of sound money, the explanations of the evolution from gold standard toward fiat money and the main economic critics against a possible reintroduction of gold as medium of exchange as a solution to the current high financial instability.

1. Sound money used as medium of exchange

Starting point in any discussion about the reforms that should be applied to current financial system should be the concept of sound money. During the history in the economy were used different types of money:

- Commodity money: any tradable good could be used as money in a particular exchange. This type of money is the oldest known money. The most tradable goods gained a better position in the choice regarding the medium of exchange facilitating with lower trading costs the transactions between the individual participants to the market. The value of the commodity as medium of exchange is based on this general acceptance as commodity by the market’s participants. Without previous acceptance as a commodity is impossible to establish a real value for this asset used as money for facilitating a specific transaction. There were a lot of assets used as money: shells, salt, spices, tobacco, cigars, animals, alcohol and even cannabis.

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- Metallic coins: due to the specific properties of metals (ore, cooper, silver and gold), metallic coins represented the next step in the evolution of money. This type of assets offered a greater acceptance from the market’s participants and was generally introduced in the economy in different shapes and composition, inscribed with different signs and marks in order to reduce the counterfeiting risk.

- Paper money full covered in metal: the rediscovery of China by Europeans in the Middle Ages (14\textsuperscript{th} century) allowed the access to their achievements, including the paper (in China paper money was introduced in 806 A.D after a severe shortage in the cooper reserves the Tang Dynasty). This ancient practice was imported and introduced in Europe later in the 17\textsuperscript{th} (firstly by several Italian and Flanders banks and later by the predecessor of the Bank of Sweden the first central bank - Stockholms Banco in 1660) because of the advantages of paper banknotes in terms of avoiding risky transportation of big quantity of gold or silver from a place to another. Without a central bank, this initial paper money was 100\% covered in a demand deposit of metal in the vaults of the private banks. The banknotes were issued with a specific discount that covered the cost of depositing the gold in the banks.

- Fiat paper money: the creation of central banks in the 17\textsuperscript{th} century legalized and strengthened the fractional reserves of commercial banking activities. Central banks replaced the gold (or silver) as medium of exchange with a cheaper and easy to print money and started to produce money in an unlimited quantity. This money has no market value and are strongly based on undersigned promissory of the central bank’s governor that the paper has that nominal value. This credibility is vital for the stability of the system and is impossible to be fulfilled by financial institutions less interested to keep the quantity of money fixed in time and more interested to maximize their profits from inflationary production of money.

- Fiat electronic money: is the ultimate form of money developed by commercial banks with the fully support of central banks. A lot of financial products (such as credit cards, debit cards, electronic payment orders, electronic cheques) discourage now the use of cash in the transactions with other goods and services. With a lower cost than paper money, commercial banks started to play a more active role in the production of money in an unlimited quantity more and less correlated with real economy and transactions between market’s participants, with fully support of central banks.

Modern financial systems are using only fiat money (paper and electronic) without any intrinsic value. According to “regression theorem” (Mises, 1953, pp. 97 - 123), a sound medium of exchange should be valuable prior as commodity (money are held today in cash balance because of the prior purchasing power of this money in terms of goods and services). It is impossible to consider that money could be created from nothing and that it is possible to allocate a value to it by using a simple signature and
official marks of a public institution (central bank). When we try to identify if an asset could be used as a sound money we should take a look to the main characteristics of it (Jevons, 1875, p.8): [1] utility and value (market’s participants should be able to establish a clear value of this money in exchange with all other goods and services); [2] portability (individuals are able to carry money with them and transfer it to other individuals with low costs and efforts); [3] indestructibility (money must not be subject to easy deterioration or loss); [4] homogeneity (all divisions of money should have identical quality with exactly the same value); [5] divisibility (any asset used as money should be mechanically divisible almost without limit in order to allow any payment in any value); [6] Stability (currency should not be subject to change of its value); [7] Cognoscibility (money should be easily recognize and distinguish from other assets and should be impressible with seals, design and marks that testify the authenticity of it).

Figure no. 1. Characteristics of sound money

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<th>Characteristics</th>
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<td>Utility and value</td>
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The use of gold money is a result of a very long history and evolution of money. Market’s participants used different types of assets as money but, due to its natural characteristics, gold remains the perfect asset to be used as medium of exchange. Fiat money (paper and electronic) used in modern economies is imperfect money that meets partially the characteristics of sound money. Created from nothing by a discretionary action of a public institution (central bank), fiat money has no a sound value and utility associated to it. Paper and electronic fiat money could be easily destroyed and counterfeited by fraud. Fiat money could be produced in an infinite quantity, central banks acting always discretionary as a “legal counterfeiter” of existing quantity of money. Commercial banks multiply this quantity of money in the economy by using demand deposits with fractional reserve (demand deposits are borrowed to a different user, money being in the same time at disposal of two different participants to the market). This behaviour strongly affects the stability of money. Inflation generated by the actions of central bank and financial intermediaries alter the portability of money (is known well the situation in countries that experienced huge inflation where a significant quantity of paper money should have been used to buy only a simple bread).

2. How and why has the gold standard been abandoned?
Natural money (such as gold, silver) emerged from the market selection that always replaced “bad money with good money” (known as Gresham Law). When the first
central bank was created in Sweden (1668 – Riksbank that financed The Nordic Wars: 1700 - 1721), a new public policy was introduced in the economic environment: monetary policy. Until central banks were created and consolidated at the level or each country (Bank of England was created in 1694 to finance The Nine Years War (1688 – 1697); Bank of Prussia founded between 1765 and 1775 to finance The Seven Years War (1755 – 1763); Banque de France created by N. Bonaparte in 1800 to finance Napoleonic Wars that determined the creation of central banks in Finland (1811), Netherland (1814), Austria (1816), Norway (1816) and Denmark (1818); Bank of Portugal created as a consequence of Civil War (1846-1847), The First Bank of United States created in 1791 to finance the War of Independence (1776 - 1783), replaced by The Second Bank of United States in 1816 that was replace in 1913 by Federal Reserve created to finance the participation of United States in the First World War) the currency of different countries circulated covered 100% in gold. This phase is known as gold standard and had the following characteristics: few paper currencies issued by banks circulated in the system in connection with a specific quantity of gold deposited in the banks (100% coverage in gold); the exchange rate between different currencies was fixed (due to the fixed quantity of gold that covered each currency). Even in the gold standard central banks started to accept fractional reserves for commercial banks’ credit operations.

**Figure no. 2. Evolution of money in modern financial systems**

During the First World War, the states involved in the conflict needed important financial resources to support the war expenses. The gold reserves of the states were limited so the monetary expansion was impossible. Consequently, the gold standard was removed and central banks started to issue national currencies in the necessary quantity to support the war’s efforts. After the end of this war, countries participating...
to the international financial system tried to reverse the system to the previous gold standard. One of the results of the Great War was the independence of a large numbers of countries that claimed their right to use their own currency. Without having gold reserves (a lot of these countries were former colonies or territories from the great empires existing before the war) a compromise was required. So, it was accepted the idea that the value of a currency could be established based on the existence of a specific reserve in gold or a specific reserve in foreign currencies of countries that are in a gold standard. This phase is known as “gold-exchange” standard and lasted until 1931 due to a very competitive and aggressive depreciation policy run by the most powerful central banks, the frequently change of the structure of international reserves for small countries that had no gold to support their own local currency and the credit expansion promoted by central banks from the most developed countries (mainly US and UK) in order to help less developed countries. This inflationary system failed in very huge crisis in 1930 (Heilperin, 1939, 1968). After the Second World War started another stage of international financial system having less connection with gold – Bretton – Woods System (1945). In this case, it was established that only dollar should stay fixed in terms of gold (35 dollars per ounce of gold) and all other currencies in the system were fixed in terms of dollar (within a narrow band of +/-1%). This restriction wasn’t perfect because the Treaty allowed depreciation in case of significant problems of balance of payments (without defining these particular situations). The gold reserves from commercial banking system were nationalized and located in the vaults of the central banks. Any transaction with gold was strictly controlled by monetary authorities. The first problem occurred when British Pound, French Franc and Swiss Franc gained their full convertibility on the market. Another problem was generated by the massive Cold War expenses assumed by US. The only possibility to obtain liquidity in the system was to achieve more gold (very difficult from private markets) or to achieve more dollars by increasing exports in US. The consequence was a lower prices in US and higher prices elsewhere (export of inflation) that was considered inequitable by all non-American participants to the system. After strong crisis and massive transfers of gold from US to Europe, on 15 August 1971 US President Nixon announced that US will no longer participate to the Bretton Woods system. From that moment any link between money and gold was eliminated and money started to be an asset without intrinsic value. Central banks from everywhere started to imagine different solutions for a new financial order without obtaining a general consent on any idea. The economic role of monetary policies, monetary regimes, monetary targets, monetary instruments, central banks and commercial banks significantly increased replacing good industries with bad industries (less people being interested to produce something real and more people willing to be involved in financial and monetary industry). Without having any objective criterion to establish how much money should be issued in real economy, central banks acted blindly and push global economy in more and more severe crisis (“Oil crisis” from middle and end of ‘70s, external debt crisis from middle ‘80s, currency crisis from middle of ‘90s, “Dot com” crisis from 2002 / 2003 and now “Subprime” crisis).

In conclusion, the intrinsic characteristics imposed the gold as natural and sound money. This money was freely imposed by market forces and recognized by all as the best medium of exchange. Today we lost any connection with gold and we are forced by the power of law to use imperfect money – fiat money issued by central
banks as legal tenders (so called “forced money”, see G. Hulsmann, 2008, pp. 24 - 29). The main reasons to cut the link between money and gold were to secure and to capture the production of money by public entities and to transfer the costs of this inflationary and expansionist policy on the side of private users and owners of these money by using the force of law. Public institutions and private institutions that survive only because that they gain public contracts (including here entire financial industry expanded and developed only because they have the monopole in the trading of a public good – money) are the most interested into keeping alive this unfair financial system that is very profitable for them (and very unprofitable for the others). The economic theory produced a lot of fake arguments against the reintroduction of gold as medium of exchange, in order to strength and to “explain” the necessity of introduction and use of fiat money without intrinsic value.

3. Main arguments against a reintroduction of gold standard

Socialism and interventionism in the economy have less effectiveness without a currency fully controlled by a public authority. Any action of the state in the free market requires important resources that could be less costly produced by printing more money. The defenders of fiat money are in fact the defenders of socialism or interventionism.

The first argument against gold standard consists in the incompatibility of a fixed quantity of money with current population growth or technological development, increasing productivity. Higher population, better technology and higher productivity could increase the quantity of goods in the economy and the demand for money. In fact, the natural growth rate for gold reserves and competition between similar commodities (silver) will ensure a sufficient stability to the system. The creation of new technologies and the replace of obsolete ones will be made with less waste of resources if the producers and buyers will know better that their resources that could be involved in R&D activities are limited (today there are a lot of public research activities financed from the public budget impossible to be developed and promoted without fiat money). The population growth is also influenced by fiat money system: there are a lot of social programs (retirement programs, social aids) that minimize the role of families or subsidize the birth rate in different countries. “The determining the supply of money, like all other goods, is best left to the free market.” (Rothbard, 1990, p. 34).

Another argument against gold standard states that gold supply is inelastic on a short run (increasing marginal cost of extraction) and on a long run (natural scarcity) and will induce a price effect in case of a sustained economic development. Any fixed stock of an asset that is considered sufficient for being used medium of exchange will be capable to meet the requirements of sound money. There is no need to grow the stock of money in the economy, money being only a facilitator of exchanges and wealth and not a generator of it. Despite this false criticism, the gold reserve does increase at a very predictable and low rate between 1% and 3% per year. In this case, the rate of gold extraction is assumed to be sufficient to emphasize this price effect. Gold could be combined with silver that has the similar characteristics, in order to reduce this inelasticity and to ensure additional stock of money to prevent the price effect. The economy will grow with a more stable rate and the business cycles will be
less disruptive (boom and crisis will have a lower magnitude and they will occur at wider time intervals).

One of the most obsessive fears about a reintroduction of gold standard is related to the idea that this initiative will induce a deflationary spiral on the global economy (this is also the most invoked argument against gold standard in economic theory). In case of gold standard, an increase of money demand will decrease the demand for other goods and services. The goods will not be sold at the existing price. A deflationary spiral will be inevitable. Strong deflation will incite people to reduce their consumption (this is a false argument because the consumers will have a higher purchasing power), will have a negative impact on the aggregate production (not so clear because the producers will face with a lower cost for raw materials, equipments and other inputs), difficulties in service previous debts (previous debts obtained prior deflation will have a higher cost than current debts) or will increase the unemployment (but in fact, neither paper money will provide a better solution, the real causes of unemployment being only a transitory phenomenon in a free market case) (Hulsmann, 2008). If the gold (and silver) stock will increase with a sufficient rate (let say 2%) this will be enough for a natural economic growth (not all business ideas should be successful, on the free market will be erroneous projects, entrepreneurial errors, new products will replace old products). The deflation is a truly nightmare especially for public institutions, central banks and commercial banks trading fiat money and all other companies living exclusively from contracts with the state. For all the others, deflation is good and it is a solution to correct any previous disequilibrium on the market in terms of goods and services produced and consumed.

A similar argument against gold standard states that too few resources are involved for gold standard to be viable. The reduced quantity of gold will generate prices expressed in microscopic quantities of gold. If there will be a problem, quantity of gold could be completed by any other commodity with the same characteristics, especially for small payments (silver, cooper or other metals, tokens). And electronic payments and new technologies could be reconsidered in favour of this monetary system. Contrarily, other economists argued that too many resources are involved to maintain the gold standard viable. Gold standard will make the gold industry very profitable and there will be a waste of resources allocated to mine, process and mint gold. In fact, today there is a well developed gold mining industry and a lot of resources continued to be allocated to extract gold from mines (due to commercial and industrial value of this commodity). This waste of resources is not as high as it is suggested. When it is introduced such an argument it is forgotten or underestimated the huge cost of FOREX markets created to diminish a specific problem of fiat money – volatility of exchange rate - that is very risky for international business.

Unemployment effect (also known as sticky prices argument) is another well invoked argument against gold standard and strongly connected with disinflation. A fixed quantity of gold (money supply) and an increased quantity of goods will create a pressure on the prices (to be lower). To remain profitable companies will fire people and recession will start because the gold mining, processing and minting industry will be insufficient to employ all workers (Keynes, 1964). It is illusory to believe that paper money (unlimited quantity) will ensure full employment. “Suppose that
powerful labor unions push up nominal wage rates in all industries to such an extent that entrepreneurs can no longer profitably employ a great part of the workforce at these wages. The result is mass unemployment”. (Hullsman, 2008, p. 68 - 69). The key element underestimated by Keynes is the fact that entrepreneurs could respond to "sticky price" effect by reducing the wages of their employees (that will remain at the same purchasing power due to disinflation). It is not necessary to lay off your specialists because the nominal profitability is lower (in fact, the real profitability is the same). The entrepreneurs that will decide this could make a huge mistake to reduce their personnel when they act in a very competitive market.

The next argument against gold standard says that the prices in the economy should be kept stable and only central monetary authority, that will administrate a sound monetary policy, will be able to stabilize the prices on the market. When the economy will grow the prices will be kept stable if the quantity of money will increase (Pigou, 1949). Economic growth doesn’t mean that the production for all goods and services should increase (for some goods this production will decrease, in the market will be introduced new goods etc.). "The injection of new printed money will not ensure neither constant prices, nor economic growth, the pattern of prices being strongly affected” (Mises, 1939). A connected argument with the previous one asserts that money has neutral effect in the economy, the most prices being rigid (especially labor costs) and more money could enhance economic growth. "Sound money is neither stable in value (that is a matter of relative price) nor neutral in its effects on the economy (money bound the market process together into a web of exchange)” (Mises, 1919, 1939, 1949, 1965). A similar argument against gold standard, shared both by Keynesists and monetarists, states that, in case of paper / fiat money, a central authority (central bank) could develop an optimal monetary policy that could neutralize the effect of money on the economy. There is a long story about an optimal monetary policy that will maximize economic welfare (Fisher, 1935; Friedman, 1951). Central banks failed to target economic growth, prices level or other macroeconomic targets, producing more and more instability in the system. In practice, “the Fisherian stabilization movement was an abject failure” (Hulsmann, 2008, p. 76). The main reasons are: the imperfection of instrument proposed to measure inflation or exchange rate volatility (indices of prices) and the imperfection of macroeconomic variables used as targets for so-called optimal monetary policy (GDP, national income).

Keynesian macroeconomists often declared that gold standard is not so flexible and reduces the possibility of the central authorities to boost the economy by diminishing the interest rates during economic recessions (by printing more money and introducing it as capital on the market). Cheap money and credit will reduce interest rate, investment will increase and economic growth will be enhanced. In fact, cheap printed money means inflation and if this inflation will be anticipated the capitalists will ask for higher price premium but there will be no overall improvement (Hullsman, 2008, p. 70). If this inflation is not anticipated by capitalist, they will enter in an error and wrong investment decision (Mises, 1966).

Gold standard is not suitable for modern globalized economies (is not an appropriate international monetary regime) for at least two reasons: [1] is an unstable or unsustainable international monetary regime; [2] it cannot prevent disequilibria in
the Balance of Payments of any country participating to the global market. According with the interventionists’ view, commercial balance of a country could be equilibrated by using exchange rate (Marshall, 1890; Lerner, 1932; Keynes, 1936). But fixed exchange rate under gold standard allows an automatic adjustment of the balance of payments (D. Hume, 1777; D. Ricardo, 1817; M. Heilperin, 1939; J. T. Salerno, 2010) via direct – spending effect or indirect – relative prices effect (M. Heilperin, 1939, p. 163). A global paper money finally will “collapse in hyperinflation or force the government to adopt a policy of increasing control, and eventually total control, overall economic resources” (Hulsmann, 2008, p. 236).

In the same logic, few economists argued that gold standard will provide a massively unfair advantage to gold producing countries and existing holders (former colonial powers). The mistake made in this case consists in neglecting the fact that the countries with important reserves of gold will have higher prices in gold for all products, so all countries will be interested to sell their products in such countries. Consequently, the gold reserves in excess will be rapidly transferred abroad to those countries more aggressive in terms of exports to these rich in gold countries. Gold standard reduces imperialism because the Governments cannot just print money to fund military missions. Some others considered that fixed exchange rate existing in case of gold standard (due to the fact that all currencies will be fixed quantities of gold) will encourage the speculative attacks on local currencies. In fact, this would be real a problem only if it is kept a central monetary authority to administrate the system. This speculators will try to anticipate the issue of notes without being fully covered in gold and will sell today this notes (at a higher price) to be delivered in the future (at a lower price) when the information about the real quantity of gold and total financial instruments issued on the market will became available. In a 100% free banking system this speculative attacks are not present. Without any discretionary intervention on the market, more gold will be obtain only if with the ability to sell something valuable on the market (there are no artificially created resources that could be used to buy gold). The future price of gold will be determined only by fundamentals derived from money relation (demand and supply of money). Therefore, speculations on future gold price have the natural corrective function of free market speculation in general. If, in a pure gold standard, speculation and “instability” are natural, in a fiat money system the unavoidable setting of certain variables (such as paper currency gold exchange rate, paper currency versus paper currency exchange rate) at arbitrarily decided levels, constantly pushes speculators to test the discrepancy between these levels and fundamentals. Consequently, the natural speculation is supplemented by an artificially induced speculation.

According with Keynes the gold Standard is a “barbaric relic” (Keynes, 1964). This is not a sound economic argument because there are a lot of other “relics” that are still sound: the law of supply and demand, the Newton’s law of gravitation or the Euclidian axioms in geometry. It can be argued also that gold standard will deemphasize a nationalistic symbol surrounding a local currency (in few countries this element continued to have an important national value). In case of the “sound money”, cultural or national values are not mentioned to be a relevant characteristic. Cultural utility of money is far away from economic use of money and is not relevant for the value of money, its purchasing power or credibility between the market’s participants. When the governments will have no power to produce their money for
their personal use, the war industry will have no sufficient funds and the conflicts will be less disruptive. The nationalism and other arguments like security, national defense or patriotism will be significantly deemphasize.

Few theoreticians introduced in the discussion about gold standard the argument of the “hoarding effect”: the people will become obsessed by gold and silver and will start to accumulate it. The economy will be deprived of these important resources due to this risk adverse behavior that will keep in the individual cash-balances an important stock of gold. “Hoarding merely entails a reduction of money prices; hoarding on a mass scale merely entails a large reduction of money prices. Consider the (completely unrealistic) scenario of a nation hoarding so much silver that the remaining silver would have to be coined in microscopically small quantities to be used in the exchanges. In a free society, the market participants would then simply switch to other monies.” (Hulsmann, 2008, p. 64). In fact this is not a monetary problem and will have a similar positive effect as the sterilization of money has.

The last argument discussed is provided by Keynes (1923) that argued: “If... the external price-level lies outside our control, we must submit either to our own internal price-level or to our exchange being pulled about by external influences. If the external price-level is instable, we cannot keep both our own price-level, and our exchanges stable. And we are compelled to choose.” In fact, Keynes had a problem with the global market and with the openness of an economy to external supply and demand forces. The similar argument is invoked by the defenders of a closed capital account as a solution to the import of an external crisis. In a globalized world it is clear that more wealth will be obtained if the entrepreneurs will accept the challenges of an open competition. The instability of prices discussed by Keynes could act in a positive way for an open economy: more capital resources imported from abroad could diminish the cost of capital and will reduce the scarcity of capital on a market without sufficient savings rate, a higher supply with goods or services from abroad will reduce de prices on a local market etc. In a gold standard the prices will reflect the real market conditions, including here the global influences. Any manipulation of prices derived from this obsession of stable prices will punish the competitive industries and economies and will significantly alter the structure of production in an irreversible way.

4. Concluding remarks

Despite the strong opposition of socialists and interventionists against gold standard, the current situation on international financial markets reopens the case of it. More than ever, any discussion about sound reforms that should be applied to financial systems should start from a serious analysis of the idea of sound money. The gold standard is a viable solution producing net benefits for all participants to the globalized economies.

When we analyse the costs and benefits associated to these two different systems: fiat money system (that exists today) and pure gold monetary system (100% reserves free banking) we should take into consideration two kinds of costs – production costs of money and other opportunity costs. In terms of production costs, fiat money (paper and electronic money) are less costly and easy to be produced in an unlimited
quantity. Gold as a medium of exchange is more expensive to be produced in a limited quantity (with a very low and predictive growth rate). On the other hand, paper money is more inflationary, significantly increasing the price stability (often not so visible because central banks publish an imperfect index of consumer prices that exclude a lot of assets like real estate or financial assets). Paper money is not a stable financial regime, increasing the frequency and magnitude of business cycles (boom and bust intervals). More and more paper money are used to save the system and the financial institutions affected by an irresponsible expansionary monetary policy. Paper money system induces significant errors in entrepreneurial decisions due to the discretionary production of money in an unlimited amount. Money without intrinsic value is very volatile and dependent upon the credibility and trust of users in the stability of monetary system (significantly affected by current crisis). Additional risks (currency exposure, country risk) and costs with currency risk management are induced for local and international business and investments.

The political instability generated by governments involved in different military actions and strategic defence programs is very high in a paper money system. Today, any public servant could print more money to finance an external conflict. Military and security sector is artificially expanded by this discretionary power to create money from nothing and to waste it without any external control. The public institutions fuelled with cheap paper money in any desired quantity started to increase their control in the economy and assumed more and more “public” services by aggressing private sector and wealth. This unfair redistribution induced by paper money system will fail as any socialist project. Paper money systems operate with higher moral for central banks, commercial banks and public institutions and exponentially increased public deficits and public debts.

Due to its net benefits for economic systems, pure gold standard is net superior than current paper money system. Any position that defends current paper money system, in fact defends the spirit of central planning and control within the monetary sector. “The advantage of the gold standard is due solely to the fact that, if once generally adopted in a definite forms, and adhered to; it is not subject to specific political interference.” (Mises, 1978, p. 80)
References