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The Means to Establishing Financial Order

By Lewis E. Lehrman

Recently on this page Milton Friedman wrote: "Despite vigorous efforts by the Fed to implement the [Oct. 6, 1979 Volcker] policy, monetary growth has varied over a wider range since Oct. 6, 1979, than in any period of comparable length for at least the last two decades. That fact is recognized by the Fed itself, by its defenders and by its critics." Prof. Friedman's remarks go to the heart of the problem of the Federal Reserve System.

The Fed's governors honestly believe they can attain a goal that is not within their reach—namely, to fix the specific quantity of money in circulation. They also believe they can fine-tune the world's most complex economy by changes in credit policy and monetary base manipulation. Monetary base manipulation leads to the Fed's daily interventions in the open market for government securities, creating uncertainty and disorder in the credit markets. In recent years Fed open-market operations have led to the systematic expansion of its portfolio of government securities. Not only has this process indirectly financed the government deficits; but, along with reduced reserve requirements, open-market operations have been the primary source of the perennial 8% to 9% increase in total adjusted Federal Reserve Bank credit—about three to four times the average growth of output. Through this mechanism of open-market operations, the Fed has become the engine of world inflation.

It is important to understand that in a free market order neither the amount of money in circulation, nor its growth rate, can be determined by the central bank. For, quite simply, the Fed does not possess all the necessary market information, the proven operating techniques or the foresight to bring about a predictable rate of growth of money now or in the future. It is true that the Fed does influence conditions governing the supply of money; but it is the users of money in the market who alone determine their demand for it.

An Elusive Abstraction

Indeed, the money supply cannot be precisely defined or measured. How can the Fed control such an elusive abstraction? Moreover, no money-supply growth rate during a specific market period is necessarily correlated with a specified rate of inflation, deflation or with price stability. For example, during part of 1978 the quantity of money in Switzerland grew approximately 30%, while the price level rose about 1%. Conversely, in the U.S. in 1979, the money supply grew about 5% while the consumer price index rose 13%. In 1980, M1A grew at 5%, M1B grew 7.3%, while the CPI rose 13%. It is clear that the Fed cannot precisely control the relationship between the rate of growth of the money supply and the rate of inflation.

This should come as no surprise. Consider the institutional constraints on the Federal Reserve System. First and foremost, it is a bank. More precisely, it is a monopoly—the "bank of issue." The Fed has a monopoly over the issue of paper currency; that is, Federal Reserve notes. But it also has a balance sheet, which limits even the actions of a government monopoly. The Fed buys assets (Fed credit) with the resources created by its liabilities (largely the monetary base). Total Federal Reserve credit is a precise magnitude which regulates the rise and fall of credit supplied by the Fed to the rest of the banking system. If the credit supplied is actually desired in the market, the price level will tend to be stable. If the new credit created by the Fed is *forced* on market participants, it will quickly be spent by them at home and abroad, thus tending to cause inflation and a depreciating dollar.

Therefore, in the future, the Fed should allocate credit by using the superior technique of the *price mechanism*—not the mechanism of open-market operations, a blunt and unwieldy *quantity* technique. If we must have the central bank, then remobilize the discount rate, which is the *price* of credit for loans from the Fed to the commercial banks. Recently the amount of this type of Fed credit has ranged from $1 billion to $3 billion—5% to 10% of bank reserves held at the Fed. At 13%-16% the present discount rate constitutes a subsidy rate to substantial commercial bank credit expansion—because it is below market rates. During periods of inflation, the discount rate should be above market rates, for example the rates on Treasury bills or Fed funds. Thus the subsidy would be eliminated. The discount rate, as a market-related technique of central banking, was repudiated long ago by the money-supply fine tuners; and not coincidentally, so was a stable value for the dollar.

> *The true means by which to achieve the goal of a stable value for the dollar is a remobilized discount rate joined to a true international gold standard.*

The problem of equalizing the supply and demand for credit by means of the discount rate illustrates the fundamental issue of monetary policy and central banking. *Instead of fixing a specific quantity of money, the goal of the central bank should be reasonable price stability, or even better, a stable value for the dollar. The*

means by which to achieve this goal is a remobilized discount rate joined to a true international gold standard.

When excess credit causes inflation, the Fed, by raising the discount rate above market rates, should promptly eliminate the subsidy to bank credit expansion, thus removing the stimulus to inflation. As a result, excess money and credit will be absorbed in order to hit the correct target: *the volume of money in circulation should always be equal to the amount of money actually desired in the market.* Inflation is caused by excess money. If there is none there can be no inflation. Such a monetary target can be hit so long as the government does not finance its inflationary deficit spending by continually demanding new money at the Fed and at the banks. That is why a balanced budget is crucial. It keeps the government from demanding new money at the Fed and the commercial banks.

To establish financial order, a sound Fed credit policy is a necessary condition of financial order; but it is not sufficient. History and classical economic analysis show that the policy best-suited to ensure stable money over the long run is to define the dollar as a weight of gold. But a domestic gold standard is not enough, because our national economy is fully integrated with the free world economy. It follows that only a *world* monetary system can provide an impartial, common currency, not subject to sovereign political manipulation. Such a world monetary system is the international gold standard. *This is the classical monetary policy.*

As a monetary standard, the value of gold compared to other goods in the world economy is determined by its relative costs of production, while the costs of production of one more unit of a paper currency is almost zero. Zero production costs explain why most government currency monopolies have overproduced paper money and thereby destroyed its value. On the other hand, gold is an ideal monetary standard because its real costs of production cause it to have a relatively inelastic supply curve. It cannot be overproduced. Its rate of growth of production over centuries has been about 1.5% to 2%—proportional, that is, to the rate of long-term economic growth and population growth in the industrial world. It is this unique and stable long-run relationship between the rates of increase of the supply of gold and of economic growth which, among other reasons, makes gold the optimum monetary standard.

Gold Is Least Imperfect

Unlike paper and credit money, the supply conditions of gold cannot be fundamentally and swiftly altered by politicians. Supply conditions for gold depend upon the real-world economics of gold production, which are, in general, not susceptible to scale-techniques of mining. When scale techniques of production are applied to other, more easily mass-produced commodity money standards, oversupply results and the monetary standard depreciates. In an imperfect world, the gold standard is, therefore, the least imperfect of the monetary standards. That is why over the centuries a gold currency was *freely* selected as money by the market.

Under conditions of modern central banking, a disciplined discount policy at the Fed is *only* useful for providing elasticity to the supply of credit in the short and intermediate term. But a gold currency is an independent *long-run* stabilizer of the supply of money and credit in the world economy—the gyroscope, if you will, of a free world-market-order. The true gold standard rules out excessive manipulation of money by politicians and bureaucrats. Therefore, in order to end inflation and to restore trust in the U.S. currency, the dollar must be defined in law as a weight unit of gold. A modernized gold standard would be a guarantee of the purchasing power of money and, therefore, of the future value of money savings. And we know that in the absence of increased savings there can be no long-term economic growth.

Thus, given President Reagan's unequivocal commitment to stable money and a policy of economic growth, it is time for the United States to offer the free world a real money, and to call for monetary reform based on the international gold standard.

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