# REAL MONEY

Buttressed by gold

by Lewis E. Lehrman

THE WORLD ECONOMY of the nineteenth century was, above all, characterized by the gold standard. Each great power defined its currency by a weight unit of gold and guaranteed such convertibility. Thus all national currencies were linked by a specified ratio to an underlying and universal common denominator, gold, which functioned as a neutral world currency. The gold standard was the impartial arbiter of the world financial system. Though linked to all national currencies, gold was nevertheless a reserve currency asset, "outside" and beyond the manipulation of any sovereign country.

World War I ended the preeminence of the classical European states system. On the eve of war, the belligerents suspended the gold standard—the guarantor of a hundred years of price stability. War and the prospect of inflationary war finance doomed the maintenance of a gold-linked currency. In order to stem runs on central-bank gold reserves, the governments of Europe ceased to honor the gold convertibility laws. The expansionary credit policies subsequently pursued by the European central banks led, during the next decade, to the great paper-money inflations in France, Germany, and Russia—among other European countries.

An Age of Inflation began. Writing as early as 1919, while attending the Paris Peace Conference, John Maynard Keynes argued that there was no surer means of "overturning the existing basis of society than to debauch the currency." Inflation, he warned, "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."

DECADES LATER, I watch—both at home and abroad—the disintegration of the value of the paper dollar. Inflation is upon us once again. The astronomical rise of the price of gold from $35 in 1971 to $600 in June of 1980 merely denotes the meaning of inflation—i.e., the debasement of the dollar and all other paper currencies. This corrosive process began, however, after the early years of the Great Depression (1929-32), when President Franklin D. Roosevelt abruptly ended the domestic gold standard in 1933 and in 1934 devalued the dollar by raising the price of gold from $20 to $35 per ounce.

At the time, Roosevelt and his economic advisers believed that in order to arrest the deflation of prices it was necessary to stimulate the economy. To this end they raised the price of gold, and thus lowered the value of paper money, hoping also to raise depressed commodity prices. By manipulating the gold price and depreciating the currency, FDR hoped to cause all other prices to rise and, as a result, restore prosperity. The dollar was, as the phrase went, no longer "as good as gold." For Americans, the dollar would no longer be linked domestically to an article of wealth. In the future, the dollar would be a managed currency, its value substantially determined and regulated by the opinions of the members of the board of governors of the Federal Reserve System. But the dollar-depreciation policy failed. Five years later, in 1939, unemployment still exceeded 10 percent of the work force. Later, World War II ended the Depression.

At Bretton Woods in 1944, ten years after Roosevelt's dollar devaluation, an international monetary agreement, largely determined by the Americans and the British, was concluded. The Bretton Woods agreement established the dollar as the "official" world reserve currency. The values of foreign currencies were to be determined by their relationship to the U.S. currency, which was convertible *only for foreigners* at $35 per ounce.

Between 1945 and 1958, the European countries ran huge government budget deficits and financed part of their debt by creating new money at their central banks. At that time, the U.S. government budget deficits were not chronic, nor were they very large. Keynesian fiscal policies were possible in Europe because European currencies were not mutually convertible into gold at a fixed rate. Convertibility would have limited the freedom of their central banks to create new money. Thus the European governments created excess money, which caused their currencies to be chronically weak compared with the relatively stable dollar. The economic experts called this problem the "permanent dollar shortage."

After 1958, the leading European nations reestablished mutual convertibility of their currencies, limited their budget deficits, and ceased to finance government debt with the creation of new money. But the United States, especially after 1960, developed annual budget deficits and practiced the same expansive central-bank credit policies that had characterized the European countries during the 1940s and 1950s. Predictably, the excess dollars, created by government budget deficits and "accommodating" central-banking monetary policy, gave rise to chronic bal-

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ance-of-payments deficits and a weak currency. Almost overnight a glut of dollars replaced a shortage.

THROUGHOUT THE 1960s the American balance-of-payments deficit, generated by these expansive U.S. monetary policies, led to periodic foreign-exchange crises and eventually to foreign-exchange controls. The Bretton Woods system groaned under the flood weight of excess U.S. dollars in financial markets abroad, where they were accumulated in the official foreign-exchange reserves of America's trading partners. Thus was the U.S. deficit recycled. Excess dollars went abroad: they were purchased by foreign central banks and were then reinvested in dollar securities, often Treasury securities. In effect the excess dollars went abroad, but the dollars then returned from abroad to finance the U.S. Treasury deficit. This legerdemain was described by one critic as "a deficit without tears." In a word, the *reserve currency* country, the United States, had no incentive to end its deficit. The adjustment mechanism of a true gold standard, needed to ensure equilibrium in the budget and in the balance of payments, had been immobilized. This failure of the adjustment mechanism was the chief defect of the Bretton Woods system, based, as it was, on a managed national currency—the dollar.

Indeed, the United States enjoyed the exorbitant privilege of running deficits to finance inordinate social programs at home and irresolute and costly wars, like Vietnam, abroad. Only the reserve-currency country gained this unique seigniorage, at the expense of the rest of the world. Even the nominal gold link was diminished during the 1960s by abolishing the domestic gold reserve required to back the dollar. And predictably, with the discipline of a legally required gold cover brushed aside, budget deficits, inflation, and the balance-of-payments crises intensified.

During the 1960s, professional economists—Keynesians and monetarists alike—made the case for a new era of central-bank "managed money." A managed currency was especially the triumph of Keynesian economists, who dominated economic policy and academic circles between 1945 and 1965. Their "demand management" policies, designed to eliminate recessions, relied on federal budget deficits substantially financed by the Federal Reserve's willingness to create new money.

On the international side, both Keynesians and monetarists criticized the faltering Bretton Woods fixed exchange rates. Ironically, on this issue these intellectual enemies agreed, but not on the reform of Bretton Woods. Instead they advocated its demolition. In the place of the convertible currencies of Bretton Woods, they proposed central-bank-managed currencies, floating exchange rates, and the demonetization of gold.

Even Richard Nixon as president was gradually converted 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 desirability of replacing the Bretton Woods fixed-rate system with floating exchange rates. On August 15, 1971, Nixon closed the gold window, refusing to redeem excess dollars for gold, as the British government had demanded a few days earlier under the terms of the Bretton Woods treaty. The last remnant of a tattered gold-exchange standard was discarded by the leader of the free world. Thereafter, the dollar ceased to be a real money—that is, a money linked objectively to an article of wealth such as gold. Now it would be a nominal money, a paper monetary token, linked to nothing but the subjective opinions of its regulators at the Federal Reserve System.

LENIN ONCE OBSERVED that gold should adorn the floors of latrines. Keynes labeled the gold standard a "barbarous relic," and Milton Friedman has recently said that for a monetary standard one may as well use pork bellies.

When President Nixon demonetized gold in 1971, Henry Reuss, chairman of the House Banking and Currency Committee, predicted that the price of gold would fall to $6 per ounce. It is true that gold remained below $40 until 1972. But by January of 1980, the price of gold was soaring above $800. Recently it has fluctuated between $500 and $600. What caused the exponential rise, fluctuations, and fall of the gold price? I believe that the cause of the violent rise was the same as the cause of other commodity-price rises. Indeed, the same cause was behind the balance-of-payments deficits of the 1960s and the inflation of the 1970s: quite simply, the excessive expansion of money and credit, engineered by the Federal Reserve System in order to finance the Treasury deficit and fine-tune the economy.*

Thus there is irony in the comments of the monetary authorities who declaim that gold is too volatile to stabilize the monetary system once again. On the contrary, it is not the gold price that is unstable. From 1540 to 1976, the purchasing power of gold has remained constant, according to Prof. Roy Jastram in his book *The Golden Constant*. In fact, it is the value of the dollar that is unstable, an instability caused in the past by the Fed's unpredictable and expansionary monetary policies.

The truth is that the Federal Reserve managers are honest and well-intentioned. But they believe they can achieve a goal that is not within their power to achieve—namely, to manage the currency. Moreover, they believe they can fine-tune the world's most complex economy by changes in credit policy. The Fed's ever-changing open-market interventions to this end have only created uncertainty and disorder in the financial markets.

THE FUNDAMENTAL problem of Federal Reserve monetary policy is that the amount of money in circulation cannot reliably be determined by the Federal Reserve board of governors. Therefore, the Fed should stop trying to do so. The Fed simply cannot either accurate-

*The credit policy of the Fed can be observed in the following numbers.

TOTAL FRB CREDIT EXPANSION
(Average annual compound rates)

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|---|---|
| 1960–65 | 8.6% |
| 1965–70 | 8.8% |
| 1970–75 | 8.4% |
| 1975–79 | 8.7% |

As the table shows, the expansion of central-bank credit has for two decades been almost three times the rate of economic growth. The excess credit created by the Fed went abroad in the 1960s when it was known as a balance-of-payments deficit. The same excess credit also caused domestic prices to rise in the late 1960s. During the 1970s the excess money created by the Fed caused inflation at home and the decline of the dollar abroad.

ly know the demand for money in the market or fix precisely its supply. Nor does the Fed possess the information, the operating techniques, or the vision to bring about a certain rate of growth of money supply and credit. Nor could this growth of supply be consistent with the precise demand for money in the market. Moreover, as history shows, no stipulated level of money supply during a specific market period is necessarily correlated either with a specified rate of inflation or deflation or with price stability. For example, during part of 1978 the quantity of money in Switzerland grew approximately 30 percent, while the price level rose only about 1 percent. While inflation rates in Switzerland have subsequently accelerated, inflation has persisted at a modest fraction of the growth in the quantity of money. Conversely, in the United States in 1979, the money supply grew about 5 percent while the consumer price index rose 13 percent and the wholesale price index even more.

Previous experience also gives one little confidence in the limitless discretion of the Federal Reserve governors under the present system of floating exchange rates. Consider what the Federal Reserve is: First and foremost, it is a bank. More precisely, it is the "bank of issue." It has a balance sheet and it has an income statement. As a banking institution it can perform no magic with money. The Fed buys assets with the resources provided by the liabilities it assumes. But it is important to recognize that, within limits, the central bank can also vary the composition of Federal Reserve credit, its assets. Federal Reserve credit is a precise magnitude that tends to regulate the rise and fall of credit and money supplied by the Fed to the banking system. If the credit or money supplied is actually desired in the market, the price level will tend to be stable. If some of the new credit created by the Fed is undesired, it will quickly be spent at home and abroad, the price level will tend to rise, and the value of the dollar at home and abroad will tend to fall.

This problem of equalizing the supply of credit and the demand for it in the market illustrates the problem of monetary policy and central banking. To conduct the operations of the central bank, there must be a goal. If the goal is both price stability and a specific amount of money in circulation, the Fed must know precisely, among other things, not only the amount of money in circulation but also the volume of money and credit actually desired in the market. For only when the supply of money equals the amount desired in the market will there be no inflation. If by open-market operations the Fed *unwittingly* creates excess money in the market, prices will rise, as the excess money is rapidly used for purchases.

But if, instead of a specific quantity of money, the goal of the central bank were primarily price stability, the Fed would promptly reduce the amount of credit it made available to the commercial banks when excess credit was causing inflation. As Fed credit growth contracted, so would the money stock. As a result, excess money would be absorbed until the level of actual cash balances in the market was strictly equal to the amount of cash balances desired for economic growth. During such a market interval, inflation—or excess demand—would dissipate and prices would gradually stabilize.*

If the goal of the central bank during a period of inflation must be to restore reasonable price stability, then the central bank should reduce the quantity of money in circulation to make it once again equal to desired cash balances. Under this restrictive monetary policy the banking system must tend to avoid making new bank loans. This is a monetary policy that will work, because the supply of money and credit will, as a result, tend to decline and to equal the desired amount. If cash balances are strictly equal to the level of desired cash balances, prices will be stable. If there is no excess money in the market, there can be no inflation.

The consequences of such a monetary policy will make themselves felt throughout the economy. Since the supply of money will tend to equal the level of money desired, consumers as a whole will not wish to make purchases with their existing cash balances until they first produce something new. In a word, consumers will not make demands in the market without first offering supplies. Under such conditions the price level will be stable. It will vary moderately around unity, and there will be no inflation arising from excess cash balances created by the central banking system.*

*Cash balances are the ready means of payment we hold in our pockets or at the bank. So is money. Money is often used by people to mean wealth. But money is not the same thing as wealth. Modern money consists of currency and checkbook deposits. Money is, therefore, that balance of our wealth that we choose not to hold in the form of financial assets, goods, and services. This money balance is cash. Money, strictly defined, is a synonym for cash balance.

HISTORY AND ECONOMIC analysis show that the policy best suited to ensure price stability is to make the value of paper money equal to a weight of gold. Thus the volume of currency would be linked to a real commodity, gold, the supply of which grows over the long run at 2 percent a year, roughly proportionate to the rate of economic growth over long periods.

A currency convertible at a fixed price into gold is a long-run stabilizer of the money supply, while central-banking discretionary instruments are useful only for providing elasticity to credit and currency supplies in the short and intermediate term.

Although one wants to give the managers of our central bank a certain degree of discretion in order to supply money for the market, one doesn't want to give them so much discretion that in the short run, for political reasons, they might abandon the goal of reasonable price stability—a goal that only the convertible currency will ensure.** Indeed, a convertible currency constrains all central-banking techniques.

*This concrete monetary policy finally comes to grips with the quantity theory of money and Jean Baptiste Say's Law of Markets, famous classical issues of economics that preoccupied Lord Keynes in *The General Theory.* Say's Law holds that the value of total supply always equals total demand. Keynes disagreed, and he was right. If Say's Law were correct, there could never be an imbalance between supply and demand; therefore, no inflation could occur. But inflation does occur.

The monetary policy to be derived from a *modified* Say's Law is clear: minimize the difference between actual and desired cash balances, and supply through the regulating mechanism of the central bank only the amount of money actually desired in the market.

** A favorite gambit of presidents seeking reelection is to throw monetary sheets to the wind and expand the money supply, thus inducing a false sense of prosperity among the electorate.

For if money is pumped into the system, there will appear on the market a surfeit of cash balances. Those receiving money in excess of desired levels would then appear at the central bank with a demand for redemption in gold. Such evidence of excess money offered at the fixed price for redemption in gold will signal unequivocally to the monetary authorities that there are indeed excess cash balances. The true signal of excess money can be given only by people and firms, concretely expressed by those who would desire to convert such excess funds at the central bank for gold. Such money would be clearly unwanted or it would not be brought in for redemption at the bank. On this signal the Fed would gradually reduce credit to absorb these excess cash balances. The inflationary episode would be cut short because of the requirement to sustain the fixed convertibility ratio between the limited quantity of gold and the undesired currency.

Some would argue that a gold-backed currency is costly, in social and economic terms, compared with a pure paper currency. But whatever the minor social cost of a currency convertible at a fixed parity into gold, it is a superior monetary stabilizer and a more efficient price regulator. As Professor Jastram shows in *The Golden Constant*, the history of the gold standard provides evidence of reasonable, long-term price stability. If the goal of the United States is an end to inflation and reasonable price stability, it is not an excessive cost to allocate a minor share of our resources to the regulating mechanism of the money supply. Nothing else but real money will assure the indispensable virtue of permanent trust in the currency. Without real money, saving evaporates, investment languishes, and the future is impoverished.

Consider also that Americans are required by law to accept paper dollars in exchange for production and labor of a stipulated value. Money, therefore, if it is to be anything, must be at least an efficient and trustworthy instrument by which working people accumulate savings. Men and women carefully save cash balances from the proceeds of their labor. Surely they must insist that the future value of their money closely approximate the objective present value of their labor. The implied convertibility between a unit of real money produced by labor and an article of wealth created by human labor for the market must be assured. Therefore, the value of the monetary unit should have a real objective regulator. But the value of money has an objective regulator only when it is linked to a real commodity, like gold, itself requiring the cost of human labor to be produced. By comparison, the value of inconvertible paper money has no objective regulator, its marginal cost of production being nearly zero.

THE COVENANT between any worker and society must be underwritten by something more lasting than a nominal paper currency or mere monetary tokens. In exchange for work, there must be the payment of real money, the value of which endures. Over thousands of years a gold-related currency has performed this function for civilized men. By establishing real money, men rule out its debasement. In the long run, the value of an ounce of gold is proportionate to an objective quantity, namely the amount of labor invested to mine and to fabricate it. Moreover, a gold currency exhibits the properties that make real money the foundation of an exchange economy. It is scarce, storable, measurable, divisible, immutable, transportable, malleable, and fungible.

Above all, the value of a monetary unit, defined by a weight unit of gold, has a fair and efficient regulator of its value in the world economy, namely, its costs of production. For example, if it requires fifty man-hours to produce one ton of coal and a hundred man-hours to produce one ounce of gold in an open market, then approximately two tons of coal will be exchanged for monetary units sufficient to buy one ounce of gold. If men were able to exchange one ton of coal (fifty hours of labor) for the money to buy one ounce of gold (one hundred hours of labor), men would cease to mine gold in a free market and they would dig enthusiastically to mine coal. They would produce more coal for money and purchase the gold they desired. The increased demand for gold and the increased supply of coal would gradually reestablish an equilibrium ratio between the two commodities—a ratio roughly proportionate to the quantity of labor required to produce them.

Therefore, in order to end inflation permanently and to bring about stability and trust in the U.S. currency, the dollar must be defined in law as equal to a weight unit of gold, at a statutory convertibility rate that ensures that average wages do not fall. Nothing less will yield an enduring currency and a stable social order. Currency convertibility into gold at a fixed rate is virtually a constitutional guarantee of the purchasing power of money and, therefore, of the future value of savings. The legal framework of a convertible currency makes of money a lasting political institution. It is now time for the United States to offer the world a real money, underwritten by a guarantee of gold convertibility.

As a result of a true international gold standard, no central bank, not even the Federal Reserve System, could expand credit beyond the desired level in the market. This self-denying ordinance of central banks is the principal foundation of financial order. The ordinance must work, because to create an excess supply of money and credit in the market would cause the prices to rise and the exchange rate to fall —while the gold-convertibility price of the currency would remain the same. Therefore, the stable gold price would be falling relative to rising general prices. The demand for the relatively cheap gold would create an increasing cash demand for a limited supply of gold. This unique signal of excess cash balances now offered for exchange into gold at the bank would alert the Fed to the danger of inflation.

It is clear that a true gold standard will assure that the supply of money will tend to equal the quantity of money desired for steady economic prosperity. What matters is that the amount of cash balances and the level of interest rates be determined in the open market, *not* in the Open Market Committee of the Federal Reserve System. There is no need in such a market for monetarist fine-tuning of the money stock through continuous open-market operations. Indeed, the effects of Keynesian fiscal fine-tuning and monetarist money-stock fine-tuning are the same: they create chronic instability of the price level and, in this expansionist era, inflation. □