THE STRUGGLE FOR FINANCIAL OF IN THE WESTERN WORLD

by Lewis E. Lehrman

Twice Jacques Rueff saved the French franc. The first time was in the 1920s, after the military and financial catastrophe of World War I. The second was in 1958, after the collapse of the Fourth Republic, when President de Gaulle called on the philosopher-economist to end inflation and reform the currency. Both times Rueff was successful, by restoring the franc's convertibility into gold, and by balancing the budget.

In 1958, after 12 years of withdrawal, De Gaulle had been called to power from his home in Colombey-les-deux-Eglises. He quickly summoned Rueff to restore financial order. Inflation was raging; the balance of payments was hopelessly in deficit; and there were only 45 days of foreign exchange reserves. The French franc was the sick man of Europe, and the immobilized government was virtually bankrupt.

Out of chaos De Gaulle created the Fifth Republic. But it was Jacques Rueff who restored the French economy. His plan was simple. Rueff knew that the causes of stagflation and financial disorder were unbalanced budgets, central bank credit expansion, and an inconvertible currency. So he reformed financial and monetary policy to balance the budget and reestablish convertibility. And he deregulated and opened up the overplanned and insular French economy.

Thanks to the Rueff reforms, France has had one of the most rapidly expanding economies in the world since 1959, with a rate of growth exceeding Germany's.

Our financial disorder and stagflation are similar, but in 1959 Rueff had two advantages, marginal tax rates were low and his target for currency reform was an existing monetary standard -- the gold dollar.

Rueff found it ironic that in 1971, we abandoned the last vestige of our historic gold currency, and undermined the monetary basis of international financial order. We forfeited free world leadership in monetary policy, as we had in foreign policy.

Rueff despaired that he was unable to help create a true gold standard for the whole West. Without honest money, he believed we were doomed. He looked to the United States for world monetary leadership, and was profoundly disappointed that we did not exercise it.

Rueff was right. We alone can lead the free world. When we restore the currency convertibility in the United States during the next decade, the entire world will repair to our monetary standard -- even the Soviet Union.

The Choice Before Us

A free people can have a nominal paper dollar; or they can have a real dollar, defined by its weight in gold, which is the historic American monetary standard. When we had a sound dollar, we had no serious inflation.

If we create a dollar as good as gold, we shall end inflation and financial instability. We will also, by this action, establish the conditions for a balanced budget.

Financial order, and a growing world economy, are essential in order for all Americans to make whatever success they want to make. And there would be hope once again for their children.

For those conditions to endure, we need a stable currency which, alone, will encourage the willingness to save, to risk, to invest for the long run. Cutting marginal tax rates is necessary but not enough. A true and lasting reform of our monetary institutions, domestic and international, must be based on the gold standard and the balanced budget.

For two decades, we have heard presidents, Fed chairmen, and Treasury Secretaries give well-meaning speeches. They declared in the 1960s that our goal was gradually to end the balance of payments deficit, and now they say that we shall gradually end inflation. Somehow we have failed.

The Keynesians have failed. The practical monetarists have failed -- in France under Prime Minister Barre, in England under Prime Minister Thatcher. And today, 20% interest rates, and growing bankruptcies, accompany monetarist policies in the U.S. The monetarist policy -- gradually to reduce the rate of growth in the money supply -- has so far not worked anywhere in the world.

Monetarists and Keynesians have failed, not because they chose the wrong goal, but because they chose the wrong means. To desire a goal without the effective means to attain the goal is to court political disaster.

The Fallacy of the Fed

Inflation is a decline in the value of the dollar caused by the Federal Reserve's supplying more money and credit than market participants desires. This excess money and credit causes the value of the currency to fall and prices to rise.

The participants in the market, the consumer and the businessman, not the Fed, decide exactly how much money they will demand for whatever purposes they have in mind. All of their purposes cannot be known to the Federal Reserve

System, no matter how farseeing, well-intentioned, systematic, or careful its research.

Accordingly, colossal disturbances arise in the financial markets because of Federal Reserve money market interventions, designed to hit a target beyond its aim -- determining the quantity of money in circulation.

In free societies, all monopolies are regulated. If we have a monopoly central bank, then, like the Fed, it must adopt reasonable self-denying ordinances. Ours is a government of laws, not men, and this moral imperative is especially important if we want to contain the evils of monopoly. Predictable rules must limit the Fed's unruly operations in the money markets.

Regulation can only be reasonably efficient when it simulates the market. Instead of trying to influence the level of interest rates, the foreign exchange value of the dollar, the quantity of money in circulation, or the level of employment, the Federal Reserve must realize that 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. That means the gold standard.

The virtue of the gold standard is its simplicity. In fact, that is a prime reason why many economists, politicians, and intellectuals reject the gold standard. It is too straightforward. They want something more complex to manipulate.

The gold standard, in the absence of world war and trade war, has actually worked reasonably well in the past -- the best test for any political or economic institution. But there are other reasons for adopting it: gold money can be understood and its quantity controlled by working people who do not have sophisticated accountants, financial advisers, and economists to figure out the actions of the Fed. A gold-based currency freely convertible and upheld by law, is democratic money, just as speech and press, freely articulated and upheld by the first amendment, are democratic values. Gold is real money which free people, and not the Fed, would control. If government printed too much paper money, free people would exchange it for gold, compelling the government to stop creating paper and credit money to finance budget deficits.

<u>We must have a balanced budget</u>

Some economists talk as if all the economy needed were reductions in marginal tax rates. This is important, but not sufficient. We need monetary and budgetary reform.

A balanced budget at today's level of tax receipts, and not through increased taxes, is absolutely necessary for the restoration of financial order.

Those who are indifferent federal spending and to budget deficits hurtle down the road to doom. In Thatcher's England, the consequences of wild public sector spending are easily seen.

The Tory monetarists have been unable to get the budget under control because Margaret Thatcher put too much emphasis on monetarist central bank policy, and too little emphasis on the growth of government spending.

Monetarists are too little concerned with the size of the government deficit, which must be financed by an elastic but limited pool of savings.

The public sector deficit has almost doubled in two years under Thatcher -- from 7.5 billion pounds to 13.5 billion -- 5%-6% of GNP. The deficit absorbs most of the savings which British enterprise needs for new investment and the

U.K.'s economy is foundering badly. Manufacturing output during the past year-and-one-half has fallen almost as sharply as in the Great Depression.

The United States has a $2.75 trillion economy and a $60 billion deficit, plus off-budget federal credit and guarantee programs. Combined with state and local government borrowing, they equal about $150 billion of government borrowing this year. This borrowing represents is the true deficit -- about 5%-6% of GNP -- comparable to Thatcher's England. But personal savings in the U.S. are running at only about $100 billion. Government borrowing alone exceeds personal savings. When public and private borrowings wildly exceed savings, interest rates rise. And that is why interest rates have skyrocketed to 20%.

The reason a substantial budget deficit and huge federal credit demands are destructive is straightforward. The government goes into the capital markets, sells government securities, and removes scarce savings equal to the government deficit and other federal credit programs. Business is denied these savings; interest rates rise above the rate of return in investment; and the result is stagflation.

If government spending and borrowing equalled the current level of tax receipts, there could never be a deficit. Savings would remain in the capital markets for businesses and families to borrow at lower interest rates, to invest and create new products, new jobs, and new homes.

Gold and the Global Economy

Effort and intelligence creat all wealth.

Real money, a gold currency also requires real effort, capital, and intelligence to produce. In the past, real money was the common currency of world trade which produced a reasonably stable global price level. In a financial world anchored by the gold standard of real money, workers, investors, and businessmen cease to speculate on fluctuating paper currency values at home and abroad. People know that the value of hard currencies, linked to one another across national borders, would be stable over the long term. Thus, long-term investment and trading commitments could be confidently undertaken, with an increase in the efficiency and wealth of the free world economy.

Today, economic policymakers in Washington, Paris, London, Bonn, and Tokyo often imagine they are making self-contained policy for their national economies. But there is no such thing.

Through the mechanism of arbitrage, the prices in national economies are linked. There is only a single global economy.

But the openness of the world economy is good. It leads not only to the maximum liberty for the individual, but also to the maximum production of goods and services, to the special benefit of the poor here and abroad. Those looking for a legacy need a stable growing economy.

History and analysis show that the most stable international coordinating mechanism, the gyroscope of reasonable price stability over the long run in a growing world economy, is the true international gold standard.

The Selection of Gold as Money

Free people naturally selected gold as money because gold exhibits special monetary properties, unmatched by any other commodity in the market.

With a commodity currency, the authorities the banks, or both, stand ready to give every working person a certain amount of the commodity money for an equal quantity of the paper (or bank deposit) money in circulation. If the monetary standard were oil or pork bellies, as Professor Milton Friedman has facetiously suggested, or if it were cinderblocks, as Jude Wanniski has humorously suggested, then the monetary authority and the banks would be required to exchange a specific quantity of paper currency or deposit money for a specific quantity of oil, pork bellies, or cinderblocks. But oil, pork belly and cinderblock production can be quickly increased.

At declining costs, entrepreneurs would rapidly overproduce these flawed monetary standards at declining costs and exchange them at the set price for more paper currency. There would be inflation, i.e., a depreciation of the currency based on a boom in the production of the monetary standard. That's why pork bellies, aluminum, oil, lumber, and a basket of commoditites are deficient as monetary standards. But gold is different.

It once took centuries, and now takes about a generation, for the technology of gold production to improve significantly. Even special mining techniques -- leeching, open pits, vast amounts of capital equipment, new inventions for finding and extracting -- have not led to rapid discovery or production. It costs about half a billion dollars to open a single new gold mine in South Africa today.

There have been discoveries and innovations in gold production, but at a pace which never caused, under the gold standard, a sustained average rise of more than three percent a year in the price level. On average, gold production has increased, over hundreds of years, only about one-and-a-half to two percent a year because of the unique conditions of slow discovery and difficult production economics. The supply of gold is inelastic, an ideal characteristic for a monetary standard.

Professor Milton Friedman has invented a monetary rule, which he leaves to the Fed to carry out: that the quantity of paper and credit money in circulation expand over the long run at a steady rate, say 3-5%. But the gold standard, by the very nature of underlying economic reality itself, fulfills that role.

Over long periods, the average rate of increase of new gold production (1%-2%) parallels the rate of population and economic growth over long periods of time (about 2%), thus preserving the purchasing power of the monetary standard. Gold production is elastic only in proportion to real economic growth. 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.

Among all potential commodity standards, gold exhibits best another unique characteristic: it is an excellent standard of measurement.

Over the long run, it takes a relatively constant amount of capital and labor to produce a constant amount of gold. Gold production is a meter of economic value. It gauges the relative productivity of capital and labor. For this reason, gold money is the best way to measure the value of other products in the market.

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.

Merchants and traders of long ago weren't aware of scientific explanations about the economics of gold production. But inevitably, gold emerged as the best monetary standard. In an imperfect world, a weight of gold was freely selected as the stable monetary standard of value that men must have for exchange, rational calculation, and monetary saving.

One often hears that gold was a good standard in the past, but that today the price of gold changes too violently to be a stable monetary standard. But it's not the value of gold which is unstable, but rather the fluctuating value of the government-manipulated paper and credit dollar.

It is paper currency, unlinked to a commodity standard, which is unstable because it is manipulated by politicians and bureaucrats.

Would a Gold Standard Benefit Russia and South Africa?

Would a gold standard allow the Soviets and the South Africans, to exercise undue influence?

The Soviets produce about eight to ten million ounces of new gold per year. Total official and private gold holdings are over two and a half billion ounces. One and a quarter billion ounces of gold are held by official monetary institutions. 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 and it is less than one half of one percent of the existing gold stocks in the world. Even were the South Africans to dump, at one moment, an entire year's production on the market, that would only be about 20-24 million ounces of gold, less than one percent of the total world gold stocks.

During the history of the gold standard, there were always gold-producing countries which were ill-disposed toward the gold standard. But, it endured their hostility and served its economic purpose far better than contemporary monetary institutions.

South Africa and Russia could not disrupt the gold standard if the West were determined to establish and maintain it. In fact, the gold standard, throughout history, has failed only because of world war, protectionism, or self-centered currency manipulation. Few free economic institutions can survive these xenophobic conditions. In fact, the establishment of the gold standard will signify an end to national autarky and "beggar-thy-neighbor" policies.

Before World War I, huge discoveries of gold in South Africa, the technology of the cyanide process, and the Klondike discoveries did not disturb the stability of convertible gold currency through the Western world. These colossal discoveries caused the price level to rise about two or three % a year, and can you believe that our greatgrandfathers called this inflation?

Germany, during the 1870s, switched from a silver standard to a gold standard. Even this shift was insufficient, with the enormous weight of the German economy, to destabilize the international gold standard.

During and after the U.S. Civil War, our paper dollars, were not convertible, at par, to gold. No matter the weight of the United States in the world economy, our inconvertible paper currency did not disturb the stability of the West's gold-based monetary system.

In each gold standard era, there will always be nations not fully integrated into the monetary system -- either morally, which is what some critics of South Africa say, or morally, economically and politically, as is the case with the Soviet Union.

The South Africans are, in fact, desperate to sell their gold to the West for the foreign exchange, they need for arms and necessities. And the Russians are equally desperate to sell gold for dollars to buy grain and technology. The gold standard countries could easily absorb all gold sales of the relatively insignificant new output of Russia and South Africa.

Finally, it is inflation of paper monies which raises the price of gold to crazy levels. Thus Russia has as stake in inflation, not in the gold standard which stabilizes the value of gold and ends inflation. The opponents of the gold standard raise the issue of Russia and South Africa not because it is a true issue, but because these countries are bogeymen. The issue is a false one.

Gold and War

Other critics have said the gold standard would be impractical in a war. But the gold standard in no way restricts the freedom of Congress and the President to meet the threat of war. In fact, it will help them. By insuring the future value of the dollar, the gold standard will increase saving. In order to finance the national defense, or prepare for war, the government must sell bonds to the people in exchange for their savings. Because a gold dollar is stable, it encourages people to save and, with the security of gold backing, to lend their savings to the government in a national emergency.

The European governments made a fatal error in 1914 when they abandoned their gold currencies, because their citizens saved less for fear of inflation. As a result, the war effort had to be financed through central bank credit and the printing presses. Inflationary war finance helped to destroy Czarist Russia and Imperial Germany during the war, and almost wrecked France and Eastern Europe in the middle 1920s.

The financial discipline of the gold standard restrains exhuberant autocrats and imperial democrats from easily going to war -- because the gold standard requires governments to tax to pay for war. Governments cannot print money or expand credit, or the gold standard will be destroyed, signalling to the people the true condition of the government. Therefore, a truly free society, must abide by gold. If we truly desire a peaceful world trading system, we need the gold standard to foster international discipline and good will.

The gold standard is only one crucial element of world peace. Indeed, it is the symbol of harmony. U.S. military preparedness is also important. But under U.S. leadership, a neutral monetary standard, not a reserve currency, could be an impartial international coordinating mechanism, in which competing sovereign nations would have an immediate commercial interest. If the U.S. were strong, under the internatonal gold standard, national interest would encourage even the Soviets to adapt more to the code of Western civilization, to win our favor rather than our disapproval. How else could they exchange their gold for Western currencies to buy grain and technology.

Gold and Economic Progress

The development of the Western world, and of America from thirteen tiny colonies to the greatest nation on earth, is an example to all the underdeveloped communist and other third world countries.

The thirteen colonies had a depreciating inconvertible paper currency during the Revolutionary War. It was called the Continental. "Do you think, gentlemen, that I will consent to load my constituents with taxes," said one Member of Congress, "when we can send to our printers, and get a wagon load of money, one quire [25 sheets] of which will pay for the whole?"

Congress issued $2 million worth of Continental currency in early 1775. At first, the law required two Congressmen to sign and number each note -- a sunlight procedure that much appeals to me. But that implicit restraint limited the number of paper notes, and the issuing technique was soon changed. By 1779 Congress had issued $200 million in Continental currency and its purchasing power had fallen to 1/1000th of gold's.

American patriots suffered most of the depreciation, wrote William Gouge, President Andrew Jackson's financial adviser, since they accepted and held the paper money. "The Tories...made it a rule to part with it as soon as possible."

More than two centuries later, we still hear the phrase "not worth a Continental."

But the Founding Fathers changed all that. The American republic was established on the foundation of a real constitution and real money. It is no 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 world power -- we had a dollar as good as gold.

How to Achieve the Gold Standard

The Reagan Administration wants to reduce marginal tax rates, balance the budget, and deregulate American life. These are all essential, but we also need monetary reform.

To establish the gold standard, the President would announce that in no less than two years he would propose to Congress a statute to make the dollar convertible into gold. In fact, and in law, there would be no "price" for gold. The dollar would be redefined as a weight of gold. The "price," or weight, would be determined by the market before the date of resumption - at a level which would insure that average wages would be stable.

The price of gold in paper dollars now is about $402 an ounce (July 1981). Two years from now, 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. But because of the President's announcement, the paper dollar price would exclude the inflationary expectations that are included in the price of gold now. Everyone would realize that, with the estabishment of the gold standard, both inflation and the fluctuating paper-dollar price of gold would end.

The gold standard may be seen, in fact, as the way to end the mindless speculation in currencies and gold. That's why the effort to establish the gold standard is a very different enterprise from what some people confuse it with the activities of the "gold bugs." Gold bugs are people who know that, without a monetary standard, paper and credit monies have been overproduced throughout history. Gold bugs are, therefore, speculators in gold. But the gold standard suppresses unproductive speculation and gives speculators incentives to produce real goods and services for the market. To want the gold standard is to want an end to unproductive speculation in the value of currency. With a true gold standard, vast hoards of capital would desert collectibles and enter the investment market once again. The sluice gates to savings would reopen, and interest rates would fall.

The monetary standard of a great nation, a unit of weight, must be like the 36" standard of the yardstick, a fixed measure of length. Only a unit measure of gold can be a reasonably reliable measuring rod and an honest store of economic value. The standard of economic value must not be a floating vessel in the sea of politics, subject to wave after wave of manipulation and therefore speculation. Imagine the government changing the length of a yardstick, without warning, every day. It would destroy the economic and scientific world that depends on rational calculations. It will also destroy the harmony of a great national which depends on trust in the currency.

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.

The gold standard is a symbol of a peaceful, open, and growing world market order based on trust. As Jacques Rueff prophesized, only the United States, as the leader of the West, has the power to establish and maintain such a capitalist world order. Let us get on with our destiny.