Reflections on the Monetary History of the West – 1700-1974

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By 1700, the banking system of Europe had elaborated the institutions of money and credit we know today. And England had taken the lead. For almost 200 years, from 1717 until the onset of World War I in 1914, the British pound sterling, a weight unit of metallic money, set the example for modern monetary systems. Significantly, standard British money was called the pound. Equally important the English word money comes from the Latin word moneta, meaning literally coin or mint. Money is coin minted currency. Historic standard money of the Western world in general was coined metal. And in particular the standard unit of coin in England was the pound sterling, a pound weight of metal.

The pound of precious metal would be "monetarized" by coining from its contents the standard unit money (coins) in circulation. Within a nation or community, the issuance of such money could never exceed the quantity of precious metal imported or mined – and, therefrom, minted into the standard units of coin such as the pound in England. But also, the value of mined and imported monetary metals in the community (i.e., money) was approximately equal to the value of all the products and services created in the community against which the monetary metals were exchanged. Thus, the quantity of (coined) money in circulation was always in reasonable balance with the quantity of goods and services produced in the economy of such a community. Under such a naturally balanced monetary system, there could be no great excess of money. Thus, there could be no great inflation. Nor could there be any "shortage" of money. Each producer made a supply of goods in the market for money, the quantity of which was determined by the amount mined or imported and then coined for those who desired to hold it instead of goods. Thus, there could be no great deflation caused by insufficient money because the community produced or imported the coin, or money, it desired to hold. The money prices of goods fluctuated, but workers got the money they desired to exchange for their labor. It is true that prices gradually rose when large, new discoveries amplified the quantity of monetary metal on the market. Such an example occurred during the 16th century known to historian as "The Price Revolution." But the average rise in the price level during this period, contrary to conventional wisdom, was about three percent, a veritable age of stability compared to our own. It is also true that the price level gradually declined during periods of diminished rates of discovery of the monetary metals. Such a period was the late 19th century in the United States, known to some historians as "The Great Deflation." But the average decline in the price level during this period never exceeded 2 percent and this fall in the price level was associated with

one of America's greatest periods of economic growth. Compared to the Great Depression of 1930-1933, caused by protectionism, trade barriers, war preparations and central bankers, the monetary deflation of 1870-1900 was but a gentle decline amidst economic expansion.

It was also no accident that the historic monetary unit of the Western world was a definite weight of a real article of wealth. The English currency took its name from the pound weight of precious metal which was the customary unit of value at the town of Sterling in Anglo-Saxon England. It is true that the metallic monetary unit, even in medieval Europe, never contained the precise weight indicated by its name. In addition, the weight measures of money actually varied from locality to locality and were arbitraged in market places by money changers. But the monetary unit, the measuring rod of value during the commercial and industrial revolutions was nevertheless, always a true weight unit of bullion or coin. Intentively, a weight unit of money enabled its users to compare the value (or "weightiness") of goods and services against the proportions of value contained by the different weights of national and local monetary units. Coined money, whatever its origin, had the earmarks of a universal standard of economic value.

Even more important was the fact that a specific weight unit, not an empty abstraction, had emerged as the concrete standard of economic value; or, in other words, of the weightiness of other goods. And just as the inch is a unit of length, designed best to measure distance, so the unit weight was freely selected in the market as the best measure of economic value. Just as the true yardstick cannot vary from the prescribed length of 36", or all length measurement must break down in chaos; so the community of wealth producers decided upon a monetary unit of fixed value by weight, in the absence of which, the measurement of economic value would become unreliable and break down.

Now, the reason a unit of weight, emerged as the measuring rod of economic value is very simple. Economic exchange is uniquely human activity. Wealth consists of the real products and services offered in the market, which originate in human action. Wealth is created by human intelligence and effort. Historic money, i.e., metallic money, was also a real article of wealth produced for the market. It was desired for beauty, ornament, and endurance. But metallic must be measured by weight. The pound coined at eSterling measured the amount of intelligence and effort and capital (saved effort) required to produce a certain quantity of metal which could be exchanged against other goods in the market. All goods require for their production a certain amount of intelligence, effort and capital; therefore, a proportionality, or underlying relationship of value among all goods, must be measured best by a unit of measure which is common to all these goods. Such is the weight unit of precious and desirable articles of wealth which can only be produced by the application of a relatively constant amount of human intelligence, effort, and capital. The market discovered over centuries, that a weight of gold metal, as we shall discuss later, exhibited the property of constant value better than all other

potential and competing monetary standards. Thus, the value of human economic activity came to be measured by a constant weight unit of gold. The historic standard of economic measurement is still a gold weight. Thus did the gold standard become the unvarying yardstick of commercial civilization in the west and as we shall see, characterized its longest periods of expansion, peace, and price level stability.

The historic pound sterling was divisible by law and practice into weight units of gold and silver money. Paper pound notes, or bank notes were issued and redeemable, as we know, into their equivalent weight in gold. By the early 19th century checks, or deposit withdrawals, drawn on the expanding demand deposits of the sterling banking system were acceptable throughout the commercial world. Acceptability was insured by redeemability in English bank notes and also into gold coin or money, a money which under British leadership had become the acknowledged world money. In a way, because gold money was the optimum monetary standard and because English money was primarily gold based, and moreover England dominated world commerce, gold rapidly became the world currency. The integrated and expanding industrial world economy of the 19th century was, above all, based on its common, efficient currency. Western capitalism comprised a family of competing nations with a global and impartial monetary system, the gold standard, the elaboration of which had developed in parallel with the industrial revolution. Their coincident occurrence was not fortuitous. Throughout history, a sound and efficient money had accompanied the development of an ordered and growing exchange economy. It was no accident that the destruction of stable money in ancient Greece and Rome brought inflation, price and wage controls, rationing, tyranny, decline and fall. The process for debasement occurred over centuries, but the hindsight of the historian shows the unassailable link of depreciating money and a doomed civilization.

World War I ended the preeminence of the classical European states system and the world monetary system, the true gold standard, to which it gave rise. No less significantly, on the eve of war, the rules of the international gold standard – proven guarantor of one hundred years of price stability – was suspended by the belligerents. The onset of war, the inevitable fear, and the prospect of inflationary war finance made untenable from the standpoint of the politicians the link between European currency and credit monies and to gold. From the standpoint of today, we know that all-out war destroys all the institutions of civilization, and money could be no exception. No monetary standard can survive total war. In order to stem a run by fear-stricken citizens on the limited gold supplies of the central banks, the governments of Europe ceased to honor the gold clauses which for a century had anchored the value of bank deposits and currency in circulation. Between 1914 and 1924 expansionary central bank credit policies of war-torn European nations destroyed or depreciated most national paper currencies. The Age of Inflation was upon us. While attending the Paris Peace Conference of 1919, before his later social-democratic phase, John Maynard Keynes argued that there was no surer means of

“overturning the existing basis of society than to debauch the currency.” The process of inflation, he warned, unconscious of the future irony of his influence, “engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose.” Keynes was a shrewd man, and in this single phrase he depicted the satanic force released by the destruction of the value of money. Keynes understood inflation. He knew its effects destroyed the future because he observed them first hand after the war. Shortly after World War I, he wrote that under the conditions of inflation “a country can, without knowing it, expend in current consumption those savings which it thinks it is investing for the future; … When the value of money is greatly fluctuating, the distinction between capital and income becomes confused. It is one of the evils of a depreciating currency that it enables a community to live on its capital unawares. The increasing money value of the community’s capital goods obscures temporarily a diminution in the real quantity of the [capital] stock… For these profound reasons Europe is in danger of a lasting degradation of her standards, unless bold and conservative wisdom can take control.”

But Keynes was more than a mere analyst of the defects of inflation. He knew something about its remedies, for he wrote after World War I as if for our own age:

“If gold standards could be introduced throughout Europe, we all agree that this would promote, as nothing else can, the revival not only of trade and production, but of international credit and the movement of capital to where it is needed most. One of the greatest elements of uncertainty would be lifted…and one of the most subtle temptations to improvident national finance would be removed; for it a national currency had once been stabilized on gold basis, it would be harder (because so much more openly disgraceful) for a Finance Minister so to act as to destroy this gold basis.”

So much for the man who, when he found it in England’s interest and his own, would later expediently and contemptuously dismiss the discipline of the gold standard as “a barbarous relic.” It is not fortuitous that the decline and fall of British capitalism is closely associated with the first British suspension of the gold standard (1914 amidst World War I), and the second British suspension (1931 and Depression).

The end of the international gold standard in 1914 lead, during the next decade, to the great paper and credit money inflations in France (1924-1926) Germany (1920-1923) and Russia (1916-1918) – among other European countries. The ensuing convulsions of the European social order, and the virtual obliteration of the savings of its middle classes led directly to the rise of Bolshevism in Russia and Nazism in Germany. Revolution, during and following the great War of 1914, was closely associated with the ruination of inconvertible European paper currencies. Given the disorders of war and inflation we have learned that to desire a peaceful and prosperous world trading system is to desire the means by which to achieve it. A world trading

system needs leadership and a common currency, independent of national currencies. To avoid war requires military preparedness of the leader. To desire a global market is to desire a common currency painstakingly developed and therefore accepted after centuries of trial and error. To desire an end without desiring the correct means by which to attain it is foolish. I would go so far as to say that under current circumstances to desire peace and world economic order is to desire U.S. leadership and the international gold standard. As history suggests, to desire insolation and to deny the gold standard is, unknowingly, to desire currency depreciation, beggar-thy-neighbor policies, protectionism, tariff and trade wars, and ultimately, autarky and military conquest.

Today, three generations after the Great War of 1914, one observes – at home and abroad – the rapid disintegration and fluctuation of the value of all paper and credit monies. The scourge of inflation is again upon us; but today it is simplistically described as "too much money chasing too few goods." In fact, inflation represents a decline in the value of the preeminent economic institution of civilization – money. Similarly, the astronomical rise of the price of gold – from $20 to $35 per ounce in 1934, from $35 per ounce in 1971 to $500 in March of 1981 is merely the other side of the same coin – the decline and fall of the dollar. This corrosive process of inflation got underway in 1913 with the founding of the Federal Reserve System. World War I intensified the breakdown of monetary institutions, a process which temporarily corrected itself between 1920 and 1922. After the international monetary conference of Genoa in 1922, inflation picked up momentum again in Europe. After the early phase of the Great Depression (1929-1932) the process of worldwide inflation got underway which carries on to this very day. The historic signal for the great American inflation occurred in 1933-1934 when Franklin D. Roosevelt abruptly terminated the domestic gold standard (1933), and collected by force of law and paid $20 for all gold coins owned by United States citizens. In 1934 he reduced the value of the monetary standard by reducing the weight of the gold dollar; or as it is incorrectly stated, by raising its price from $20 to $35 per ounce. The effect of this devaluation was, overnight, to collect for the government the higher value for the gold which had rightfully belonged to the owners of the gold currency who had been dispossessed by the authorities. In this sense, the depreciation of the law of contract in a free society went hand-in-hand with the depreciation of the currency.

It is important to remember that, under the gold standard, there is no such thing as "the dollar price for gold." This phrase improperly construes the definition of the monetary standard. Under the gold standard, the dollar is defined by statute as a weight of gold. The dollar is so many fractions, or grams, of a troy ounce of gold. Confusion arises when one refers to the "price of gold" in 1932 being $20.67, or $35.00 in 1934 or 1970. There are 480 grams of gold in a troy ounce. Therefore, if the dollar by law is c. 24 grams of gold; then 480 divided by 24 grams (one dollar) = 20.67 dollars. That is, 20.67 gold dollars can be coined from the weight of one

troy ounce, or 480 grams of gold metal. This essential point must be kept in mind later, when we consider the riddle of the dollar price of gold under a future international gold standard.

Constitutional questions arose during the 1930s over the authority of the President to violate the value of contracts and debts which stipulated payments in gold dollars. The doubtful power of Congress, subsequently to pass laws prohibiting the implementation of gold clauses in already existing U.S. contracts, gave rise to landmark Supreme Court Decisions. Congress was challenged by damaged plaintiffs but the Supreme Court upheld Roosevelt and the legislature. Existing gold contracts were pronounced dead: they were declared by congressional resolution to be “against public policy.” In addition, otherwise free American citizens were prohibited by law from owning gold, a right only recently restored by law in January 1975 after years of public debate.

It was clear that the dollar after 1934 was, as the phrase went, no longer quite “as good as gold.” Americans could not exchange their paper and bank deposit money for a specified weight of gold, even though in law the dollar was still nominally defined as – grams of gold. Ironically, foreigners were still permitted to exchange their undesired paper dollars for American gold. But domestically the dollar would no longer be linked to a real article of wealth. The way was therefore open in the future for the dollar to become a fully managed currency, whose value would be substantially determined and regulated by the opinions of politicians and the Board of Governors of the Federal Reserve System.

Ten years after Roosevelt’s devaluation of the dollar, and thirty years after the founding of the Federal Reserve System, the Bretton Woods Agreement of 1944 elaborated a new international Monetary System. Bretton Woods codified and institutionalized certain central bank decisions taken at a previous world Monetary Conference in Genoa held in 1922. The inauguration in 1913 of the U.S. Federal Reserve System, followed by the conference in Genoa were two events which changed the financial history of the Western World. This view of accidental history has never been sufficiently recognized. In 1922 Europe was trying to recover from World War I. The price level, or gold prices, had doubled or more than doubled throughout Europe. But the statutory value of the gold currency remained the same in America and the British government even contemplated a restoration of the pre-war gold value of sterling. Naturally, under the conditions, a scarcity of the undervalued gold currencies developed. Therefore the central bankers of Europe agreed at Genoa in 1922 to three basic undertakings: (1) to attempt to stabilize the existing general price level or the gold value of the currency – instead of devaluing the monetary units which would have acknowledged the inflation of World War I; 2) to coordinate central bank credit policies in order to “manage” the value of their related currencies more effectively; and 3) to modify the rules of the international gold standard and to institute more or less officially the gold exchange standard in order “to conserve” the existing supply of gold while still facilitating the international movement of goods and capital.

The first point was best exemplified by Chancellor of the Exchequer Churchill who in 1925 restored the prewar value of the pound, a policy which tended to create deflation and unemployment in Britain for the remainder of the decade of the 1920s. The 1925 restoration over valued sterling and the level of wages in England, and is therefore a forerunner of the austerity program of Margaret Thatcher today. J.M Keynes was inspired to write his General Theory, published in 1935, partially an analysis and remedy for the defects of profound unemployment and stagnation of the post-war economy in England. Keynes realized that deflation and unemployment were partly caused by overvaluation of the pound sterling at its pre-war parity. Thus England failed to permit stinking wages to adjust to falling world prices. It is true that British prices fell; but manufacturing wages remained high because of protection, subsidies, and the dole. Thus, foreign competitors invaded England and foreign markets formerly dominated by English manufacturers. This displacement created the havoc of unemployment in traditional British industries like coal, steel, textiles, and shipping.

The second Genoa policy, central bank coordination of credit policies, began the practice of substituting central bank money market manipulation for the impartial and efficient adjustment mechanism which tended to preserve among nations true balance of payments equilibrium. The adjustment mechanism operated through gold flows and interest rate movements, the effect of which was to balance supply and demand in domestic and world markets.

The third policy altered the method by which money was created under the original gold standard mechanism. Under the true gold standard, a central bank creates money (its liabilities, bank rates or deposits) by purchasing gold or domestic financial claims, such as commercial loans or securities (its assets). Under the gold-exchange standard, an early form of the reserve currency system of today, a bank, or central bank, can create money (deposits bank rates or bank liabilities) by purchasing foreign exchange or foreign securities (its assets). By this analysis one sees clearly that modern money is in part made up of the liabilities or the deposits of the banking system. But there are two sides to every balance sheet. The counterpart of money exists in the loans or securities, the bank assets against which the money (or deposit liabilities and banknotes) has been issued. Under the Genoa agreement central banks endorsed the risky practice of issuing domestic money (deposits or currency) say pounds or Francs, against the purchase of foreign assets, such as dollars or U.S. Treasury securities. The problem thus created is straightforward. Under the gold exchange standard, a reserve currency system, if the foreign currency assets (say dollars or pounds), held by the German central bank, decline in value, or collapse, the domestic money (the liabilities of the bank) cannot be redeemed at its par value because the assets, valued at market, are less than the value of the liabilities. The gold value of the mark must therefore be repudiated. There are simply insufficient depreciating dollar values backing the German currency. Devaluation is the consequence. Such a process occurred twice, in 1931 when sterling collapsed and destroyed the value of the sterling backing of currency

values in many other countries; and in 1971 when the dollar collapsed and caused all nations to repudiate the implied Bretton Woods – gold link of their currencies.

The gold-exchange standard had been officially confirmed at Genoa in 1922. The dollar and the pound sterling were acknowledged as de facto official reserve currencies. It was by means of this gold-exchange standard that gold was to be economized. To do so, dollars and pounds, instead of gold, were to be held as assets by foreign central banks and they were to be exchanged instead of gold by all central banks to settle balance of payments deficits. In 1944, the Bretton Woods Agreement reestablished the dollar alone as the post-World War II "official" reserve currency. Sterling continued until 1975 as an unofficial reserve currency for some nations tied closely to the so-called sterling bloc. But the dollar became the "numeraire" of all world monetary values between 1944 and 1971. The values of foreign currencies were to be determined by their relationship to the dollar. In turn, the paper dollar derived value, under the agreement, by virtue of its convertibility into a fixed weight of gold – for foreigners, but not for American citizens. Thus, the Bretton Woods Agreement wrote into international law the "official reserve currency status" of the dollar which, as a practical matter, had prevailed for at least the preceding 22 years.

But the story of Genoa, World War I, and Bretton Woods is incomplete without grasping the importance of the Federal Reserve System. Established in 1913, the central bank of the United States was designed for the express purpose of creating an "elastic currency." An elastic currency was thought to be one which could expand with the needs of trade, one which could resist the contracting forces implicit in a financial panic. Briefly, the idea of the Federal Reserve System was born in the aftermath of the banking panic of 1907. A national monetary commission was appointed to study institutional remedies for the defects of the American banking system. The most profound influence on the legislature process was of course the bankers themselves, and certain foreign luminaries like Paul Warlburg of Germany. Five years of study and debate gave rise to the Federal Reserve System, which was modeled in the German Reichsbank and the Bank of England. Essentially, the Federal Reserve System is a private corporation, with a statutory monopoly over the currency issue and near monopoly over the regulations of the banking system. Just as the ICC regulates the railroads, so does the Fed regulate monetary institutions.

The power of the Fed consists not only in its regulating power, but in its control over the supply of credit to the banking system. Under the original statute the Fed could create credit only by advancing money against secured promissory notes of merchants and producers. The government did not qualify for credit at the Fed, and thus a government deficit could not be financed by the central bank. Additionally, the Fed was limited by the gold standard. Since the dollar was a fixed weight of gold, and the law required the maintenance of this value, the Fed could create only a limited amount of credit, such as new deposits and Federal Reserve notes. If

the limit was not observed, holders at arm and aboard of excess dollar deposits and currency would redeem them for gold, thus jeopardizing the guarantee of convertibility of bank deposits and currency for standard money, namely gold dollars.

Oversimplified, this description characterizes the Federal Reserve System in 1913. But the World War changed everything. First European gold flowed to the United States in a panic and in order to finance war purchases. Second the Fed extended credit, at interest rates below market, to commercial banks in order to finance the "Liberty Bonds." Above all, the power to create and expand credit, inherent in the monopoly powers of the Federal Reserve System, became evident during the course of the war. During the recession of 1920-21, these credit creating powers we activated through mechanism, of open market operations, i.e., the technique of Fed purchases of government securities, now permitted since World War I. In a word the Fed was able to extend credit to the Federal government. Given hypothetical conditions of a permanent deficit and a need for government financing, all the potentialities of the Federal Reserve System as an engine of world inflation were opened up. Only one check on this engine remained the gold standard. In its absence, there would be no limit on the Fed's charter to create money and credit.

In effect, World War I was a catastrophic and suicidal act which destroyed not only the European peace; it also destroyed the monetary system of Western civilization. World War II and its aftermath were the last historical acts of the unfolding drama.

All European countries struggled with inflationary disorders during the war-torn 1940s and reconstruction during the 1950s. In the mid-1950s the world passed through what was forecast by the experts of the time to be a "permanent dollar scarcity." Remember if you will that the United States economy dominated the planet as no country ever had before. During this period the gold-linked Bretton Woods dollar remained the reasonably stable epicenter around which other fluctuating currency systems orbited. But after 1958, a great event occurred. The western European governments restored the mutual convertibility of their currency systems, abolished most exchange controls, sought to establish budgetary equilibrium and (?) dollar primacy began to wane. From that very year, when the once prostrate nations of Europe hardened the value of their national monies, the U.S. has experienced virtually a "permanent" balance-of-payments deficit. The economists and experts were confounded, as overnight, the "permanent dollar scarcity" of the 1950s became "the permanent dollar glut" of the 1960s and 1970s.

Throughout the 1960s the inflation and external deficit of the dollar, generated by expansive U.S. monetary policies, led to annual foreign exchange crises and ultimately to foreign exchange controls under Kennedy and Johnson. This was the period of "the permanent balance of payments crises." The Bretton Woods system groaned under the flood weight of excess U.S. dollars, awash in financial markets abroad, where perforce they were accumulated in the

official foreign exchange reserves of our trading partners. This was also the period when politicians and civil servants led by academic neo-Keynesians Professor Paul Samuelson and Walter Heller suggested that a little inflation was controllable and desirable.

Since the U.S. dollar was the primary reserve currency, under the gold exchange standard embodied in the Bretton Woods treaty, foreign central banks were in effect required to purchase and to hold as reserves against the creation of their own money, undesired dollars received and sold by their citizens. It was also during this period (1920) that the Special Drawing Right (SDR), an international "paper" money, was invented by the International Monetary Fund in order, it was argued, to avoid a potential "liquidity shortage" in world reserves. Indeed, it was even said that the SDR, an artificially created reserve asset, to be allocated among its members by the International Monetary Fund, was necessary to finance growing world trade. But as one foreign economist remarked, the creation of the SDRs, under the existing conditions of inflation and permanent U.S. deficits, reminded him of irrigation plans during a flood.

More was to come. From 1945 on, the Federal Reserve was required to hold gold reserves equal to 25 percent of the Federal Reserve notes and deposits it created against the purchase of government securities and other financial assets. Now when President Johnson decided simultaneously to expand the Vietnam War and to build the Great Society, he moved, with the consent of Congress, to void the statutes which limited, by virtue of a stipulated gold cover, the amount of currency and credit which the Bank of Issue, the Federal Reserve System, could create. The full inflationary potential inherent in the Federal Reserve Act of 1913 was about to be realized. The institution of financial discipline, the gold-link or legal gold cover, which had limited the creation of paper and credit dollars, was virtually terminated. And predictably, with the ultimate discipline of a legally-required gold cover brushed aside, budget deficits, Fed credit expansion, inflation, and the balance-of-payments crises intensified. Unimpeded by any statutory rule limiting either budget deficit or the growth of the money supply during the late 1960s, the Federal Reserve System had complete discretion to create, subject to demands for gold from generally foreigners, servile generally servile, the new credit and money required by the Congress to finance the President's war budgets and his Great Society deficits.

Lyndon Johnson even put an end to the historic use of silver in the production of the subsidiary coinage of the United States. The vast silver hoard of the U.S. Treasury, part of the patrimony of every American taxpayer, was liquidated in the market at about 90 cents per ounce. (Footnote: Peter Grace chart) Next, in March 1968, Johnson suspended the London Gold Pool as the foreigners began to cash in their excess dollars for more gold than we were willing to supply. Between November of 1967 and March of 1969, the U.S. lost one-fifth of its gold reserves. Beginning in 1960-61, the Gold Pool had underwritten the Bretton Woods convertibility agreements, having grown increasingly shaky by excessive credit expansion in the United States and the United Kingdom. By selling gold at the stipulated dollar-gold parity of $35 per ounce in

order to redeem excess dollars and sterling accumulating abroad, the Anglo-Saxon powers had been able to finance their inordinate domestic and foreign policies. After 1968 the U.S. refused to supply gold for dollars in London. The linchpin of Bretton Woods, the link between gold and the dollar, had been ruptured if not definitively broken.

These dramatic changes in the international monetary system were welcomed by most of the academic and policy-making communities. The Bretton Woods agreement was an unnecessary discipline. Gold and silver were "outdated," declared these "experts." Professional economists – neo-Keynesians and monetarists alike – gladly dismissed the Bretton Woods fixed rate regime as the last vestige of the pre-World War I gold standard. They herald the coming of a new era of central bank "managed money" and floating exchange rates.

From 1945 to 1965 the neo-Keynesians had ruled economic policy making and academic circles in Washington and in the universities. Their demand management policies, especially during recessions, relied on budget deficits, financed by the creation of new credit at the central bank, the Federal Reserve System. The neo-Keynesians were not very much interested in the consequences of credit and monetary policy. Fiscal policy was their primary tool. Then came the counter-revolution of the monetarists who captured much of the field of economic policy and university departments in the late 1960s. From them one learned in general that money matters as much, or more, than fiscal policy. And in particular, we learned from the monetarists that men can manage inconvertible paper currencies according to certain prescribed monetary rules. Their favorite technique for controlling the money supply was so-called open market operations, the buying and selling of government debt securities by the Federal Reserve System. Simply stated, monetarists promoted the idea of a gradual growth in money and credit by means of a so-called steady "quantity rule" – say, 3 to 4 percent money growth per annum. Neo-Keynesians had, of course, offered "countercyclical" monetary management, that is, a discretionary quantity rule, whereby money and credit growth was geared to demand management policies and adjusted as well to finance the budget deficits caused by their "compensatory" fiscal policies.

Both warring schools of thought criticized the faltering Bretton Woods fixed exchange rate regime, itself a form of the ill-fated official gold exchange standard originating at Genoa in 1922. Ironically the warring monetarists and neo-Keynesians agreed – but not upon the reform of Bretton Woods. Instead they advocated its demolition. In its place, monetarists and neo-Keynesians alike endorsed central bank managed currencies; floating exchange rates ("clean" for some, "dirty" for others); and the demonetization of gold. Simply put, they wanted an end to any international exchange rate regime. The idea of monetary standard had been destroyed. These monetary doctrines soon became the fashionable credo propagated by academic economists and policy makers everywhere.

President Nixon followed Johnson and under the influence of his advisors gradually went through his own conversion to Keynesian economics ("We are all Keynesians now," he remarked.) But Nixon also absorbed some of the teachings of the Monetarist School – in particular, the importance of an independent monetary policy and the desirability of replacing the Bretton Woods fixed rate system with floating exchange rates. On August 15, 1971, the test came. The dollar had collapsed in May on the foreign exchanges and European governments became increasingly impatient to exchange their excess dollars for gold. Nixon responded by defaulting at the gold window: he refused to redeem the excess dollars for gold, as the British government a few days earlier had demanded under the contract terms of the Bretton Woods treaty. In one of those curious historical ironies, it was the anti-New Deal Nixon who affirmed in 1971 the final demonetization of gold, begun at home by the liberal FDR in 1934. The last vestiges of an official domestic and international gold standard had been abrogated by the undisputed leader of the free world. The dollar had ceased to be a real money, linked directly to an article of wealth such as gold. It would henceforth be a nominal paper money, an empty monetary token, linked to nothing but the judgment of its regulators at the Federal Reserve System.