Gresham's Law at Work: Pennies and Nickels Are Disappearing

When Kyle Bass defended his decision on BBC Radio Hard Talk on November 17th to purchase 20 million nickels, he was just putting Gresham's Law into operation. Bass, the founder and principal of the hedge fund Hayman Advisors, did the math and discovered that he could purchase 6.8 cents worth of copper in each nickel for just 5 cents. Nickels are 75 percent copper while pennies (minted between 1909 and 1982) are 95 percent copper and the recent spike in copper's price simply made it too good a deal for Bass to pass up.

This is Gresham's Law in action. The standard definition is that "bad money drives out good." Simply put, when coins of lesser value are forced to be accepted alongside coins of greater value, the more highly valued coins will be hoarded. In other words, Gresham's Law reflects the price-fixing disruption always inherent in legal tender laws. A better definition of Gresham's Law might be "When a government compulsorily overvalues one type of money and undervalues another, the undervalued money will leave the country or disappear from circulation into hoards, while the overvalued money will flood into circulation."

Prior to 1965 dimes and quarters were made of 90 percent silver and 10 percent nickel but with the Coinage Act of 1965 the silver content was removed and replaced with 75 percent copper and 25 percent nickel. Almost immediately the high intrinsic value dimes and quarters began to be hoarded as Gresham's Law kicked in. Today a pre-1965 silver dime is worth about $2.40 in inflated Federal Reserve Notes.

Dr. Gary North defines Gresham's Law more carefully by noting that the law only works when there is government intervention. In a free market, with consumers making individual decisions free of government mandates, good money will drive out bad money. As he explains:

> In an economy with a government-legislated fixed price between two currency units, the artificially overvalued currency drives out of circulation the artificially undervalued currency.

North engages in a make-believe narrative to prove his point. From the earliest days of the American republic, the government tried to impose bimetallism onto the free market, mandating that gold was worth 15 times as much as silver. When gold was discovered in California in 1848, the flood of new gold onto the market changed the ratio, but the law didn't. Here is North:

> Let us say that you were there. You get a bright idea. You go to the bank with two ounces of gold. You demand 30 ounces of silver. Then you take your 30 ounces of silver and buy three ounces of gold. Where? Across the border in Canada or Mexico. (OK, it was a long ride on horseback. Maybe there were banking trading ships just off San Francisco.) You then take your three ounces of gold to the bank and demand 45 ounces of silver. You repeat the procedure until the bank has no more

> silver to sell at the price of 15 to one.
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> Of course, you would do this with ten times as much gold. Your competitors, currency speculators, would buy a thousand times as much gold.

The gold remains in circulation while the silver disappears. This is Gresham's Law in action. And this is the law that Bass is following by purchasing twenty million nickels: he knows the nickels are undervalued and he is just doing his part in removing them from the market.

When Rep. Ron Paul (R-Texas) first introduced his "Free Competition in Currency Act" in December, 2009, he noted that gold and silver were the result of the free market making its choice about what commodities would best serve as money: "Gold and silver are difficult to counterfeit, a property which ensures they will always be accepted in commerce."

> It is precisely for this reason that gold and silver are anathema to governments. A supply of gold and silver that is limited in supply by nature cannot be inflated, and thus serves as a check on the growth of government. Without the ability to inflate the currency, governments find themselves constrained in their actions, unable to carry on wars of aggression or to appease their overtaxed citizens with bread and circuses.

Consequently, the first step in his bill is to eliminate the legal tender laws that mandate the price-fixing concerning what citizens may use for money. Paul explained:

> An emperor, a king, or a dictator might mint coins with half an ounce of gold and force merchants, under pain of death, to accept them as though they contained one ounce of gold. Each ounce of the king's gold could now be minted into two coins instead of one, so the king now had twice as much "money" to spend on building castles and raising armies. As these legally overvalued coins circulated, the coins containing the full ounce of gold would be pulled out of circulation and hoarded. We saw this same phenomenon happen in the mid-1960s when the US government began to mint subsidiary coinage out of copper and nickel rather than silver. The copper and nickel coins were legally overvalued, the silver coins undervalued in relation, and silver coins vanished from circulation…
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> In the absence of legal tender laws, Gresham's Law no longer holds. If people are free to reject debased currency, and instead demand sound money, sound money will gradually return to use in society. Merchants would be free to reject the king's coin and accept only coins containing full metal weight.

Rejecting the king's coin, his paper money, his phony Federal Reserve notes, would certainly mark the beginning of the bright day of freedom. Until then, Bass and others will no doubt continue to take advantage of Gresham's Law until nickels and pennies disappear altogether.