MORGAN STANLEY INVESTMENT RESEARCH

THE CASE FOR THE GOLD STANDARD

Reflections on the Struggle for Financial Order

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Q: My reading of the Republican platform tells me that, at least by implication, the Republican Party embraced a return to the gold standard in principle -- at least a return to some sort of commodity standard. Do you find a great deal of support for that in the Republican Party?

A: I think there is a great deal of support for the Republican platform in its entirety. There is substantial support for a stable monetary standard, and President Reagan himself said that he intends to uphold the Republican platform. He took it very seriously. The Republican platform calls for a monetary standard. Since the optimum commodity monetary standard is the gold standard, I also take the view that eventually the Republican Party will restore the gold standard.

Q: Was there any significant objection to that plank when it was put in the platform?

A: I was not there, but I understand there was a considerable amount of discussion, debate and analysis. All concluded that we need a stable dollar. We need a stable dollar over the long run that people can count on. Otherwise, they will never save. Let me read the relevant paragraph from the official Republican Platform of July 14, 1980: "Ultimately, inflation is a decline in the value of the dollar, the monetary standard, in terms of the goods it can buy. Until the decade of the 1970s, monetary policy was automatically linked to the overriding objective of maintaining a stable dollar value. The severing of the dollar's link with real commodities in the 1960s and 1970s, in order to pursue economic goals other than dollar stability, has unleashed hyper-inflationary forces at home and monetary disorder abroad, without bringing any of the desired economic benefits. One of the most urgent tasks in the period ahead will be the restoration of a dependable monetary standard -- that is, an end to inflation."

President Reagan campaigned on this platform and won. In recent years we have not had stable money. But we did have it throughout American history when we had a monetary standard -- the gold standard. You can have a nominal money, a paper dollar; or you can have a real dollar, defined by its gold weight. Let us resume the historic American monetary standard, a gold dollar, in order to end inflation. I think that's what the platform means.

Q: I see on your wall some pictures of Jacques Rueff, who was instrumental in stabilizing the French franc in 1959. What is that story? That, obviously, by my reading, buttresses your point of view on the gold standard.

A: Twice in his lifetime, Jacques Rueff saved the French currency. Once during the 1920s -- between 1926 and 1928 -- after the catastrophe of World War I. The second time, in the midst of the collapse of the Fourth Republic, President de Gaulle called Rueff to

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power to end inflation, reform the French currency, balance the budget, and renovate French economic institutions. Both times he was successful. The key elements of both French financial reforms were the restoration of convertibility of French currency into gold and the establishment of budgetary equilibrium.

The economic consequences of Jacques Rueff in 1959 were very simple and very dramatic. They are part of living memory. The Fourth Republic was collapsing; the economy of France was uncertain; inflation raged; French foreign exchange reserves equaled about forty-five days of foreign payments. The currency was declining. The government was virtually bankrupt and immobilized. De Gaulle had been called to power from his home in Colombey-les-deux-Eglises. Rueff was summoned by him to restore financial order.

De Gaulle created the Fifth Republic, the constitution and the presidential system that went along with it, a fact which was not unrelated to his admiration for the American republic. But it was Jacques Rueff who created the financial conditions which led to the restoration of the French economy.

His plan was very simple: (1) analyze the causes of financial disorder -- which were unbalanced budgets, central bank expansionism through open market securities purchases, and an inconvertible currency; and (2) organize economic policy so as to balance the budget promptly, reestablish convertibility, and deregulate the overplanned French economy.

If you study the development of the French economy since 1959 and the effect of the Rueff financial reforms, you will see that it has been one of the most rapidly expanding economies in the world. Its real tax burden is much lower than our own. Indeed, the average rate of growth in France since 1959 has been the equal of Germany, not the least because of the Rueff-de Gaulle financial plan of currency and budgetary stabilization.

Q: Was there anything distinctive in the way he reintroduced the gold standard?

A: You will remember that in 1959 Rueff had a considerable advantage. The reform of the French currency occurred under an international monetary system determined by the nominal gold convertibility of the dollar -- the Bretton Woods System. You see, Rueff did not have the same problem that we have. Then, under the so-called gold-exchange standard, his target was an existing monetary standard -- the gold dollar. In 1971, as the free world leader, we abandoned the last vestige of the historic gold currency to which all other countries had previously been linked. The United States broke the monetary link of international financial order. As a result, the weakening chain around inflation collapsed. Thus, through depreciation of our currency, we forfeited leader-

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ship of the free world in monetary matters, as we had already in military matters.

Rueff often despaired that he was never in a position to help create a true gold standard for the whole Western World, as he desired. For that reason, among others, Rueff always looked to the United States for world monetary leadership. He was profoundly disappointed that we did not exercise it. By the way, he loved America, was a believer in her unique destiny. In any event, then as now, it was up to the United States to restore the monetary standard. We alone can lead the free world. When the agreed-upon leader takes charge, either on the field of sport, battle, or politics, all of the smaller and lesser participants tend to emulate the leader. They will emulate particularly the leader's financial and intellectual conduct. I have no doubt that when we restore the gold standard in the United States during the next decade, the entire world will repair to our monetary standard -- even the Soviets.

By the way, I have never been more hopeful, because the worldview which moves me is that of the resurgent conservative reform movement. Its time has come.

Q: But the climate is not as good now as it was at the turn of the century for business success. Isn't that correct?

A: In a sense, that is exactly what we are talking about: restoring the conditions whereby Americans from all walks of life can make whatever great success they want to make. For those conditions to exist we need a stable currency which encourages the willingness to save, to risk, to invest for the long run. We're talking about restoring a stable dollar, reducing the level of taxes on savings and work, reducing the size of government, balancing the budget, and deregulating American life.

Q: An American renaissance...?

A: Well, the challenge is to be sure that the American Renaissance is not a short one. The American era should last as long as freedom rings -- forever.

Q: What about the battle over the President's program?

A: The battle rages over the boldness and comprehensiveness of the economic program, not to mention the coherence of the different elements. For example, some supply-siders tend to emphasize the crucial reduction in marginal tax rates. That is very important. It is necessary, but it is not sufficient. It is true that rising tax rates in a certain way cause rising deficits by shrinking the private economy. But a reduction in marginal tax rates is not a sufficient remedy for the defects of our present economic policy. I place a great deal of emphasis on the condition of the budget

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and the size of the deficit and federal credit demands, a point on which I argue with many of my monetarist and supply-side friends. I believe we must balance the budget at the current level of tax receipts -- promptly. To balance the budget without raising tax rates is a goal that President Reagan has stated over and over again. He was elected to do that. Indeed, he suggested originally that it should be done in Fiscal '83, or before that, if possible. I agree. I consider a balanced budget at the current level of tax receipts an absolutely crucial condition for the restoration of financial order in Washington.

Q: But, some of your monetarist friends don't agree with you on the importance of a balanced budget.

A: You are right. In fact, a curious irony is the agreement of some monetarists and some supply-siders on this point. They are somewhat indifferent to the effects of an unbalanced budget. I think that is a serious error, and I think the consequences of indifference to the public sector deficit have been demonstrated in England under Thatcher. The Tory monetarists have been unable to get the budget under control because, in general, at the beginning and even now, in the most recent budget of March 1981, they put too much emphasis on monetarist central bank credit policy and insufficient emphasis on the growth of public spending. They are concerned too little with the size of the government deficit which must be financed by the limited pool of savings. The deficit has almost doubled in two years under Thatcher -- from 7.5 billion sterling to 13.5 billion -- 5%-6% of GNP. The deficit absorbs too much of the savings which British enterprise needs for new investment. That is why the U.K. economy is foundering as badly as at any time since the beginning of the industrial revolution. Manufacturing output in England during the past year-and-one-half has fallen almost as precipitously as during the Great Depression of 1929-31.

But the current Reagan program also fails to provide for a true and effective reform of our monetary institutions, domestically and internationally. Such a lasting reform must be based on the gold standard and a balanced budget. For two decades we have been listening to dedicated presidents, experienced Federal Reserve Board chairmen, and honest Secretaries of the Treasury give speeches every month. The speeches always state that our goal is gradually to end the balance of payments deficit or gradually end inflation. Dramatic examples occur in 1961, 1965, 1968, 1971, 1974, recently in the November 1978 Miller measures and the October 1979 Volcker message. They were all going to reduce the rate of inflation. Somehow they have all failed. The Keynesians have failed. The self-described practical or pragmatic monetarists have failed. Their policy -- gradually to reduce the rate of growth of the money supply -- has failed thus far. They have failed, not because they chose the wrong goal -- an end to inflation -- but because they chose the wrong means. To desire a goal without the effective means to attain the goal is to court political disaster.

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Q: Does the Federal Reserve regulate interest rates even when various chairmen have stated that their desire is not to do that but to get a grip on the money supply?

A: Well, the view of most central bankers at the Federal Reserve System, until about 1979, was to fine tune the federal funds rate, which is the interest rate at which banks loan excess funds among themselves. By buying and selling government securities, so-called open market operations, the Federal Reserve tried to maintain a reasonably stable federal funds rate. Such a fed funds rate was held to be consistent with a certain rate of growth of the money supply. In October 1979, Chairman Volcker gave several speeches and testified to the Congress that monetary control by interest rate manipulation had been reformulated. Now the Federal Reserve would pay less attention to the federal funds rate and money market conditions. Interest rates would be permitted to fluctuate in a much wider band and the Fed would now focus on manipulating the quantity of commercial bank reserves held at the Fed. So, instead of targeting interest rates and, in particular, the federal funds rate, the Fed would target a specific quantity of bank reserves, held to be consistent with a certain rate of growth of the quantity of money in circulation, say M1b. <u>The trouble is, the Fed cannot successfully implement this abstract formula</u> in a stable fashion in the real world of money markets, as previous and subsequent Fed performance has demonstrated. An enormous amount of research is said to have moved the Fed from an interest rate control policy to a bank reserve control policy. So far they have failed to attain the goal of reducing inflation with the new policy. Inflation is still at peak levels, and so are interest rates, even if at times the Fed hits a defined money stock target.

My view is that <u>the central bank cannot fix the quantity of money in circulation. Nor, over the long run, can it fix interest rates, the monetary base, and the specific level of bank reserves. Nor should it try. The effort to do these things is wrecking the money and capital markets</u>. Ever since the early 1920s, but particularly in the last decade-and-a-half, the great error of central banking has been a lingering belief that the Federal Reserve System is able to fix the quantity of money and credit in circulation in order to "stabilize the business cycle." I do agree with the monetarists that the Federal Reserve System <u>influences</u> financial conditions by the buying and selling of government securities.

In March the Fed owned about $125 billion of government securities and that makes it a major player in the market. Just like you and me on a small scale. When we buy and sell government securities, we add to the marginal supply or demand for government securities. Interest rates will vary depending on general supply and demand conditions for these securities. The Federal Reserve is a much bigger player in the money market and, as a

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result, its activities have a powerful influence on the conditions in the money market. Also, the Federal Reserve System, through open market operations, can directly affect bank reserves and therefore the supply conditions for credit at the commercial banks. But no matter what the supply conditions, you and I alone decide how much credit or money we will demand or hold.

If the Fed supplies more money than consumers and businessmen desire to hold, then the supply will exceed demand, and the value of money will decline. Thus, the attempt by the Fed to <u>increase</u> the supply of money at a fixed rate almost always tends to cause its value to decline -- because the desire to hold money over the long run is stable, as decades of research on the subject has shown. Inflation is a decline in the value of money, or a rise of the general price level, caused by the tendency of the Fed to supply more money than the market actually desires to hold.

Each participant in the market, every consumer, every businessman, decides exactly how much money he will demand for whatever purpose he has in mind. All of their purposes cannot be known by the Federal Reserve System, no matter how farseeing or well-intentioned or how systematic and careful its research. One hundred thousand simultaneous equations programmed in a computer would be an insufficient econometric model to forecast global monetary conditions encompassing a complex world of four billion people.

You see, the consumer and producer are actually sovereign in the money markets. Not the Fed. Market participants determine their own demand for money. Accordingly, colossal disturbances arise in the financial markets because of the unceasing and hapless Federal Reserve money market interventions; these operations are all designed to hit a target beyond the aim of the Fed -- namely to fix the level of M1b, the monetary base, bank reserves, or whatever. Yes, the Fed can influence the <u>supply</u> of credit and money, but the participants in the market are the ones who alone determine their <u>demands</u>, i.e., how much money and credit they desire to hold and use.

Therefore, before reforming the present chaotic monetary system, we must first realize that in a free and open society, in a free market order, the central bank has very serious limitations on its ability to reach the goals it now sets for itself. <u>If we must have a monopoly central bank, then it must adopt reasonable self-denying ordinances</u>. Predictable rules must limit its unruly discretionary operations in the money markets and the financial disorder this causes. The theory of monopoly regulation teaches us that regulation can only be reasonably efficient when regulation simulates the market. A self-denying, market-related rule might be, for example, the stipulation of only one target of monetary policy -- not five or more as today. Instead of trying, as it now does, to influence the level of interest rates, the

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foreign exchange value of the dollar, the quantity of money in circulation, or the level of employment, the Federal Reserve must realize that, in general, each regulatory institution barely has it within its power to attain a single policy goal. The goal of the Federal Reserve System should be the stability of the purchasing power of the dollar or, saying it another way, reasonable stability of the price level -- an end to inflation. In the absence of success on this point, what use is the Fed?

The means by which to hit the correct target of Fed policy -- equalization in the market of the supply of money with the amount of money actually desired -- is not the existing technique of open market operations. I will not dwell here on Fed targets, open market operations, and the discount rate, because I have written at length on this elsewhere. Briefly, the most efficient method of monetary control is to remobilize the Fed discount rate and join this reform of central bank procedures to a more general monetary reform -- the establishment of a true gold standard.

Q: Before you proceed with that any further, what is your view on Milton Friedman's idea that it is the responsibility of the Federal Reserve to set the growth of the money supply within fixed parameters? Three to five per cent per year in steady fashion -- does that have any merit in your view?

A: I think such a goal has some merit. The question arises over the appropriate means by which to reach the goal and whether or not the Fed can attain it. I believe the Federal Reserve System does not have it within its power to create a fixed rate of growth of money, as Professor Friedman argues. I have learned so much from Professor Friedman's work that I hesitate to dispute him. I endorse his general view on free market institutions. But I deny his assumption that, in an open economy, the central bank can determine the rate of growth of the quantity of money in circulation. In order to do that, the central bank must control both the supply of dollars and the demand for dollars in the U.S. market and throughout the world. But the users of dollars throughout the world determine their demand. Market participants, and their demands for dollars, are beyond the precise control of the Fed.

Professor Friedman advocates a monetary rule -- namely, the money supply should grow at a three or four per cent steady rate each year. The monetary rule may be sensible; the goal of 4% steady economic growth each year is also sensible. But what is the best means to attain this end? Honestly to desire a goal is to desire the effective means to attain it. Professor Friedman noted in his monumental work on the monetary history of the United States that the gold standard period in the U.S. was generally accompanied by a stable rate of growth in the money supply over the long run. During most of U.S. history, the monetary constitution of the U.S. was the gold standard. The quantity rule for money growth, now advocated by Professor Friedman, was in fact the suc-

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cessful rule of the gold dollar. The steady rate of growth of the U.S. money supply came to an end only during periods of trade wars and floating exchange rates. Such periods occurred during and immediately after the Civil War, the Depression, and at present -- i.e., periods when the gold dollar was abandoned.

So, if we truly seek an effective monetary constitution and a steady rate of growth of the money supply, consistent with the rate of growth for real economic output, I believe that the optimum means to achieve the goal is the prompt restoration of the gold standard. This is the classical monetary policy. To desire the gold standard is to desire a peaceful and open world trading system. The gold standard is nothing more than a classical political institution, a measured means to a sensible end. It is not a magical enterprise. It should be stripped of the arcane mystery associated with it in the minds of some. It is strictly a political institution in an imperfect world, though the gold standard is the least imperfect institution ever evolved to prohibit inflation and produce stable money.

Q: It's not really a medium of exchange?

A: It may be. There is no reason why one cannot have gold coins in circulation if people -- free people -- choose to use or save gold coins as money. Indeed, what I am getting at is that the gold standard -- i.e., gold, coined as money -- reconstitutes a real money into which all nominal paper and credit money must be convertible. Also, to restore the gold standard is the only sure way to restore the future value of money and therefore the only certain technique by which to restore the incentive to save and to invest for future returns.

Q: But Professor Friedman is opposed to that, the restoration of any kind of gold standard. He says that in the second half of the nineteenth century the business cycle psychology produced pressure which caused the eventual establishment of the Federal Reserve System. The gold standard was not satisfactory, he says. It was not satisfactory to the business community, government, anybody. The pressure for the creation of the Federal Reserve System was a virtual demand.

A: It is true that the period 1879-1913 has produced much historical debate. It is also true that the business cycle had its ups and downs. Then as now, there were Utopians of the right and left who believed they could banish the business cycle. Some of these people favored the establishment of a government monopoly over the currency issue and government regulation of money. Oversimplified, that is how the Fed came to be in 1913. It was just one more regulatory agency, not unlike the ICC, the Interstate Commerce Commission (1888), which came along during the regulatory craze which swept up the Populist-Progressive movement at the turn of the century. But it is also a fact that, in the

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absence of the Federal Reserve System, and because of the operations of the international gold standard from 1879-1913, the general price level was almost the same in 1913 as it was in 1879. For almost two generations, the purchasing power of the dollar was stable. There was neither inflation nor deflation over the full period. From 1879 to 1895 the price level gradually declined. From 1895 to 1913 the price level gradually rose. During the whole period we had substantial real economic growth.

Professor Friedman has had several views on the gold standard. Thanks to him, we have a lucid article that he wrote in 1961. (I believe it appeared in the Journal of Law and Economics.) Professor Friedman stated in this article that he understood and approved a true gold standard. So do I. I wish I could quote the article verbatim. All monetarists should read it. Professor Friedman has since suggested that a true gold standard is impractical. It may be politically impossible, he has argued, to reformulate the existing monetary system according to the rules of the true gold standard. Now I know that Professor Friedman is a great economist, but is he a great politician? And a good political scientist? It seems to me that the proper role of the economist is to analyze what is the very best policy to attain a certain goal, and then allow the competition for leadership in a free society to determine whether or not such a policy is practical and desirable. I happen to believe that a reformulation of the present monetary system, according to the rule of the true gold standard, is not only the optimum monetary policy, but also practical. I believe that it can be done during President Reagan's administration. A lack of will, a fear of the unknown, the propaganda against the gold standard by socialists, liberals, some free market men -- by elitists from many philosophical points of view -- have tended to intimidate practical men and working people. It is not easy to go against the fashionable and established wisdom of the ruling academic and political elites.

Q: Should President Reagan choose to take your advice on the gold standard, would it not cause massive dislocations in the American and international economies?

A: We are experiencing right now a massive dislocation in the world economy and in the domestic economy because, during the past two generations, we abandoned the discipline of the gold standard. We abandoned low taxes; and we abandoned balanced budgets. That fact should cause us to reexamine the history and theory of the gold standard as a way by which to end dislocations caused by manipulated currencies and managed floating exchange rates. Floating exchange rates and excessively discretionary central banking policies have caused the present financial disorder. One should look to the restoration of the gold standard and balanced budgets as the means to end the worldwide financial disequilibrium.

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Q: What are some of the economic arguments that go along with a true gold standard?

A: First, we must have the determination and the courage to do what the American people voted for in electing President Reagan. They want to balance the budget at the current level of tax receipts, deregulate American life, and reduce the level of tax rates. If we can do these things, then I can assure you that the same leadership can and will restore the gold standard, which is a unique international political institution designed by man to maintain the free market order we desire to uphold throughout the world. Moreover, it will preserve the value of the dollar over the long run, which is the only way honestly to encourage people to save and to invest again in the future. I am making the point that if we do not have the political will to achieve the other elements of President Reagan's vision, it is equally true that we cannot achieve monetary reform. Conversely, I do not think it's too much to say that we must do all of these things together or else we may fail to achieve President Reagan's goals of sustained economic growth and an end to inflation.

Q: Can you be more specific?

A: Yes. In contemplating a financial reform which would establish and maintain a gold currency, we would also have to contemplate a reform of the accounting procedures of the federal budget. Little is said of this, but I believe it to be very important. The federal budget should be divided into two parts. A budget on current account and a budget on capital account. Today, congressmen and the executive branch look at the budget as a global laundry list of expenditures and receipts. There is either a deficit (almost always); or there can be a surplus; or there can be a balance. That is not the way to account for federal receipts and expenditures. I think the inadequacy grows out of the national income accounts which are the basis of government demand management in the Keynesian pharmacopoeia. The neo-Keynesians have governed American economic policy by this technique for at least a generation and failed. Accordingly, we must not only abolish demand management as the goal of monetary and tax policy; but we must also reform the accounting techniques of the government.

At the very least we must immediately balance the budget on current account. All current expenses, such as transfer payments, must be balanced with current tax receipts by virtue of a statutory requirement. But all government expenditures on capital account, namely <u>capital investments</u> -- dams, railways, roads, waterways, and even federal credit and federal guaranteed credit programs -- should be separated out and made part of the capital budget.

Concretely, the true capital budget for the acquisition of physical assets is now about 5%-6% of the Federal budget. The rest is for consumption.

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Q: Are you talking about unemployment compensation, things like that?

A: Unemployment compensation would be a current account or current expenditure. So would AFDC, for example, i.e., aid to families with dependent children. These outlays are not capital investments. All transfer payments are current expenses of the government. By these current expenditures, the government does not acquire an asset, a dam, or a building, or a new machine, or tools, or waterways and utilities by which to create new wealth. On the current account are consumption items such as welfare and government salaries. By statute, these current expenses, at the very minimum, should be funded year in and year out by the current level of taxes. Personally, I would go further and recommend that all Federal expenditures be balanced with current tax receipts.

Q: In which category do you put military spending?

A: Current account. Some of my friends would disagree. My reason is that, even though a tank is a piece of hardware, and a missile is a multi-million dollar piece of equipment, they produce no new wealth. On the contrary, defense hardware consumes savings and wealth and, during war, destroys them. I propose for the government what all soundly managed enterprises have been doing since they invented double-entry bookkeeping during the fourteenth century in Italy. Businessmen know that all sound capital projects should be financed long term in the market for savings -- the capital markets. If capital projects are not financed in the market for savings, they have to be financed with uncertain short-term debt, or newly created money at the banks.

For example, even government deficits may be financed by new bank credit. In fact it is this process of sustained creation of new money at the banks, unaccompanied by the creation of additional goods and services during the same market period, which causes the ascent of the price level i.e., inflation. Now if government credit demands to finance capital spending were so inordinate as to exceed the volume of true savings forecast during a budget year, then the excess government credit demands should be contingent. They should wait for the next year. Some government credit demands would be eliminated and some financed in the future.

If we permit the government to demand credit in the market, we must insist that the level of total credit demands be matched with the level of available savings. My preference would actually be to require the government to finance all its outlays out of the current level of tax receipts. That way, politicians would think twice about asking voters to fund a marginal capital project, which the private sector could do more efficiently. In any event, all I am getting at is that the present budgetary tech-

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niques and government accounting system are inadequate, unsound, and deceive us as to the underlying causes of a government-created bank credit inflation.

Q: Do you know of any other governments that use this kind of current and capital accounting system you describe?

A: Most government accounting systems are similar to ours. Most of them developed according to the system of national income accounting which was designed for the purpose of demand management. A post-Keynesian government needs a post-Keynesian accounting system, and that is precisely what I propose. The government accounting system I propose is the counterpart of a permanently balanced budget. Under a capital and current accounting system, the President would, in the future, estimate that the level of true savings will be adequate to fund the government's capital budget as well as the estimated private demands for capital needed to invest in enterprise. Thus would we create long-run equilibrium in the capital markets.

Equilibrium must develop because the government and the private sector would make credit demands approximately equal to what the market was providing in true savings.

The problem today is that the executive branch and the Congress decide how much they are going to spend on current and capital account; then, as the year goes by, tax revenues always come in below spending. As a result, we not only run permanent budget deficits but private credit demands, combined with those of the government, often exceed the real savings available in the market. That is the case today. For example, estimated net federal credit demands alone actually exceed the level of estimated personal savings for 1981. When savings are less than the sum of government, business, and individual credit demands, the shortfall must be made up by borrowing new money. Under present monetary institutions only the banks and the Fed can create new money. Government, business, and individuals demand new money from the banks, accommodated by the Fed, in order to finance purchases which they cannot finance with their own or borrowed savings. But during the market period when these additional purchases are made, new goods and services, proportional in value to the new money created and borrowed at the banks, are not created. Thus, during the specific market period under consideration, the value of total demand (purchases) exceeds the value of total supply. Of course, the price level begins to rise. Inflation will continue during the market period until the source of excess demand is removed, namely, newly created bank money. Therein lies the bank credit secret of excess demand and inflation. It seems to have escaped the monetarists, the Keynesians, and the supply-siders.

Q: Is there very much support for the type of accounting system that you are advocating? Much support in the political community?

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A: I cannot say for sure. But that does not mean there would be no support.

Q: How about in the business community and economics profession? Has there been much discussion?

A: In the business community there should be universal support for such an accounting system within the federal government. Among public finance economists, I believe that most reasonable men and women would endorse it. Certain public finance economists might want to have their own formulations of such a technique, but I think all would understand my proposals perfectly.

Q: There is something of an anomaly about an accounting system that sounds so simple, appealing, and sensible that has not been tried ever in modern times by a government.

A: You can say the same thing of the gold standard. The virtue of the gold standard is its ineffable simplicity. In fact, that is a prime reason why many sophisticated economists and intellectuals deny and reject the gold standard. It is too straightforward. They want something more complex to manipulate. Mathematicians and economists are taught in graduate school that economics is very complex. Statistics or the manipulation of statistics, we are told, is a very complex science. Therefore, economic theories and policies must be very complex and so must the bureaucracies which create the complex policies. Well, I reject that conclusion. I don't believe that laws, constitutions, or economic institutions must be intricate and complex just because the world economy is beyond the mind of a single man, or group of men, to grasp. If complexity were a virtue, the good Lord would have given us a thousand commandments instead of ten.

Q: This notion of complexity and elite manipulation is one of the pillars of Keynesian economics, is it not? Keynesian macroeconomics?

A: Yes, of course. Every false priesthood is opaque. It invents abstruse and mysterious dogmas and doctrines which cannot be understood by plain people. True priesthoods are accessible, open, and simple. One of the marvels of the gold standard is that, in the absence of World War and trade wars, it has actually worked reasonably well in the past -- the best simple test for any political or economic institution. But also, gold money can be understood and its quantity controlled by working people -- who do not have sophisticated accountants, economists, lawyers, and investment bankers to talk to the Fed and to work out their financial affairs and their taxes for them.

Thus, we return to your original question. It is for reasons of equity, utility, and simplicity that the gold standard was properly a part of the Republican platform. A gold-based currency is

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democratic money. It is money which free people, and not the Fed, would control. President Reagan has set the agenda in his speeches for such a new monetary policy. Remember it is he who wants to keep things clear and simple, he who said that we must return authority in economic matters to the people. He also said that we must balance the budget, reduce marginal tax rates, deregulate American life, and produce a stable dollar -- all together. So, I don't believe that there's anything original in what I am saying. It is the economic policy of the President. In my opinion, the centerpiece of economic policy is the monetary standard.

Q: I think that seems to be one of his great talents that he has been able to take a diverse number of theories and combine them, whereas in the conservative economics profession you have a lot of squabbling going on. Reagan seems to have transcended this and picked up from each one what he wishes, and the whole that he has come up with seems to be pretty much in line with what you are talking about.

A: Yes. He clearly understands -- indeed, he is the leader of this idea -- that you must have a comprehensive economic policy and you must try to do it all together; you cannot do it piecemeal. In the policy speeches of 1980, he made it clear that the Kemp-Roth bill was very important; but it was not a sufficient remedy. He also made it very clear that a balanced budget was important, but even the old-time Republican religion of balanced budgets was insufficient. He understands, unlike some Thatcherites, that monetary policy by itself cannot do the job. The monetary prescription of a monetary rule, whereby the central bank tries to create a specified rate of growth of the money supply over the long run, may be an important idea. But even if it could work, it would not be sufficient. In other words, President Reagan has said that the monetarists have a pretty good idea, the Kemp-Roth advocates have a good idea, the balanced budget advocates -- the National Taxpayers' Union and Senator Thurmond -- have a good idea. But the point is that only working together can the policies be sufficient. That was the burden of an article I wrote for *The Wall Street Journal* in June 1980.

Q: Some of the supply-side types have tended to pooh-pooh the necessity for spending cuts at the federal level. Is this a matter of principle or just a political tactic?

A: I think it is both. There are a few well-known economists, supply-siders and monetarists, who are relatively indifferent to the size and trend of the budget deficit. There are monetary economists who ignore the deficit, who believe that monetary policy can, if conducted properly, conquer inflation alone. There are some supply-siders who believe that attempting to reduce the level of federal spending is "impolitic"; it is bad politics, they say, and it can't be done.

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Q: You don't go along with that?

A: Positively not.

Q: How about Friedman's point that it's not the deficit itself that's important, but the size of federal spending relative to gross national product that's important?

A: I think that he is partially correct. The size of federal spending relative to gross national product is very important. It represents the real tax burden. Equally important is the size of direct and guaranteed federal borrowing requirements compared to the size of national savings. But I also believe the scale of the federal deficit and federal credit demands, *per se*, is very important. Above all, it is the way in which the federal deficit tends to be financed which makes it absolutely crucial.

Q: You seem to be wedded in principle to the idea of a balanced budget.

A: I am. Indiscipline and inordinate financial conduct of the executive branch and the legislature cause unbalanced budgets. I endorse in principle the discipline of a balanced budget at the current level of tax receipts because the economic effects of an unbalanced budget, despite pretenses of theory, are almost always destructive over the long run. Government deficits consume and dissipate private savings. Without increasing private savings available for investment in business enterprise, the economy must falter.

Q: But don't you think that were Friedman here, he would say that if you have an economy of a trillion dollars and a federal deficit of a billion dollars it's of no consequence?

A: On that precise example, I would agree. A deficit of a billion dollars in a trillion dollar economy is insignificant. The problem is that we have a 2.75 trillion dollar economy and a 60 billion dollar deficit, plus off-budget, federal credit, guarantee programs and state and local government borrowing which, all together, are approximately 150 billion dollars of government borrowing this year. This is the true deficit -- about 5%-6% of GNP -- comparable to Thatcher's England! But personal savings are running at only about 100 billion dollars. No one talks about this. Economists say our deficit is only a small percent of GNP. They are wrong. Often they incorrectly compare our "small" deficit to the "large" deficits of Germany and other countries. But properly calculated, the true deficits, plus federal credit demands, are comparable to those of Germany and England.

And by the way the corporate sector is now in deficit, too. The reason why a substantial budget deficit and huge and growing federal credit demands are positively destructive under almost all circumstances is very straightforward. The government goes into the

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capital markets and sells government securities and removes from the capital markets the savings equal to the government deficit and other federal credit programs. The government must have the money to pay its contractual bills and fulfill statutory commitments. Given the scale of the spending problem, I recommended to Dave Stockman in early November 1980 a national economic emergency statement only in order to make use of the legislative techniques of budgetary recission and deferral to balance the budget. For the purpose of promptly balancing the budget, deferral and recission are the appropriate lawful means available to Congress and the President.

Now, if government spending were reduced to the level of current tax receipts, current and capital accounts could never be in deficit. Savings would remain in the capital markets for businesses to borrow at lower interest rates. Business would invest these savings in new capital: new machine tools, new plants, new equipment, new technology, new research and development, new products and, most important, new jobs. We could then leave the Japanese and Germans in the dust. One of the reasons we are no longer competitive with Japan and Germany in some areas is that we have not been able to generate sufficient savings with which to modernize our industrial plants and to finance our voracious government. In the case of Germany and Japan, they have generated enough savings to finance both big government deficits and new plants and equipment for three reasons:

(1) they have a more stable currency; (2) they permit higher real after-tax rewards for savings; and (3) the U.S. subsidizes their national defense. We must promptly develop the first two if we want to increase savings rapidly. We are losing markets all over the world to nations which are generating huge savings in order to keep their industries modern and forward looking.

Our federal government has starved American industry.

One statistic I find most impressive throughout the history of the Industrial Revolution is the correlation between the amount of capital (saving) invested per worker and the average standard of living of the country. It's clear to me that the rate of gain of the standard of living in every advanced industrial economy is directly related to the amount of capital (saving) invested behind each worker. But the amount of capital invested is directly proportional to the quantity of savings available to back up the labor force. The Japanese and the Germans have been investing more capital per worker. And their savings are greater because the real after-tax returns for savings are comparatively better than ours.

Q: Speaking of Japan and West Germany, I gather from your talk about returning to the gold standard that you are by definition opposed to the floating exchange rates that exist. In addition to that,

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what other redesign would you propose for U.S. monetary and financial dealings in the international economy?

A: First, there is only one economy, and that is an integrated world economy. The distinction between micro and macro economics and the distinction between national economic policy and international economic policy is absurd. Economic policymakers in Washington, Paris, London, Bonn, Tokyo, very often live in a world where they imagine they are making a self-contained policy for their national economies. There is no such thing. Through the mechanism of arbitrage, the prices in one national economy are linked indissolubly to the prices in every other national economy. There is a single world economy and it is, to a very great extent, fully integrated. But I believe such openness is a good thing. It leads not only to the maximum amount of liberty for the individual, but also to the maximum production of goods and services -- especially for the less well off at home and the underdeveloped countries abroad.

You cannot conduct a monetary policy in the national interest, no matter how coherent or comprehensive, unless it is consistent with the stability of the international monetary system to which it is inextricably linked. For this reason, history and analysis show us that the very best political institution, the optimum international coordinating mechanism -- the gyroscope of reasonable price level stability over the long run throughout the world economy -- is the true international gold standard. A convertible gold currency established by law, unlike a paper reserve currency, cannot be easily manipulated by governments to achieve certain types of unfair trading opportunities at the expense of other countries through currency depreciation and appreciation.

A gold currency is an impartial common currency. But unlike government paper currency, gold is an asset outside the control of national monetary authorities. Unlike paper dollars, it cannot be produced at the discretion of politicians and central bankers. A gold currency requires real effort, capital, and intelligence to produce. In the past, it produced a reasonably stable price level over the long run throughout the world. Instead of workers, investors, and businessmen speculating on fluctuating paper currency values at home and abroad -- constantly confused as to the "real" cost of investment in Germany as opposed to France or the U.S. -- there was confidence that the value of gold currencies, linked to one another across national borders, would be stable over the long term. Thus, long-term investment and trading commitments across national borders could be confidently undertaken, leading to an increase in the efficiency and wealth of the integrated world economy.

What's more, the purchasing power of gold has been stable for centuries, as Professor Jastram of the University of California has demonstrated beyond the shadow of a doubt. Professor Jastram's

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book, The Golden Constant, proved what traders and merchants knew from time immemorial. Over the long run, the purchasing power of gold is more constant than that of any single commodity or product which could be used as a monetary standard. Which raises another interesting point. One often hears today that gold was a good monetary standard in the past, but that today the price of gold fluctuates too rapidly and too violently to be a stable monetary standard. The truth is that it's not the value of gold which is unstable. Over the long run, history shows that the purchasing power of gold, in terms of real goods and services, is stable. The volatility lies with the fluctuating value of the manipulated paper and credit dollar. In fact, the very meaning of inflation is that the paper dollar is declining in value while the prices of real goods and services, in terms of that paper currency, are rising.Paper currency, unlinked to a commodity standard, has become an unstable political football in the hands of the politicians and bureaucrats.

Q: In advocating a return to the gold standard, are you not troubled at all by those who point out that the two leading producers of gold today are the Soviet Union, a hostile power, and South Africa, which faces a very parlous future? That doesn't bother you at all?

A: Remember that I said the gold standard is a political institution. The gold standard, being a human institution, is imperfect. Its utility lies in the fact that it is the least imperfect free political institution which can give reasonable stability to the value of a currency over the long run. The fact that South Africa and Russia are large gold producers introduces a degree of uncertainty, but not very much, for the following reasons.

First, during the history of the gold standard, there were always gold-producing countries which at one time or another were ill-disposed toward the gold standard. Nevertheless, it endured their hostility and served its economic purpose better than contemporary monetary institutions. In fact, the gold standard, throughout history, has failed only because of world war, excessive protectionism, or self-centered currency manipulation. Few free economic institutions can survive these xenophobic conditions. In fact, I would suggest that the reestablishment of the gold standard will signify an end to such autarky, and a desire for economic harmony among nations.

Before World War I, huge discoveries of gold in South Africa were insufficient to disturb the stability of the convertible currency regimes throughout the Western world. At that time, the price level rose about 2 or 3 percent a year, and can you believe that our grandfathers called this gradual rise inflation? The transition in Germany, during the 1870s, from a silver standard to a gold standard was insufficient, even given the enormous weight of the German economy, to destabilize the world currency regime based on the true gold standard. During and after the Civil War, paper dollars, the so-called "Greenbacks," were not convertible, at par,

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to gold -- from 1862 to 1879. Even given the weight and the importance of the United States in the world economy at that time, the U.S. Civil War was insufficient to disturb the stability of the gold-based monetary system of Western civilization. So, in each gold standard era, you will always have nations that are not fully integrated into the monetary system of the most advanced industrial parts of the world economy -- either morally, which is what some critics of South Africa say, or morally, economically and politically, which is what I would say of the Soviet Union.

Q: Do you expect the gold standard to be implemented in the future? And what happens if there is a war, or a panic?

A: I'll take the second part of your question first. The gold standard in no way constrains the freedom of Congress and the President to meet the real threat of war. In fact, it helps them. By insuring the future value of the dollar, the gold standard increases savings. In order to rebuild the national defense, or prepare for war, the government must sell defense or war bonds to the people in exchange for their savings. A gold dollar encourages people to save and, with security, to lend them to the government in a national emergency. I believe that the European governments made a fatal error in 1914 when they abandoned their gold currencies, because the people saved less and the war effort had to be financed through the government printing presses and inflation. This inflationary war finance helped to destroy Czarist Russia, Imperial Germany, and almost wrecked France in 1926.

Under the gold standard, prudent levels of gold reserves must always be maintained; and, under panic conditions anyone who wished to redeem their paper currency should be satisfied. If they could be satisfied, of course, the panic would quickly subside. Under conditions of all-out war or intense global trade warfare, no monetary system can survive. That, however, is not a defect of the gold standard. It is a defect of human nature which causes the prospect of total war.

My view in implementing the gold standard is straightforward. If Democrats and Republicans truly desire a peaceful world trading system, what better monetary system could there be than the gold standard to foster international good will. We certainly don't wish to stop the evolution of reform, or even revolution, toward our economic and political system in the Soviet Union, or in Eastern Europe. After the Soviet Union is forced or voluntarily abandons its predatory present conduct, the gold standard would have a positive impact on bringing South Africa and a reformed Soviet Union into the world trading system.

The gold standard is only one crucial element of world peace, the symbol of harmony, so-to-speak. U.S. military preparedness is even more important. But under U.S. leadership the gold standard could be an efficient international coordinating mechanism, in

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which a different Soviet Union, after it has given up its imperial goals, would have an immediate commercial interest. It would tend to encourage the Soviets, if the U.S. were strong, to adapt more to the code of Western civilization, in order to incur our approbation rather than our disapproval.

Q: What happens if the Soviets all of a sudden dump a massive quantity of gold on the world market?

A: Under conditions characterized by a true gold standard, current gold production is so small, relative to stocks on hand, that the Soviet Union, or even South Africa, which is a much bigger producer, could not affect the stability of the gold standard. The Soviets produce about eight to ten million ounces of new gold per year. Total official and private gold holdings are over two billion ounces. Approximately one billion ounces of gold are held by official monetary institutions. Now, as you can see, if the Soviets decided to dump their entire annual production on the world market, it could be easily absorbed. Soviet gold is like salt in the ocean. It is but a fraction of one percent of total official gold reserves. It is less than half of one percent of the total volume of gold stocks in the world. This fact elucidates one of the reasons why gold is the optimum monetary standard: <u>total new gold production in any single year is only a very minor fraction of the total amount of gold in existence</u>. Thus, the value of the new production of gold money cannot substantially depress the total value of all existing supplies, given the steady demand conditions for gold in general -- and in particular the even steadier demand conditions under the gold standard. The specific supply and demand conditions of the gold market are unique. That is why other proposed monetary standards are less satisfactory. In any one year the new supply of any other commodity, or "baskets" of commodities, relative to existing stocks in existence, is very substantial. That fact is true for oil, silver, copper, aluminum, lumber, wampum, pork bellies, and cinderblocks. Even were the South Africans to dump an entire year's production of gold on the world market, that would only be about 20-24 million ounces of gold. That is only about one percent of the total of public and private world gold stocks. And it is about two percent of official government owned gold stocks. A mere drop in the bucket!

<u>The technical meaning of the gold standard is that the countries that belong to it are prepared to buy and sell at the official rate all the gold offered or all the gold demanded</u>. If the U.S. and its allies were determined to uphold the new monetary system, then even South Africans could withhold all their production, a relatively small amount, equal only to a very small percentage of total world gold stocks. Conversely, the gold standard countries could absorb easily all sales of the relatively insignificant new output.

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Frankly, this business about South Africa and Russia is a canard, and a foolish one at that. It shows a lack of historical perspective, imperfect economic analysis, a lack of knowledge of the economics of gold production. Finally, it shows a lack of knowledge of the actual statistics having to do with the effect of South Africa and Russia in world gold markets under rules and conditions characteristic of the gold standard.

Q: Assuming President Reagan follows your advice and attempts to implement a return to the gold standard, how can he go about doing this in a way that causes the least dislocation and helps his remaining program?

A: Above all, he must reform the domestic monetary system, as part of his overall economic plan, and link the monetary reform to the tax, budget, and regulatory program which we talked about. The monetary reform could happen shortly after the rest of the program; but it should be linked in time and policy to the other aspects of the plan. For example, one can imagine that President Reagan will soon observe the successful progress of his economic reform program in Congress. Let us call it the conservative reform program. It includes the elements that he laid out carefully in his speeches of September 1980 and February 1981. The goal of the President's economic program is to restore conditions of sustained growth and price level stability. In order to end inflation, the most important monetary reform to be introduced would establish the dollar as a weight unit of gold. The reestablishment of a gold dollar would be historic. President Reagan would point out that, since the founding of the Republic, a gold currency has been the traditional base money of Americans. I think he knows this history because, very often in the past, he's thought about and discussed the possibility of the gold standard, though he has never, to my knowledge, committed himself officially to such a program.

How could he implement such a program now? First, he would lay out the history of the gold standard in the United States and in the industrialized world. Then he would lay out the important reasons for creating a stable dollar, one with a reliable future purchasing power. He would emphasize that a stable dollar is the crucial incentive, a necessary precondition by which to develop sufficient private savings in order to rebuild a competitive national economy. Money savings dry up when the future value of money is in doubt.

Then there would be an analysis of the failed alternatives to a stable convertible currency -- i.e., Keynesian credit policy and monetarism. One concludes that only the classical monetary policy -- a dollar defined as a weight unit of gold -- has given the American currency reasonable stability of purchasing power in the past. A gold-based currency will do so in the future, he could confidently forecast.

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I think a knowledge of history is important. The history of the development of the western world and of America from a tiny nation of thirteen disparate colonies to a great world power, the greatest nation on earth, is associated with the history of the gold dollar and the international gold standard. Remember that the thirteen colonies, before the constitution, had a depreciating inconvertible paper currency -- the "continental." That is where the phrase, "Not worth a continental," came from. I do not think it a mere coincidence that in the 1790s, at the beginning of the Constitutional period -- and also in the 1950s, at the peak of our prestige as a republican world power -- we had a hard currency, a sound dollar, a dollar as good as gold.

In any event, the President would announce his intention to restore convertibility, i.e., a gold dollar. The transition period, from the present inconvertible paper dollar regime to a gold standard, would be defined perhaps by a two-year interval. If such a commitment were made, let us say in January 1982, one could initiate the transition and effect the resumption of convertibility in January 1984. January 1984 would be the date on which the government and the banks would be prepared to redeem paper dollars or bank deposit dollars for a specified weight of gold. During this transition, in addition to establishing an unequivocal trend toward a balanced budget, the credit policy of the Federal Reserve System would have to be cautious and steady. It could not be volatile and it could not be excessively expansionist. The total value of Federal Reserve Bank credit (or the monetary base which is its counterpart) would have to grow slowly at a predictable and steady pace, not inconsistent with the pace that Professor Friedman himself has recommended for the growth of the money supply.

Q: You are asking the Fed to do something here it has never done before though, right?

A: On the contrary. But for the interruption of war, the Fed operated under the discipline of the international gold standard during the first 58 years of its existence -- from 1913 to 1971. When the government and the Federal Reserve conducted a credit policy reasonably consistent with maintaining an open economy and the convertibility of the dollar, the value of the dollar was fairly stable and so was the price level. There was little inflation. When in 1929, the government defied the rules of the international gold standard by imposing quotas and tariffs on trade, we got deflation in the 1930s; and when the Fed and the government became excessively expansionist, we got inflation in the 1960s and 1970s. <u>Our big inflation begins in 1972, right after the August 1971 suspension of dollar convertibility</u>. Look at the commodity charts and the exponential curve of rising inflation immediately thereafter. The fact is undeniable.

Q: You are talking about <u>reestablishing</u> the gold standard though?

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A: What I am saying is that the Federal Reserve System, in the past, has conducted its monetary policy in a framework dictated by the fact that, according to law, the dollar was convertible into a weight of gold -- and must be maintained at that stipulated value. So, the central bank, our Federal Reserve System, knew that if it overexpanded the money supply, the so-called dollar/gold convertibility ratio could not be maintained and the value of the dollar would fall. Moreover, if the Fed did not supply the quantity of credit and money actually desired in the market, then it also knew that the price level would fall and the value of money would rise. So all I meant to say was that the Federal Reserve has, in the past, conducted a credit policy within the framework of a gold standard. The present government should accept the discipline of the gold standard and do it again.

Q: But the dollar/gold link between the end of the war and 1971 was much more tenuous than the one you are talking about restoring.

A: That's correct. And that tenuousness was due to a profound defect of the so-called gold-exchange standard, or the dollar reserve currency system. The gold/dollar link after World War II was determined by the Bretton Woods Agreement of 1944 which allowed foreigners to base their currencies on the paper dollar rather than on gold. It was not a true gold standard. It was a defective fixed-exchange rate regime based on a reserve currency. It was doomed to failure. The reserve currency status of the dollar must be ended. It is both a burden which hobbles us, and an improper privilege, to which our trading partners often object.

In addition, Americans could not get gold for their paper dollars from 1934 to 1974. Only foreigners could. In a true international gold standard the monetary standard for us, as for other countries, could not be the paper dollar. And there would be no restrictions on gold sales and purchases.

Not the paper dollar, but a weight of gold would be the reserve currency. Gold, unlike domestic paper monies, cannot be manufactured at the printing presses, or created through central bank credit market operations. Nor can a gold currency be quickly depreciated or manipulated by sovereign national authorities.

Q: Very frankly, are there any other commodities that you could think of that would serve the purpose, the same purpose as well as gold?

A: Throughout history many different commodities have served as monetary standards. But each of these monetary standards quickly failed. They failed quite dramatically, except for silver. We have the case of wampum. We have the case of tobacco in colonial Virginia. We have the case of stones in certain island cultures. And we have the case of mixed standards, bimetallic standards. The interesting thing is that throughout Western history, as a result of free decisions of free people in the world market, gold has generally

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emerged as the prevailing optimum monetary standard. People who are free to choose decide for gold. Historians, economists, and economic theorists have often believed that the choice of gold as a monetary standard was adventitious, that there was really no underlying economic reality that brought this about. That's why John Maynard Keynes, one of the greatest economists of our time, referred to the gold standard as a barbarous relic. He did not understand what was unique about gold. The uniqueness of gold has also escaped famous contemporary economists as well. Now is the time to demythologize the gold standard.

Actually, the reason why gold was the historic modern monetary standard is clear. First, in free markets, free people determine what is money. Not the authorities, but free people determine what is trustworthy and acceptable as money. And over the centuries, merchants, consumers, traders, producers gradually selected gold coins, i.e., gold money as the most desirable money. They didn't have fancy theories to justify it. It was just that over time gold exhibited certain stable characteristics that no other medium of exchange exhibited. Only when the government prohibits gold money, through legal tender laws, does gold take a back seat. Now when you examine the underlying economic reasons for the natural selection of gold as money, you find that gold exhibits special monetary properties, characteristics unmatched by any other commodity in the market.

Let me simplify the issue. The economics of production, for most commodities and products, are often characterized by economies of scale, i.e., declining cost of production per unit of output over time. Now, when you adopt a commodity currency in a modern economy, the authorities and the banks stand ready to give every working man and woman a specified quantity of the commodity money for an equal quantity of the paper (or deposit) money in circulation. Now if the monetary standard were pork bellies, as Professor Friedman himself has facetiously suggested, or if it were cinderblocks, as the pathbreaking political economist, Jude Wanniski, has humorously suggested, then the monetary authority and the banks would be required to exchange a specific quantity of paper currency and credit money for a specific quantity of pork bellies or cinderblocks. Now, pork belly output is susceptible to economies of scale characteristic of mass production. Entrepreneurs and innovators will constantly refine the techniques of pork belly production such that their costs of pork belly production will fall to the very minimum under existing market conditions. Cinderblocks are manufactured goods whose production is even more susceptible to economies of scale. Imagine now that the monetary authority is subject to a statutory rate at which paper currency is convertible into the monetary standard -- cinderblocks and pork bellies (or all other commodities or products which we know are more or less susceptible to scale production techniques and declining marginal costs). Entrepreneurs will constantly discover techniques to lower the production costs of these commodity stan-

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dards. They would rapidly overproduce these monetary standards at declining unit costs and exchange them for more currency with the monetary authority at the fixed convertible rate. And of course, there would be inflation, i.e., a vast overexpansion and depreciation of the currency.

<u>Scale production techniques, or potentially rapid exploration and discovery rates, are characteristic of virtually all commodities on the market</u>. That's why Milton Friedman's pork bellies or aluminum, or oil, or lumber, or a basket of commodities, and other proposed standards are not good as monetary standards. Their supply can be expanded too rapidly. <u>But gold is not very susceptible to production economies of scale</u>. Throughout history, gold production has <u>not</u> been characterized by rapidly declining marginal costs of production per ounce of new gold produced. The marginal cost of producing another unit of gold is generally above or close to its average cost -- over long periods of time. It once took centuries, and now it takes about a generation, for the technology of gold production to improve appreciably. Increasing the production of gold through special mining techniques -- leeching, open pit mining, vast amounts of capital equipment, new inventions for finding and extracting -- has led neither to rapid discovery nor to economies of scale production. Declining costs of production or quicker supply increases, more typical of other metals such as copper or silver, do not typify gold production. Discovery and innovation in gold production have occurred, but at a pace which never caused, under the gold standard, a sustained annual rise of more than 3 percent in the price level -- very modest inflation compared to the floating dollar of the present.

The average increase in the quantity of gold production over hundreds of years has been limited to one-and-a-half to two percent a year -- because of the unique conditions of slow discovery and difficult production economics. In a word, gold has a very inelastic supply curve, an ideal characteristic for a monetary standard. Here I might make an observation about the 3-5 percent monetary growth rule of my monetarist friends. The monetary rule Professor Friedman would invent, and leave to the discretion of central bankers to carry out, the gold standard provides by virtue of the very nature of underlying economic reality itself. You can see that the quantity of gold in circulation expands over the long run at a steady rate. Indeed, that explains why gold has been instinctively and wisely chosen as a monetary standard by free people from all walks of life over hundreds of years -- because the average rate of increase of new gold production (1%-2%) tends to parallel the rate of population and economic growth over long periods of time (about 2%), thus preserving the purchasing power of the monetary standard -- gold.

Among all potential commodity standards, gold exhibits best another unique characteristic of money -- it is an excellent standard of measurement for economic value. <u>Over the long run, it takes a</u>

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relatively constant rate of application of a certain quantity of capital and human labor to produce a constant quantity of gold. Gold production is like a metering device which gauges the relative productivity, over time, of capital and labor. For this reason, gold money is the best measuring rod of the value of other economic products desired in the market, all of which require capital and labor to be produced. Gold prices measure ("meter out"), on a steady basis, the application of human intelligence, labor, and scarce capital, to the production of other goods and services. That is why gold prices still dominate the world trading system, in spite of what governments do to dethrone this remarkable and stable accounting device.

So here you have, fortuitously as it were, by virtue of the nature of things, a monetary standard, the growth rate of which is proportional to population and economic growth in the industrial world. Surely merchants and traders long ago weren't consciously aware of careful scientific explanations of the economics of gold production. But ineluctably, gold emerged as the monetary standard par excellence. In an imperfect world, the gold standard was freely selected as the stable monetary standard that men must have for the combined purposes of exchange, rational calculation, and monetary saving in sophisticated, rapidly growing industrial economies.

The gold standard establishes a stable legal framework, a monetary constitution, within which the central bankers and the prime ministers and presidents must work. They will know, therefore, that government deficits cannot be financed by printing currency, or by creating new credit at the central banks. Because if they overproduce the paper and credit currency, free people will turn in the undesired money for gold at the fixed rate. But the authorities must maintain the convertibility to which they are pledged by law or the constitution. Therefore, the authorities must promptly reduce the growth of money and credit.

Q: But there have been periods of inflation in countries with a gold standard?

A: If you mean that during gold standard periods the price level has exhibited tendencies to rise or fall very gently, yes. But under the gold standard, there have been no periods of sustained high, long-term inflation like the 1970s -- nothing comparable to the sustained double-digit inflations of pure paper and credit money systems of past and present.

Even during earlier epochs of commodity standards this was true. For example, even during the great "price revolution" of the 16th century, when Europe plundered the gold and silver mines of the New World, there was modest inflation compared to the present.

Q: What about the U.S. in the late 1960s?

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A: Don't forget we abandoned the gold standard domestically in 1934, and "de facto" internationally in March 1968.

Q: I thought it was still in effect to some degree until 1971.

A: Only formally. In March 1968, the U.S. decided to abandon the London gold pool which supplied gold at the fixed rate to the world market on demand. In March 1968 Lyndon Johnson abandoned the gold pool which had maintained the Bretton Woods monetary agreement. In August 1971, President Nixon formally and legally repudiated the last vestige of the international gold standard.

In any case, in the early 1960s, the rate of inflation averaged less than two percent. After the onset of the Vietnam war, the rate of inflation rose steadily above three percent. But it was not until after 1968 and 1971, when we finally repudiated convertibility entirely, that the rate of inflation rose consistently above five percent and then higher. Now for two years in a row, we have averaged twelve percent.

If historians refer to the "price revolution" of the 16th century, when the rate of inflation averaged approximately three percent a year over a century, I wonder what historians are going to call the last ten years in the U.S.! My point is, of course, that if you establish a monetary standard based upon a real commodity, and that real commodity is gold, there can be no long-term inflation properly speaking. And depending on business cycle conditions, there will be tendencies for the price level to decline gently during other periods. A true gold standard exhibits a "retrieval phenomenon," always bringing the price level toward stability and unity. Periods of gently falling prices under the gold standard (1875-1895) have led to periods of modest reflation (1895-1914). And by the way, both were periods of economic growth in the U.S.

Q: I think you were in the midst of describing your method for getting us onto a gold standard when I interrupted you. Could you pick up where you left off?

A: Sure. Since I hope that the Reagan Administration has the will to reduce marginal tax rates, balance the budget, and deregulate American life, I have no doubt that with the same kind of leadership, the gold standard could be restored within two years. A balanced budget at the current level of tax receipts, reduced tax rates, and the gold standard would lead to sustained economic growth with a reasonably stable price level. If he desired, the president could announce that within two years he would propose to Congress a statute which would establish a dollar convertible into gold. In fact there would be no "price" for gold. Properly speaking, the dollar would be redefined as a weight of gold. The "price," or weight, at which that would be determined would be influenced largely by market conditions preceding the date of resumption.

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The price of gold in paper dollars right now is about $500 an ounce (March 1981). Two years hence, the value of gold in paper dollars would naturally reflect the supply and demand of gold, relative to supply and demand conditions for all other goods, during that particular period. But because of the President's announcement, the price would be substantially devoid of the inflationary expectations that are included in the paper price of gold now. All the market participants would realize that, with the resumption of convertibility, the fluctuation in the value of paper dollars, and therefore of gold prices expressed in paper dollars, would end.

The gold standard may be seen, in general, as the way to end the mindless speculation in currencies and, in particular, as the end to speculation in gold. That's why the gold standard is very different enterprise from what some people confuse it with -- namely, the activities of the "gold bugs." Gold bugs are people who know that paper and credit monies are overproduced. Gold bugs are, therefore, speculators in gold. They're speculating for the rise in gold, and they're speculating for the fall in paper monies. One of the virtues of the gold standard is that it suppresses unproductive speculation and sends the speculators back to producing real goods and services for the market. To want the gold standard is to want an end to such unproductive speculation in the value of currency. The monetary standard of a great nation must be, to the extent possible, like the unvarying 36" standard of the yardstick. True money must be a reasonably reliable measuring rod and honest store of economic value. It must not be a floating vessel in the sea of politics, subject to wave after wave of manipulation and therefore speculation. Imagine changing the length of a yardstick, without warning, every day.

If we truly desire to restore the future of America by reviving the will to save and invest, and if we genuinely desire to renew the spirit of capitalism around the world, then we shall have to give the world a real money, a true and reliable measuring rod of economic value. That's why I believe no economic program in this country will ever yield the American Renaissance we hope for unless we restore the international gold standard. It is the unique monetary institution and sovereign symbol of a peaceful, open, and growing world market order. Only the United States, as the leader of the West, has the power to establish and maintain a capitalist world market order. Let us get on with our destiny.

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