MILTON FRIEDMAN

EPISODES IN MONETARY HISTORY

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Preface

In the course of decades of studying monetary phenomena, I have been impressed repeatedly with the ubiquitous and often unanticipated effects of what seem like trivial changes in monetary institutions.

In the Preface to an earlier book, *The Optimum Quantity of Money*, I wrote: "Monetary theory is like a Japanese garden. It has esthetic unity born of variety; an apparent simplicity that conceals a sophisticated reality; a surface view that dissolves in ever deeper perspectives. Both can be fully appreciated only if examined from many different angles, only if studied leisurely but in depth. Both have elements that can be enjoyed independently of the whole, yet attain their full realization only as part of the whole."

What is true of monetary theory is equally true of monetary history. Monetary structures that, looked at from one angle, appear bizarre, when looked at from another are seen to be simply unfamiliar versions of structures we take for granted, almost as if they were part of the natural world. The first chapter of this book is a striking example: stone money and gold money are so alike that they might be found in the same quarry.

That brief chapter having, I hope, intrigued you by illustrating how misleading surface appearances can be in dealing with monetary phenomena, the second chapter sketches the essence of monetary theory in simple terms. It provides a background for appreciating the historical episodes that follow.

The next three chapters tell true stories of seemingly minor events that have had far-reaching and utterly unanticipated effects in history. Chapter 3 tells how the seemingly innocent omission of one line from a coinage law came to have major effects on both the politics and the economics of the United States over several decades; chapter 4 provides the empirical underpinning for those conclusions; and chapter 5 tells how the work of two obscure Scottish chemists destroyed the presidential prospects of William Jennings Bryan, one of the most colorful and least appreciated politicians of the past century.

Following this examination of historical episodes, chapter 6 examines a great issue—bimetallism—that played a major role in the events described in chapters 3, 4, and 5. A recent writer describes bimetallism as giving rise "from the mid-1860s to the mid-1890s [to] the liveliest theoretical disputes among economists and the sharpest economic policy debates in the 'civilized world' " (Roccas 1987, p. 1).

Chapter 6 contends that conventional wisdom about the merits and demerits of bimetallism as a monetary system is seriously mistaken. My focus is narrow: it is to compare bimetallism as a system with monometallism. It is *not* to maintain that the United States, or any other country, should seek under current conditions to institute a bimetallic system. Indeed, to try to do so would conflict completely with my belief that (as Walter Bagehot pointed out more than a century ago) monetary systems, like Topsy, just grow. They are not and cannot be constructed *de novo*. However, as is exemplified by "the crime of 1873," they *can* be altered and affected in all sorts of ways by deliberate action—which is why an understanding of monetary phenomena is of much potential value.

These four chapters, then, all deal with many of the same events looked at from different points of view.

Chapter 7 returns to a particular historical episode, the effects of the U.S. silver purchase program of the 1930s. It seems fantastic that the decision of President Franklin Delano Roosevelt to placate a few senators from western states could have contributed in any detectable way to the triumph of communism in far-off China. Yet the sequence of events by which it did is clear and unmistakable, and the early steps were clear even to those contemporary observers who had some understanding of basic monetary theory.

The final step in the sequence to which the U.S. silver policy contributed was hyperinflation, an extreme form of a disease that has stricken many countries over the course of millennia. Chapter 8 examines the cause and cure of inflation, using recent and historical data for a number of countries to illustrate its central thesis: that inflation is always and everywhere a *monetary* phenomenon.

Chapter 9 is a testament to the role of chance on the effect of monetary changes. What happened in the United States—and it was completely outside the range of influence of the policymakers in Chile and Israel—had the effect of rendering one set of policymakers in one of those countries villains, while another set of policymakers in the other country became heroes.

Chapter 10 explores the probable consequences of the monetary system that now prevails throughout the world—a system that has no historical precedent. Since the time when President Richard Nixon broke the final tenuous link between the dollar and gold in 1971, no major currency, for the first time in history, has any connection to a commodity. Every currency is now a fiat currency, resting solely on the authorization or sanction of the government.

The final chapter is an epilogue that draws a few general lessons from the episodes examined in the preceding chapters.

This book provides only small glimpses at the endlessly fascinating monetary gardens that have flourished and decayed in the course of the several millennia since the day when mankind found it useful to separate the act of sale from the act of purchase, when someone decided it was safe to sell a product or service for something—a something that he had no intention of consuming or employing in production but, rather, intended to use as a means to purchase another product or service to be consumed or employed in production. The "something" that connects the two transactions is called money, and it has taken innumerable physical forms—from stones to feathers to tobacco to shells to copper, silver, and gold to pieces of paper and entries in ledger books. Who knows what will be the future incarnations of money? Computer bytes?

Earlier versions of some chapters of this book have been published separately: chapters 3 and 4 in the *Journal of Political Economy* (December 1990), chapter 6 in the *Journal of Economic Perspectives* (Fall 1990), chapter 7 in the *Journal of Political Economy* (February 1992), and Chapter 10 in *Bank of Japan Monetary and Economic Studies*

(September 1985). I am indebted to these journals for permission to reprint. Chapter 8 is a revised version of chapter 9 of Milton Friedman and Rose D. Friedman, *Free to Choose* (1980). I have made minor revisions of the earlier versions in order to avoid repetition between chapters and to provide greater continuity, as well as to take account of reactions to the published versions.

I have benefited greatly from the knowledge and advice of many friends. Their contributions to particular chapters are acknowledged in the notes to those chapters. I owe a more general acknowledgment to Anna Jacobson Schwartz, my longtime collaborator on monetary studies, who has as always been there when I needed some help. Also, to my longtime secretary and assistant, Gloria Valentine, who did invaluable background research in basic sources, patiently typed, retyped, and revised version after version of the text, made sure that all references were accurate, and was available when I needed her in and out of office hours.

William Jovanovich, who contributed so much to two previous books by my wife and myself, *Free to Choose* and *The Tyranny of the Status Quo*, has made an important contribution to this one as well. And the readers and I owe a debt to Marianna Lee, who served as executive editor of this book, and to the skilled copy editor who corrected many an infelicity in the original text.

The Hoover Institution, under two successive directors, W. Glenn Campbell and John Raisian, provided ideal working arrangements, giving me maximum freedom to pursue my interests and providing nearly ideal resources for doing so.

I have left the best to last. I have been fortunate beyond my dreams in my mate, Rose Director Friedman, who has enriched my life since we first met fifty-nine years ago. I cannot count the many ways she has contributed to this book, as she has to all of my other personal and intellectual activities.

Milton Friedman
Stanford, California
July 5, 1991

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CHAPTER I

The Island of Stone Money

From 1899 to 1919 the Caroline Islands, in Micronesia, were a German colony. The most westerly of the group is the island of Uap, or Yap, which at the time had a population of between five thousand and six thousand.

In 1903 an American anthropologist named William Henry Furness III spent several months on the island and wrote a fascinating book about the habits and customs of its inhabitants. He was particularly impressed by the islanders' monetary system, and accordingly he gave his book the title I have given this chapter: *The Island of Stone Money* (1910).

> [A]s their island yields no metal, they have had recourse to stone; stone, on which labour in fetching and fashioning has been expended, is as truly a representation of labour as the mined and minted coins of civilisation.
>
> Their medium of exchange they call *fei,* and it consists of large, solid, thick, stone wheels, ranging in diameter from a foot to twelve feet, having in the centre a hole varying in size with the diameter of the stone, wherein a pole may be inserted sufficiently large and strong to bear the weight and facilitate transportation. These stone "coins" [were made

from limestone found on an island some four hundred miles distant. They] were originally quarried and shaped [on that island and the product] brought to Uap by some venturesome native navigators, in canoes and on rafts. . . .

[A] noteworthy feature of this stone currency . . . is that it is not necessary for its owner to reduce it to possession. After concluding a bargain which involves the price of a *fei* too large to be conveniently moved, its new owner is quite content to accept the bare acknowledgment of ownership and without so much as a mark to indicate the exchange, the coin remains undisturbed on the former owner's premises.

My faithful old friend, Fatumak, assured me that there was in the village near-by a family whose wealth was unquestioned—acknowledged by every one—and yet no one, not even the family itself, had ever laid eye or hand on this wealth; it consisted of an enormous *fei,* whereof the size is known only by tradition; for the past two or three generations it had been, and at that very time it was lying at the bottom of the sea! Many years ago an ancestor of this family, on an expedition after *fei,* secured this remarkably large and exceedingly valuable stone, which was placed on a raft to be towed homeward. A violent storm arose, and the party, to save their lives, were obliged to cut the raft adrift, and the stone sank out of sight. When they reached home, they all testified that the *fei* was of magnificent proportions and of extraordinary quality, and that it was lost through no fault of the owner. Thereupon it was universally conceded in their simple faith that the mere accident of its loss overboard was too trifling to mention, and that a few hundred feet of water off shore ought not to affect its marketable value, since it was all chipped out in proper form. The purchasing power of that stone remains, therefore, as valid as if it were leaning visibly against the side of the owner's house. . . .

There are no wheeled vehicles on Uap and, conse-

> quently, no cart roads; but there have always been clearly defined paths communicating with the different settlements. When the German Government assumed the ownership of The Caroline Islands, after the purchase of them from Spain in 1898, many of these paths or highways were in bad condition, and the chiefs of the several districts were told that they must have them repaired and put in good order. The roughly dressed blocks of coral were, however, quite good enough for the bare feet of the natives; and many were the repetitions of the command, which still remained unheeded. At last it was decided to impose a fine for disobedience on the chiefs of the districts. In what shape was the fine to be levied? . . . At last, by a happy thought, the fine was exacted by sending a man to every *failu* and *pabai* throughout the disobedient districts, where he simply marked a certain number of the most valuable *fei* with a cross in black paint to show that the stones were claimed by the government. This instantly worked like a charm; the people, thus dolefully impoverished, turned to and repaired the highways to such good effect from one end of the island to the other, that they are now like park drives. Then the government dispatched its agents and erased the crosses. Presto! the fine was paid, the happy *failus* resumed possession of their capital stock, and rolled in wealth. (pp. 93, 96–100)

The ordinary reader's reaction, like my own, will be: "How silly. How can people be so illogical?" However, before we criticize too severely the innocent people of Yap, it is worth contemplating an episode in the United States to which the islanders might well have that same reaction. In 1932–33, the Bank of France feared that the United States was not going to stick to the gold standard at the traditional price of $20.67 an ounce of gold. Accordingly, the French bank asked the Federal Reserve Bank of New York to convert into gold a major part of the dollar assets that it had in the United States. To avoid the necessity of shipping the gold across the ocean, the Federal Reserve Bank was requested simply to store the gold on the Bank of France's account. In response, officials of the Federal Reserve Bank went to their gold vault, put in separate drawers the correct amount of gold ingots, and put a label, or mark, on those drawers indicating that the contents were the property of the French. For all it matters, the drawers could have been marked "with a cross in black paint," just as the Germans had marked the stones.

The result was headlines in the financial newspapers about "the loss of gold," the threat to the American financial system, and the like. U.S. gold reserves were down, French gold reserves up. The markets regarded the U.S. dollar as weaker, the French franc as stronger. The so-called drain of gold by France from the United States was one of the factors that ultimately led to the banking panic of 1933.

Is there really a difference between the Federal Reserve Bank's believing that it was in a weaker monetary position because of some marks on drawers in its basement and the Yap islanders' belief that they were poorer because of some marks on their stone money? Or between the Bank of France's belief that it was in a stronger monetary position because of some marks on drawers in a basement more than three thousand miles away and the Yap family's conviction that it was rich because of a stone under the water some hundred or so miles away? For that matter, how many of us have literal personal direct assurance of the existence of most of the items we regard as constituting our wealth? What we more likely have are entries in a bank account, property certified by pieces of paper called shares of stocks, and so on and on.