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Chapter 17
The Sound Money Solution

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. Ideologically it belongs in the same class with political constitutions and bills of rights.

—Ludwig von Mises[1]

We have seen the destruction wrought by fiat money and central banking. The obvious solution to the problems of rampant price inflation and economic crises, is to remove political interference with the institutions of money and banking. When money is once again a good produced by the market, and when bankers receive no special privileges exempting them from their contractual obligations, people will once again be able to lean heavily on a stable medium of exchange for their financial planning. We will have a *sound money*.

As Mises explains in the quotation above, sound money was an integral plank in the classical liberal program. Just as a free press is necessary for a free citizenry, so too is sound money necessary for a free economy. All other aspects of what is meant by the term "economic freedom" in conventional circles—low tax rates, mild regulation, no trade barriers—are a moot point if the government has a printing press at its disposal.

Ultimately, a society can only return to sound money when enough people demand it of their government. That is why education is the first and most important step—people need to understand the importance of sound money, and the dangers of fiat money and central banking. Everyone knows our current financial system is sick, but only people steeped in Austrian economics can offer the correct diagnosis and cure.

Unfortunately, our financial freedom was eroded over many decades; it was a slow path to our current crisis. There are also many powerful people and institutions who benefit from the status quo. This means that unwinding the government's stranglehold on our money and banking sector may take years of agitation and political reform.

The present book is not a political manifesto. The current authors do not pretend to be political strategists, let alone revolutionary leaders. In the remainder of this chapter, we offer some practical suggestions for how our society could move, bit by bit, back towards the ultimate goal of complete freedom in money and banking once again. There is nothing magical about the below proposals, especially in their particular details. But the following goals are frequently recommended by those who understand the lessons of the Austrian economists.

Step 1: Tie the U.S. Dollar Back to Gold

Mises once wrote, "Sound money still means today what it meant in the nineteenth century: the gold standard."[2] Many of Mises' followers endorse his recommendation in our own time as well. If the United States government officially announced that it would once again redeem dollars for physical gold, such a bold move would instantly reassure investors the world over that the dollar was once again a bedrock asset.

Another virtue of this move is that it could be implemented at a moment's notice. To tie the dollar back to gold would require no new powers on the part of the government, or even require any new legislation. Strictly speaking, Fed Chairman Ben Bernanke could simply announce that the Fed would hand over an ounce of gold for a stipulated number of dollars, and (less crucially) that he would hand over a stipulated number of dollars for anyone selling an ounce of gold. Bernanke has the power to buy and sell assets, and he would merely be announcing in advance his willingness to sell (and buy) gold at a particular dollar-price. Of course, to give the pledge real teeth, Congress would eventually have to codify the new arrangement, perhaps even specifying penalties (such as immediate dismissal) for Fed officials should they ever renege on the new peg. The point is, however, that we wouldn't need to wait for a protracted and melodramatic Congressional battle *before* restoring sanity to the world financial markets with a stable currency.

In order to give a concrete example of how such a policy could work, suppose that Bernanke called a press conference and announced the following (keeping in mind that the officially reported U.S. gold reserves in December 2009 were a little over 8,000 tons)[3]:

"Effective immediately, the Federal Reserve will begin a program of gold accumulation, purchasing 100 tons per month, until total official reserves equal 15,000 tons. Every quarter we will allow outside auditors to inspect our vaults and verify our holdings. Furthermore, in exactly twelve months we will peg the one-month future price of gold at $2,000 per ounce. Any party, whether foreign central bank, foreign government, or private individual—domestic or foreign—will be guaranteed the ability to obtain an unlimited quantity of gold from the Federal Reserve's holdings at $2,000 per ounce, and to sell gold to the Federal Reserve at a price of $2,000 per ounce, less a small transaction fee. This peg will remain a

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permanent feature of Federal Reserve policy, and the dollar-price of gold will remain forever fixed at $2,000 per ounce."

To repeat, there is nothing magical about the particular numbers in our hypothetical scenario, but here is the logic of the idea: By steadily increasing its gold holdings, the Fed would bolster its ability to honor its commitment to tie the dollar back to the precious metal. By setting the peg well above the current market price (around $1,100 as of this writing), the Fed would obviate the need for a general drop in the dollar-price of all other goods and services.

In other words, when the Fed begins a massive program of buying an asset—including gold—that asset's price will rise. If the Fed had announced, say, a target gold price of $1,000 or $500 in a year's time, even as its massive gold purchases drove up the relative price of gold compared to other goods, then achieving the low target would force a massive collapse in the price of everything else (where the price is measured in U.S. dollars). By setting the target well *above* the current market price, the Fed would allow the adjustment to largely occur in the spike upward in the gold price, rather than a large drop for everything else.

As the months passed, and the deadline approached for the Fed to begin redeeming dollars for gold at the specified rate, Bernanke and the rest of the Fed's policymakers would need to carefully monitor their activities. Presumably the gold price would drift upwards (if it had not immediately jumped up after the announcement) to *at least* $2,000 per ounce, because it would be silly for holders of gold to sell at *less* than that price, when they knew the Federal Reserve would soon offer $2,000 per ounce to any sellers.

On the other hand, suppose that three months out from the deadline, the market price of gold were $2,400. Bernanke would realize that speculators would line up at the Fed's door (metaphorically speaking) on the day the redemption policy went into effect, in order to buy gold from the Fed at $2,000 and then sell on the market for $2,400. This would quickly drain the Fed's gold holdings, and destroy the Fed's credibility.

Therefore, if the Fed were serious about restoring faith in the dollar/gold peg, Bernanke and the other Fed policymakers would have to act quickly to get the gold price down. How would they do this? Simple: they would have to tighten up on monetary policy. The standard way of doing this is to sell assets from the Fed's balance sheet, in order to drain reserves from the banking system. (This is what the Fed does when it wants to raise interest rates.) The reduction in reserves would force the commercial banks to likewise restrict their own lending, in order to get their outstanding deposit balances back in line with the smaller amount of reserves. Loosely speaking, if the dollar-price of gold were above the $2,000 target, Bernanke would need to remove dollars from the economy. As more

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gold was brought into circulation through mining (due in part to the high prices caused by the Fed's purchases), and as the outstanding amount of dollars shrank due to the tightened Fed policy, then the dollar-price of gold would fall.

In our hypothetical scenario—in which Bernanke announced his intention to return to a strict dollar/gold peg in one year's time, and yet the market responded by pushing the price of gold *above* the announced target—the Fed would have to sell off its other assets, such as U.S. Treasury debt and "toxic" mortgage-backed securities, in order to make room for its growing stockpile of gold bullion. If the gold price stayed above the target of $2,000, Bernanke would have to shrink the overall size of the Fed's balance sheet, in addition to changing its composition towards gold. For example, for every $100 million in new gold that Bernanke purchased, he might have to sell off $120 million worth of Treasury debt or mortgage-backed securities (which the Fed currently possesses in abundance).

Once the deadline had passed, and assuming the Fed had done its job and gotten the market price of gold down to $2,000 per ounce, it would forever be constrained in its creation of new dollars—at least if it wanted to keep its credibility. Over time, as investors observed that they could buy gold from the Fed at the stated price, they would become far more confident in investing in dollar-denominated assets. They would know that whatever else happened, they would have a "call option on gold" as it were, as part of their decision to hold U.S. dollars. Investors would know that regardless of the dollar-prices of other assets, they would always be able to bail out of dollars and obtain physical gold bullion. This option would give the dollar an enormous advantage over the fiat currencies issued by other central banks, making the dollar appreciate again the euro, yen, etc., year after year on the foreign exchanges. Interest rates on debt issued by American corporations would fall, as investors around the world knew that the dollar would be stronger (relative to their own currencies) when their loans were repaid; therefore they would be willing to accept a lower interest rate as quoted in dollars. American businesses and consumers, for their part, would find that foreign goods would become cheaper to buy over the years, as their dollars' purchasing power constantly grew relative to every other world currency. Even on a purely domestic front, the prices of American goods and services (quoted in dollars) would be stable or actually could gently fall year to year, because the Federal Reserve could only create a limited number of new dollars due to the maintenance of the peg to gold.

The reason for the renewed worldwide confidence in the dollar would be simple: Other central banks, without having a peg pinning down the purchasing power of their respective currencies, would be free to print money whenever a crisis struck. The Federal Reserve, in contrast, under the new policy would have its hands tied. It could only expand the supply of dollars as new gold came into circulation (through mining or melting down of jewelry), or as the demand for gold fell, two factors which would tend to push down the gold price. But except within that narrow limit, the Fed couldn't expand the supply of dollars too quickly, because if it did the dollar-price of gold would surge above $2,000 per ounce, and people would trade their paper dollars for physical gold and begin draining the Fed's reserves.

Naturally, it would be very unlikely that Federal Reserve officials would happily submit to the above scenario. It is in the nature of bureaucracies to expand their scope of arbitrary power, and to resent any constraints. In order to make investors believe in the new dollar/gold peg, Congress would need to codify the arrangement with stiff penalties for the Fed's abandonment of the pledge. Even in that case, investors wouldn't *really* take the Fed seriously until the first major crisis, in which the "old Fed" would have cut interest rates and pumped in boatloads of new "liquidity," whereas the "new Fed" responded much more conservatively for fear of unleashing too many new dollars.

To reiterate, merely reintroducing a gold standard for the U.S. dollar would not eliminate our financial woes. But it would be an excellent first step—particularly amidst our current worldwide crisis—and in principle the Federal Reserve could implement this strategy immediately.

Step 2: Privatize Money and Banking

In order to make sense of the Sound Money Solution, an analogy will be useful. Suppose it is the early 1800s, and a Southern plantation owner has died in his old age, leaving his estate to his adult children (the wife having died earlier). Now part of the estate includes dozens of slaves, which are recognized in the eyes of the law as "property." However, the children have all read the writings of the abolitionists, and are convinced that slavery was a moral outrage. What should they do?

One of the children suggests that they immediately free the slaves, then liquidate the remaining assets to give some money to the former slaves to help them start their new life of freedom. This sounds like a great idea, until one of the children worries that the lifetime of dependency may not have equipped the slaves to make it on their own. After all, they have had their basic needs taken care of, and it might actually be unkind to simply dump them into the world with some dollars and a handshake.

Finally the children hit upon an equitable solution: They will immediately free all the slaves, as before. However, the children will continue to run the plantation, and will offer employment to any of the former slaves who wish to remain. In other words, any former slave who wishes to "opt out" and start a new life is free to go, immediately. But, for those who are not ready for such a shock, they can remain on the plantation, working for food, shelter, and so on. During the winding down period, the children would do what they could to prepare the former slaves for an independent life, by teaching them to read, keep track of money, and so forth. The ultimate goal would be to establish all of the former slaves as independent members of the community, but this approach would take in the realities of the legacy of slavery.

We in the United States face a similar situation in terms of our financial system. Through deceit and outright force, the government has taken control of our monetary and banking institutions. In recognition of this violation of property rights, one obvious solution would be an immediate abolition of the entire Federal Reserve apparatus.

However, many private sector institutions around the world have become dependent on the current arrangement. If the President of the United States were to announce on a Monday morning that he and Congress would abolish the Fed that week, it might unleash a global panic. With the fate of the world economy so intimately tied to the U.S. dollar, such a bombshell could wreak havoc on the very people who were being freed from financial bondage to the U.S. central bank.

In light of these unfortunate realities, a compromise path might be the best option. As with our hypothetical children inheriting the plantation, the U.S. government would give the right