

Monetary Policy and Rule of Law

The Gold or the Green?

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“A system of capitalism presumes sound money, not fiat money manipulated by a central bank. Capitalism cherishes voluntary contracts and interest rates that are determined by savings, not credit creation by a central bank,” says Ron Paul. The medium of exchange significantly affects the workings of the economy. Implementing poor monetary policy has the potential to disintegrate an economy. Establishing sound money opens the opportunity for the economy to flourish. Money is central to exchange; as thus it is crucial to understand how different monetary systems uphold or destroy private property rights. This paper examines the links between monetary systems and the rule of law in three environments: with commodity money, in a dollarized economy and under a fiat currency. Commodity money best upholds citizens’ rights to their private property, while fiat money poorly secures freedom.

The rule of law is defined as upholding the principle that “to be just among equals, everyone should be ruled as well as rule.”¹ Rule of law is the principle that governmental powers are limited to only exercise authority according to the power provided by written laws that are adopted according to established procedure. Aristotle continues,

The rule of law is preferable to that of any individual. On the same principle, even if it is better for certain individuals to govern, they should be made only guardians and ministers of the law. ... to give authority to any one man when all are equal is unjust. ... He who bids the law rule, may be deemed to bid God and Reason alone rule, but he who bids man rule adds an element of the beast; for desire is a wild beast and passion perverts the minds of rulers, even when they are

¹ (Aristotle, 1885, III.16)

the best of men. The law is reason unaffected by desire.²

Frédéric Bastiat expounds upon this concept in *The Law*, writing, “Do not the legislators and their appointed agents also belong to the human race? Or do they believe that they themselves are made of a finer clay than the rest of mankind?”³ Sustaining the rule of law requires the restriction of government power according to established laws. When government policies are in accord with the rule of law, assuming a righteous law, then the citizens’ rights are upheld. The arbitrariness of despots is put under check.

This paper narrows the over-arching concept of the rule of law by focusing on private property rights. The monetary system of an economy shares significantly links with the degree of private property granted in the economy. The comparison of monetary systems is done under the framework of how well each upholds property rights.

Sound money is defined as a hard currency, meaning that it is backed by a commodity. In this case, the currency serves as a store of value. The purchasing power of the monetary unit cannot fluctuate with the whims of the ruling powers. According to Ludwig von Mises, sound money means the gold standard.⁴

Commodity Money

The best monetary system for securing property rights is a commodity money system. Using commodities as currency prevents the government from unlawful creation of money and eliminates the possibility of despotic inflation. Individuals have clear property rights over the commodities that they own, and any confiscation of those

² (Aristotle, 1885, III.16)

³ (Bastiat, 1850)

⁴ (Mises, 1953, p. 438)

commodities is clearly stealing. The history of commodity money goes back to the earliest societies.

Primitive societies exchange through barter. Under a barter system, if there is no coincidence of wants, the two parties cannot trade. For example, a cow farmer will often not be able to trade away a whole cow or bottle of milk for the goods he desires. These goods are poor mediums of exchange; a cow is indivisible, and milk is high perishable. Due to the difficulties of bartering, eventually individuals begin to engage in indirect exchange. Mises writes, “Indirect exchange becomes more necessary as division of labour increases and wants become more refined.”⁵ The dairy farmer will trade the goods he produces for other goods which are more easily traded. Then he will trade these intermediary goods for the goods that he wishes to obtain. This is the origin of the medium of exchange.

At first, multiple goods that are fairly divisible, transportable and durable arise as mediums of exchange. With time, the number of mediums tends to reduce until it becomes general practice to only accept one or two mediums. Throughout history, the preferred mediums of exchange have been precious metals. Silver and gold possess the necessary qualities to function well as a medium. Carl Menger describes this phenomenon:

The reason why the precious metals have become the generally current medium of exchange ... is because their saleableness is far and away superior to that of all other commodities, and at the same time because they are found

⁵ (Mises, 1953, p. 31)

to be specially qualified for the concomitant and subsidiary functions of money.⁶

The gold standard, silver standard and other metal standards function similarly. In the context of this paper, arguments regarding the gold standard apply to all metal standards.

The gold standard is essentially a private monetary system. Friedrich Hayek writes, “If we ever again are going to have a decent money, it will not come from government: it will be issued by private enterprise.”⁷ Government intervention is unnecessary and in fact harmful for money to come into being and become the accepted medium of exchange. The market decides what precious metal to use, and all exchange it freely. There is no need for a central bank or for legal tender laws. Individuals can choose to accept the dominant currency, gold, in return for their goods and services, or they can reject it. But they often have no need to reject it, because of its inherent value. Mises writes, “Thus the sound-money principle has two aspects. It is affirmative in approving the market's choice of a commonly-used medium of exchange. It is negative in obstructing the government's propensity to meddle with the currency system.”⁸ The major benefit from a gold standard is that the government is removed from the monetary system.

For the gold standard to function properly in a society, there are some assumptions that must be met. The governing officials must be willing to abide by the budgetary constraint enforced by having a commodity currency; the ruling powers must not engage in corrupt activity, such as debasing the currency or revoking redemption claims.

⁶ (Menger, 1892, p. 250)

⁷ (Hayek, 2008)

⁸ (Mises, 1953, p. 414)

Likewise, counterfeiters must not debase the currency. The public must accept the chosen medium of exchange and not desire to replace the commodity with another monetary system. If all of these assumptions hold, then all of the following advantages will necessarily occur.

Money is the life-blood of an economy.⁹ As such, it is best left to the market. The advantages to a private monetary system are numerous. First, it requires the government to curb their spending to be at or under the tax revenue. Under a gold standard, the government can only legally spend money after it has been collected, enforcing fiscal responsibility. Hans Sennholz writes, “The gold standard forces governments to balance their budgets.”¹⁰ Without the power to inflate, the government must restrict its expenditures. With limited budgets, less money is wasted.

Secondly, the gold standard prevents artificial booms in the economy which inevitably turn to bust. Sennholz continues, “The gold standard forces governments to ... refrain from policies of credit expansion which create booms and unavoidably lead to periods of depression.”¹¹ The boom and bust cycle significantly harms entrepreneurs; so its elimination is beneficial for business. Also, its elimination eradicates the inevitable busts and depressions that cause unemployment, bankruptcy and business losses.

Next, a central bank need not exist under a gold standard. Many of the policies of the United States Federal Reserve are common to all central banks: they interfere with the natural workings of the economy and thus hinder economic growth. One of the Federal

⁹ (Kem, 1975, p. 168)

¹⁰ (Sennholz, 1955, p. 296)

¹¹ Ibid.

Reserve stated policies is to stabilize prices.¹² When the economy suffers from short term price shocks, the Fed seeks to offset those changes. These offsetting policies often reduce stability and bring about unintended consequences. Without a central bank, the economy is free to fluctuate according to the market, without harmful interventions. The Cato Institute discovers that "A gold standard does not guarantee perfect steadiness in the growth of the money supply, but historical comparison shows that it has provided more moderate and steadier money growth in practice than the present-day alternative."¹³ The economy does not need perfect steadiness of the money supply, but it does need restriction of erratic monetary policies.

The underlying benefit of sound money is that it protects private property rights. Unsound money is often linked with inflation and an expansion of the quantity of money. In a study of a large sample of countries over many decades, Federal Reserve Bank economists found that money growth and inflation are higher under fiat standards than under gold and silver standards.¹⁴ Because inflation is a decrease of the purchasing power of money, essentially it is theft. When the purchasing power of money is diminished, the value of the money is reduced, which is the same effect when a thief enters and steals a wad of cash. Sound money avoids these problems.

Some argue that the gold standard also suffers from detrimental inflation. The rationale behind this proposition is that increases in the stock of gold surely have the same inflationary effects as increases in the stock of money. However, the evidence proves otherwise. The largest supply shock of gold occurred during the California Gold Rush in

¹² (The Federal Reserve System, 2005, p. 15)

¹³ (White, 2008)

¹⁴ (White, 2008)

the middle of the nineteenth century. The newly mined gold caused an inflation of the price level, as expected. Yet the degree of the inflation is far lower than many predict. During the most inflationary time, the general price index rose 12.4 percent over the spread of eight years. The compound annual price inflation rate over those eight years was slightly less than 1.5 percent.¹⁵ Thus the possible inflation with a gold standard is insignificant enough that it is not a threat to the economy.

Finally, economic growth flourishes best with a sound money system. Unsound money threatens and endangers the economy. Unsound money also jeopardizes liberty because the citizens' property rights are insecure. According to Sennholz,

The return to sound money policies is of utmost importance. Without sound money there can be no economic recovery, no prosperity, no economic cooperation, no international division of labor, no unification. Sound money is the cornerstone of individual liberty.¹⁶

For freedom, unity, prosperity and economic development, an economy needs sound money. Of the monetary systems, the gold standard best upholds the rule of law and best protects private property rights.

There are many theories of banking under the gold standard, the strictest of which is Murray Rothbard's 100 percent reserve banking.¹⁷ Typically, when banks lend money, they lend more money than they actually hold in reserve. Banks do this by issuing two or more claims to the same bullion of gold. When everyone rushes to the bank to withdraw

¹⁵ (White, 2008)

¹⁶ (Sennholz, 1955, p. 296)

¹⁷ (Rothbard, 2008)

their deposits at the same time, the banks suffer from bank runs. This system is called fractional-reserve banking. It is inflationary because it creates credit.

Rothbard's system of 100 percent reserve restricts banks to lending out only the amount of money that they hold in their vaults. Regardless of how much money individuals deposit in the bank, the total quantity of money never changes when banks retain 100 percent in reserves. While the form of money changes, the quantity remains the same.¹⁸ Thus, under this most extreme version of banking under a gold standard, banks can issue credit and extend loans without causing harmful inflation.

In summary, under the gold standard, the free market controls the monetary system; governments demonstrate fiscal responsibility; the power to cause artificial booms and busts is eliminated; there is no central bank; the rule of law is sustained as private property rights triumph; the currency is protected from government-induced inflation; and the economy has the freedom to flourish. Finally, a 100 percent reserve banking system can be implemented and enforced, extending credit to entrepreneurs without first creating it.

Mises writes, "It is impossible to grasp the meaning of the idea of sound money if one does not realize that it was devised as an instrument for the protection of civil liberties against despotic inroads on the part of governments."¹⁹ Sound money protects individuals from unjust rulers by upholding the rule of law.

Dollarized Economy

¹⁸ Ibid, p. 95

¹⁹ (Mises, 1953, p. 414)

Dollarization is a middle ground monetary policy. In a dollarized economy, there is more rule of law than in an economy with fiat money, yet less rule of law than is found under a gold standard. Dollarization is the process by which a country adopts a foreign currency as its own. The adopted currency need not be the United States dollar. Any currency is acceptable. Many currencies, including the Euro, New Zealand dollar and Australian dollar have been adopted in the process of dollarization.

Dollarization takes many forms. The official form occurs when the new currency is adopted as legal tender, either exclusively or predominantly. Partial dollarization happens in situations where the local currency remains legal tender, but the foreign currency is used legally in transactions. Partial dollarization increasingly affects a wide set of countries.²⁰

Governments choose to dollarize for a variety of reasons. Ecuador was in the middle of a banking and economic crisis in 2000, facing a crippled economy, a poor currency with high inflation, citizens without trust in their government, high levels of unemployment, a low GDP and a low income per capita. Dollarization helped to reverse a number of these problems. In contrast, El Salvador chose official dollarization for the purpose of enhancing the set of economic stability structural reforms already implemented. The ultimate objective was to attract foreign investors.²¹ El Salvador was not on the brink of collapse; dollarization is not merely a process reserved as a last resort. It provides a number of unique advantages.

As in the case of the gold standard, a dollarized economy also relies upon some

²⁰ (Gulde, Hoelscher, Ize, & Marston, 2004, p. 1)

²¹ (Quispe-Agnoli & Whisler, 2006, p. 55)

fundamental assumptions. The necessary preconditions for full and official dollarization are that the government surrenders the right to issue currency; the people recognize and accept the new currency as legal tender; the government owns sufficient stock of the currency to adequately give it in return for the former currency; and the government follows the proper procedures to make the transition.

When a government dollarizes, it relinquishes many broad powers. First, it loses the ability to manage monetary and exchange rate policy. Secondly, it eliminates the possibility of printing fiat money. Next, it surrenders the capability to guarantee the liquidity of bank deposits. Finally, it can no longer default on the real value of nominal commitment.²² The loss of these four categories of abilities significantly restricts illegitimate power of the government and the central bank.

The process of dollarization requires many steps. The country's central bank must set an exchange rate at which their former currency can be traded for the new money.

Rather than picking a specific exchange rate, the legislation would establish an official date for dollarization and mandate that starting then, each unit of local currency will be exchanged for the amount of dollars that resulted from application of the formula: *Exchange rate at which conversion will take place = stock of international reserves/(Money base + interest-bearing securities denominated in domestic currency)*.²³

In addition to exchanging the currency, many scholars argue that the country must

²² (Hausmann & Powell, 1999, p. 6-7)

²³ (Gruben, Wynne, & Zarazaga, 2003, p. 248)

concurrently adopt fiscally responsible practices.²⁴ Once the dollarization is officially implemented, the government cannot print money to get itself out of debt. Thus, it must adopt fiscally responsible policies or collapse. Fiscal reforms reduce the likelihood of defaulting on debt and of running out of money in the middle of projects or programs. The Cato Handbook for Policymakers supports this point by publishing the following advice: “Dollarization alone cannot solve a country’s economic problems, but for countries with poor monetary policies, dollarization would end currency risk, reduce interest rates, and help stimulate investment and growth.”²⁵

Dollarization brings about many advantages. The most notable advantage is that the currency is now accepted with increased confidence. Not all countries choose to dollarize because of crises, but for those that do, dollarization proves to be a significant force in the right direction by providing economic stability.

In The Federal Reserve Bank of Atlanta’s 2006 Economic Review, research economist Myriam Quispe-Agnoli explicates some benefits:

The expected benefits of full dollarization include the elimination of exchange rate risk, contributing to the decline of the country risk premium and interest rates, as well as the reduction of the inflation rate and inflationary expectations.

These outcomes are expected to encourage foreign investment.²⁶

This review highlights three distinct advantages. The elimination of exchange rate risk occurs because the dollarizing country now uses a foreign currency. Dollars are dollars

²⁴ Ibid, p. 245

²⁵ (Vásquez, 2009, p. 643)

²⁶ (Quispe-Agnoli & Whisler, 2006, p. 55)

no matter in which country they are held, and as such their exchange rate is always one to one. Secondly, the reduction of the inflation rate and inflationary expectations occurs in most situations. When the foreign currency suffers from high inflation, the dollarized economy will also experience inflation. In most cases, however, the foreign currency often has greater stability than the former domestic currency of the dollarized economy. The third benefit is that dollarization encourages foreign investment. Foreign investors are lured in because of the low exchange rate risk, which provides more capital for local entrepreneurs.

Further benefits from dollarization stem from the check on power and the increased confidence in the currency. The central bank can no longer function as the lender of last resort, which “encourages changes in the way supervisory and regulatory institutions manage liquidity and solvency risks.”²⁷ Essentially, dollarization reduces the moral hazards inevitable with the powers of the central bank.

Secondly, local banks benefit from reduced threats of inflation. When a country prints its own fiat currency, the quantity of money can increase overnight according to the capricious requests of central bank officials. In contrast, “with the return of confidence in the currency and financial stability, one expects an increase in bank deposits and loans supporting the development of the banking system.”²⁸

Finally, official dollarization promotes financial integration with the world economy and encourages trade. Investing in a dollarized economy has lower transaction and information costs; diminishes the impact of external shocks; and signals to international

²⁷ Ibid, p. 58

²⁸ Ibid.

markets that the country has a commitment to currency stability.²⁹

The country of Ecuador chose to officially dollarize in 2000. In late 1999, the public so strongly opposed dollarization that they ousted President Mahuad because he planned to implement it. Nevertheless, in January 2000, Gustavo Noboa, the VP of Ecuador, was ratified as President of the Republic. Almost immediately, Noboa implemented the dollarization that Mahuad had announced. His reasons were plentiful. Most critically, the country suffered from deep corruption and economic woes. The central bank drastically devalued the currency, leading to high inflation and distrust of the government. The high inflation and other poor policies led to high unemployment and crippled economic progress. All of these troubles called for drastic measures. Thus, Noboa dollarized the economy.³⁰ Benefits ensued immediately.

Ecuador's economic growth averaged five percent per year for the next six years. Within eight years, per capita income increased from \$1,300 to approximately \$4,000. In the same time period, data from the United States Department of State reveals that the poverty rate fell from 51 percent to 35 percent.³¹ Unemployment, which had reached a peak at fifteen percent, dropped to eight percent in the first two years. Inflation had reached a high at 90 percent before 2000; since dollarization, it has been consistently under 10 percent.³² Dollarization does not happen in a vacuum; Noboa worked to implement other stabilizing policies as well. Nonetheless, dollarization clearly played a significant role in improving Ecuador's economy.

²⁹ Ibid.

³⁰ (Hanke, 2003, p. 134)

³¹ (Bureau of Western Hemisphere Affairs: Background Note: Ecuador, 2010)

³² (Hidalgo, 2010)

Problems exist in a system of dollarization. First, the country must rely upon a foreign central bank to satisfy its local demand for paper currency.³³ Such foreign dependence is often considered as a sign of weakness, and it also allows the effects of major crises that occur in the foreign country to have an impact. Furthermore, the only means of obtaining more of its new paper currency is by producing or exporting real goods or services.³⁴ Even though the government cannot print money, they can tinker with their stock of currency. Whether by fixing interest rates, interfering in foreign trade or by other means, the governing powers prefer dollarization to a gold standard because it leaves them some wiggle room to exercise power.

Some dollarized economies do not have a central bank; others have one but it is essentially useless and potentially dangerous. The Republic of Panama has operated without a central bank since its independence over a century ago. The absence of a central bank allows the free market to determine the monetary supply. In Panama, banks must act responsibly because there is no Federal Reserve to bail them out of their problems or to provide cheap credit. Any bad loans must be paid by the shareholders.³⁵

Without a central bank and without legal reserve requirement ratios, banks are relatively free in dollarized economies to operate according to their own wisdom. Research economists found that “given the absence of a lender of last resort, banks need to hold adequate reserves to respond to any sudden increase in nonperforming loans.”³⁶ Under dollarization, banks can create credit by extending loans of more value than the actual stock of gold they possess. Such banking exposes itself to the problems from which 100

³³ (Selgin, 2005, p. 144)

³⁴ (Saied, 2007)

³⁵ (Saied, 2007)

³⁶ (Quispe-Agnoli & Whisler, 2006, p. 69)

percent banking system frees itself. These problems include inflation, starting the boom and bust cycle, and unsound banking practices.

A dollarized economy guards private property rights to some extent. The rule of law remains under dollarization because the country's governing officials have practically no lawful power to implement monetary policy. They are held under the law, just as their citizens are, as Bastiat advocates. The foreign currency is subject to alterations unknown in a gold standard. Even so, a foreign currency is to be preferred to a fiat currency.

Fiat Money

In a fiat money economy, private property rights are shaky at best. It is impossible to secure rights and sustain the rule of law when a central bank consistently changes the stock of money and when it has the power to make monetary adjustments. The very act of tinkering with the quantity of money requires violating individual private property rights.

Fiduciary medium is unsound money, a freely vacillating currency.³⁷ It is distinct from dollarization and the gold standard in that it has no foundation or certainty. Mises highlights the key characteristic of the fiat money: "The owner of any amount of it has no claim whatever against the treasury, a bank, or any other agency. There is no redemption either de jure or de facto. The pieces are not money substitutes but money proper in themselves."³⁸ Under the gold standard, money has full redemption. Under dollarization, money has no redemption claims, but yet still it provides an expectation of certainty. Under a fiat currency, no one wants it for its value. The only reason to accept paper bills

³⁷ (Mises, 1953, p. 431)

³⁸ Ibid.

is because individuals know that others will accept it as money in the future. If it is not legal tender, no one would accept it.

Fiat currency is simply political money. As such, the state owns it and controls it. “Since the life-blood of economics is money, to make money political is to surrender economics and man's wealth and properties into the hands of the state. The freedom of the new economics becomes slavery. Very simply, managed money means managed men.”³⁹ The implications of this wreak fear by threatening freedom and liberty.

Sound money is a means through which the government can respect the rights of its citizens. Unsound money abuses rights because inflation redistributes wealth and alters the capital structure of the economy. It necessarily results in inflation. When the central bank has the power to inflate, it will inflate whenever such inflation provides a net benefit to itself. It does not have the control required to not tamper with the money supply. Hayek writes, “Providing the public with good money which it can trust and use can not only be an extremely profitable business; it imposes on the issuer a discipline to which the government has never been and cannot be subject.”⁴⁰ The benefits to creating money far surpass the costs. Thus, the printing continues.

The inflation present under a fiat money economy causes drastic consequences. Sennholz writes, “No control and no government coercion can alter the fact that the purchasing power of the inflated currency is bound to decline as long as other officials are busily employed in increasing its quantity.”⁴¹ This inevitable inflation disturbs the free market and its functions. Furthermore, it causes injustice by transferring wealth.

³⁹ (Kem, 1975, p. 168)

⁴⁰ (Hayek, 2008)

⁴¹ (Sennholz, 1955, p. 277)

Many economists call inflation a hidden tax, because it is a way for the government to extract money from its citizens without going through the Internal Revenue Service. Every citizen who owns dollars pays the tax without giving consent. As a result, inflation though fiat money does not uphold private property rights.

Writing for the Mises Institute, George Smith identifies the negative effects resulting from a fiat currency. First, it allows the government to ignore the fiscal resistance of its citizens. When individuals choose not to support a government policy or program, they can engage in civil disobedience, but they cannot legally refuse to fund it. Secondly, it benefits the central government at the expense of others. Essentially, fiat money promotes injustice. Third, it institutionalizes irresponsibility and allows for a moral hazard. These effects guarantee recurring economic crises.⁴² The essence of the government is to uphold liberty and protect its citizens, not to cause crises.

Further effects are that it encourages business to fund their ventures by borrowing equity, increasing liabilities and decreasing assets on their balance sheets. This is because inflation makes credit cheap and as such it is hard to resist.⁴³ The result of this is that businesses become dependent on banks and the lenders have their grips on the control of the economy. Next, citizens turn to personal debt,⁴⁴ because debtors favor inflation. This causes savings and investments – the crucial factor for capital production – to decrease. In time, the capital structure disintegrates, bringing significant losses to the economy and society. Finally, perennial inflation deteriorates product quality.⁴⁵ Industries have difficulties keeping up with erratic inflation, so they compensate by producing lower

⁴² (Smith, 2009)

⁴³ Ibid.

⁴⁴ Ibid.

⁴⁵ Ibid.

quality products. Businesses face riskier investments and have more difficulty producing products that benefit society as a whole.

Having a fiat currency also exacerbates domestic instability which hinders economic prosperity. Sennholz describes the link between fiduciary media and instability: “The destruction of the gold standard by central banks and national treasuries and its substitution by monetary planning, which always means inflation and depreciation, resulted in domestic instability and chronic international chaos.”⁴⁶ This clear causal chain has unfortunate consequences for the United States of America.

Fiduciary media also threaten wealth creation. Currencies which fluctuate at the mercies of a central bank fail to provide a firm foundation for prosperity. The means to prosperity requires having secure and guaranteed private property rights, but inflation erodes property rights. Entrepreneurs must account for increased risk in their ventures.

These numerous effects demonstrate the pervasive nature of inflation throughout society and reveal the extent to which inflation damages the economy. Inflation is diametrically opposed to the rule of law in the ways in which it destroys private property rights. Smith quotes Jörg Guido Hülsmann, saying, “In all known historical cases, paper money has come into existence through government-sponsored breach of contract and other violations of private-property rights.”⁴⁷ The trampling of property rights never brings benefit to society.

In addition to the consequences of inflation, there also exists the fundamental problem of the purpose behind inflation – to fund government expenditures. Sennholz writes,

⁴⁶ (Sennholz, 1955, p. 22)

⁴⁷ (Smith, 2009)

In order to finance policies of “fair prices” “fair distribution” and nationalization programs, planners cannot do without the most desirable instrument of government planning—power over the currency system. Through credit expansion and inflation the government purse is made inexhaustible for vast projects of spending for public and social works. Once government control over money and credit has been established, a policy of “abundance” and “fair distribution” can be conducted.⁴⁸

Without fiat money, these policies are severely restricted. Inflation opens the door to vast projects with obscene budgets. Many of the governmental policies made possible by inflation are based in faulty economic reasoning. “Fair distribution” policies are in essence unfair because of the way they redistribute wealth. The welfare state has plentiful problems of its own. A gold standard protects society from many of these problems, which is why Sennholz says, “The gold standard, whose very eminence consists in limiting government spending and leaving the monetary purchasing power independent from government measures, is the first victim of the central planner.”⁴⁹

The banking system under a fiat currency is often fractional-reserve banking. Fractional-reserve banking occurs when a bank extends loans on the same quantity of money in its vaults. If the reserve requirement ratio is ten percent, then a bank can lend ten times as many claims to the money than it actual owns. A bank which holds \$10,000 in reserve has the ability to offer loans of \$100,000. As soon as the bank lends the money, the credit is created. This is clearly credit expansionary and inflationary.

⁴⁸ (Sennholz, 1955, p. 196)

⁴⁹ (Sennholz, 1955, p. 196)

Under fractional-reserve banking, a lending bank earns ten times as much interest on their loans than they do under a 100 percent reserve requirement. This is a highly lucrative enterprise. If the reserve requirement dropped to five percent, banks would earn twenty times the interest they would receive under a 100 percent reserve system. Rothbard writes,

The irresistible temptation now emerges for the goldsmith or other deposit banker to commit fraud and inflation: to engage, in short, in fractional reserve banking, where total cash reserves are lower, by some fraction, than the warehouse receipts outstanding. It is unlikely that the banker will simply abstract the gold and use it for his own consumption; there is then no likelihood of ever getting the money should depositors ask to redeem it, and this act would run the risk of being considered embezzlement.⁵⁰

Bankers face an irresistible temptation to expand the money supply. Thus inflation inevitably ensues.

Rothbard launches a critique against this system of banking: “Modern fractional reserve banking is a shell game, a Ponzi scheme, a fraud in which fake warehouse receipts are issued and circulate as equivalent to the cash supposedly represented by the receipts.”⁵¹ Just like the fiat money system itself, so also under fractional reserve banking citizens are issued receipts that do not have the value they are assumed to have. Essentially, the system is based in a lie, because all savers cannot go to the bank and extract their savings without causing a bank run. The money they loan does not exist.

⁵⁰ (Rothbard, 2008, p. 96)

⁵¹ Ibid, p. 97

Under the fractional reserve system occur unintended consequences. Jesus Huerta De Soto notes the problem of the tragedy of the commons, saying,

It is a well-known fact that whenever property rights are not adequately defined—and this is the case with fractional-reserve banking, which by definition involves the violation of depositors’ traditional property rights—the “tragedy of the commons” effect tends to appear.⁵²

As no one owns responsibility for the banking system, no one is held responsible for the damages it causes. The problem lies in the lack of property rights. A fiat money system allows for a fractional reserve banking system. Both of which undermine the rule of law by disintegrating the security of private property rights.

Conclusion

The monetary policies of a country produce direct and significant impacts on the country’s economic well-being, wealth creation, banking structure and economic growth. The foundation for prosperity is rock solid protection of private property rights. Only one of the three monetary systems analyzed in this paper produces unshakable property rights: the gold standard. The gold standard upholds the rule of law by establishing secure ownership of money. Fiat money disregards the rule of law by weakening individual property rights. A dollarized economy falls in the middle of these extremes by existing without a central bank but being yet being tied to a foreign fiat currency. Freedom is only sustained with sound money, and the only sound money is a gold standard with 100 percent reserve banking.

⁵² (De Soto, 2009, p. 666)

A brief comparison of the advantages and disadvantages of each monetary system clearly demonstrates that gold is the best currency. A gold standard limits the power of the government and forces governmental accountability; it prevents the central bank from causing inflation or credit expansion; it keeps the central bank from tinkering with the free market by making adjustments whenever short term and long term shocks occur.

A dollarized economy is beneficial in that it prevents the dollarized country's central bank from having any noteworthy power; it provides a degree of monetary stability and often maintains confidence in the currency. Yet it is negative in that it allows for fractional reserve banking and inflation; creates dependence on a foreign power; and subjects the country to the whims of the central bank of that foreign power.

Fiat currency is rife with disadvantages. This system gives the central bank free reign to print as much money as it desires; is often highly inflationary; causes domestic instability; hinders economic prosperity; and opens the door to other property rights violations and wealth distribution programs.

With unhampered markets and the rule of law, people are free. Only the gold standard is a free market monetary system, and only the gold standard supports the rule of law. Both dollarization and fiat money reduce freedom by eroding property rights. Charles Rist, the author of the *Triumph of Gold*, succinctly summarizes this paper, writing, "We shall have sound money; or we shall cease to be free."⁵³ Private money, the gold standard, is an essential component of freedom.

⁵³ (Rist, 1961, p. 2)

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