The Washington Post

Sunday, February 20, 1983

If We Had 'Real' Money We Could Still Salvage The Reagan Revolution

By Lewis Lehrman

THOSE OF US who believe in the goals of the Reagan revolution had better face up to the consequences of the last two years. We called for boom and got something very close to bust. We called for a balanced budget and got record-shattering deficits. We called for a restoration of capital markets so business could borrow money for long periods at reasonable interest rates, and we got a devastating credit crunch.

Why? There are many possible explanations, but in my view the missing link is a policy we called for nearly three years ago but quickly forgot. Let me quote the 1980 Republican platform:

"One of the most urgent tasks . . . will be the restoration of a dependable monetary standard." The restoration of the true American monetary standard — a *gold* standard, the symbol of the classical monetary policy — was held up as an alternative to the conventional economics that has shattered the great American prosperity.

I know that a gold standard is unfashionable among the political, bureaucratic and academic elites. But so, until 1980, was President Reagan — and he won without them, because he was right. The gold standard will win out, too, because its efficacy is based upon its ineffable simplicity and practicality. It is an honest standard, a form of discipline that will guarantee that our money has real value. When we have real money people will again make long-term investments — because they will be confident that their investments will pay off in real money.

Ironically, this very simplicity is a prime reason why sophisticates ridicule the idea. To them, a currency convertible to gold is too straightforward a solution to economic stagnation and inflation. Mathematicians and economists are taught in graduate school that economics and economic statistics are very complex subjects. To them, therefore, economic policies must be equally complex.

But given the dismal failure of the experts' manipulative economic policies, isn't it time we chose a monetary standard they cannot manipulate?

All the 1980 campaign speeches and the rhetoric of President Reagan had repudiated 30 years of failed attempts to manipulate money and credit. But in two years, we have again fallen victim to the manipulators, to the conservatives of the austerity school at the Federal Reserve Board who thought they had a new magic potion to control "the money supply" that would save the economy.

Instead these wizards gave us double-digit real interest rates that ended the recovery from the 1980 recession, overwhelmed the 1981 tax cut, and sent the economy reeling for the second recession in as many years. This back-to-back double recession in two consecutive calendar years is unique in the recorded history of American business cycles.

This record was so bad that even Chairman Paul Volcker and his colleagues at the Fed got the message. In July they abandoned their three-year experiment with "targeting" the supply of money by trying to control the size of bank reserves. Last July 1, by an 8-to-4 vote, the Fed's Open Market Committee abandoned the experiment. Eleven percent unemployment and a world banking crisis produced pressures from Congress and the international financial community that forced Volcker to give up on austerity.

The underlying truth is the Federal Reserve cannot fix the quantity of money in circulation. Nor, over the long run, can it fix interest rates, the monetary base, or the level of bank reserves. Nor should it try. The Fed effort to do these things has wrecked America's long-term capital markets.

The Fed could help us out of the mess we are in. By finally announcing a market-related discount interest rate and lending money to banks at that rate, by forswearing any Fed purchase of Treasury bills and notes (an inflationary transaction that expands the money supply with printing-press dollars), and by reestablishing a real gold standard, we *can* have reasonable price stability and sus-

tained economic growth.

A marvel of the gold standard is that, in the absence of world war and trade war, it worked reasonably well in the past.

It is also true that *no* free economic institution can long survive global war and protectionism.

Most important, gold money can be understood and trusted by working people. They alone can control its quantity. A gold-based currency is democratic money. It is a populist institution beyond the reach of a guardian elite.

If we adopt the gold standard, there is, of course, a price to pay. The central government and the Federal Reserve will no longer be able to manipulate the value and supply of the American dollar. Alone, free people will determine its quantity.

Curiously for a conservative administration, the Fed has been pressed by neo-Keynesians in the White House *not* to reform our diseased money, but once again to expand central bank credit as quickly as possible. The new Fed credit policy is to accommodate not only U.S. government borrowing requirements, but also the reckless big city banks and the insolvent Third World countries — not to mention the legitimate needs of private industry.

What we will get in the future, under present economic policies, may be something quite different from what we expect. The Fed's policy now is to "reflate" the economy. In the short run, this will boost output, reduce unemployment and reinvigorate commodity markets. Economic growth will exceed the administration's forecasts for 1983. But another speculative bubble lurks on the horizon. It will burst, bringing foreign exchange crises, commodity booms, precious metal hysteria, more budget crises and world monetary disorder.

True, the Fed will have bailed out the big banks and the bankrupt Third World; monetarism will be a thing of the past; the immediate unemployment crisis will have passed; nominal interest rates will have fallen under the weight of Fed credit policy. All these things are certainly better than the austerity of '81-82. But all we really have at the moment is one more postwar cyclical recovery, engineered by a Fed reflation, and guaranteed to end as all other recent "recoveries" have ended.

And this time engineering the recovery will be more difficult than ever. The Fed is trying to launch a worldwide credit reflation under budgetary conditions unique in our history. This policy on top of historically unprecedented deficits could, if sustained for several years, cause a complete collapse of U.S. financial institutions.

It does not have to be this way. The Reagan Revolution is not necessarily at an end. It is at a way station. Here and now, the president can decide the direction of the world economy for a generation. Will it be more of the same stop-go misery? Or will it be true monetary reform and an enduring legacy of rapid non-inflationary growth?

Once the wonder of the Western world, American long-term capital markets have already ceased to exist as our forefathers knew them. Whether they have a future at all — whether we shall ever inaugurate a period of sustained noninflationary growth — will be determined by the Reagan administration's monetary policy.

The political stakes are great. That is because a true reform of monetary policy can change the present cyclical upswing into a long term boom.

To do so, the administration must establish a convertible currency, end floating exchange rates, and create a new international monetary order based on a common world currency, the gold standard.

The world needs a unified currency because we now have a unified, integrated world economy. There can be no such thing as an independent, national monetary policy, the effects of which are contained within the national economy. We live in one monetary world now.

History shows that the optimum monetary institution of international financial order must be an impartial, global coordinating mechanism, outside the control of any soverign state. Such a coordinating mechanism is a multilateral, fixed exchange rate regime based on unrestricted convertibility of national currencies to gold. The true international gold standard operated effectively between 1879-1914, amidst a sophisticated banking system that was at least as integrated as ours is today. The true gold standard was successful because, as an efficient world currency regime requiring prompt gold settlements to adjust balance-of-payments deficits, it operated in the manner of a global gyroscope to maintain long-run price stability and an efficient allocation of scarce capital the world over.

This arrangement was not perfect. But no world monetary system has worked as well as a gold based exchange rate regime.

Even huge gold discoveries never resulted in sustained, high inflation. The vast expansion of gold money in Europe during the 16th and 19th centuries never caused the price level to rise more than an average of 3 percent a year over a long period. Compared to the past 10 years of central bank-managed paper money and floating exchange rates, 3 percent inflation is the essence of stability.

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Gold is the optimum monetary standard because it exhibits, better than any commodity, a necessary virtue of money: total new gold production in any single year is only a minor fraction of the total supply of gold in existence — about 2 percent. This is one reason why a common criticism of the gold standard — that it would most benefit South Africa and the Soviet Union — is wrong.

In fact, the average rate of increase of new gold production is equal to the average rate of gain of overall productivity since the onset of the industrial revolution. That is why gold money is stable money.

Moreover, annual South African production, about 21 million ounces, and Soviet production, 8-10 million ounces, is a drop in the bucket compared to total world stocks, about 2.5 billion ounces. Withholding or selling new production of such small quantities could not disturb the stability of the gold standard.

Over the long run production statistics show that in the market the values of the supply and demand for gold are stable. Stable production in a gold-standard world would mean stable growth of the money supply — something my monetarist friends rightly say we need. The alleged price volatility of gold is a curious inversion of the truth. It is not gold which is unstable, but the paper currencies in which it is priced.

A study of the supply conditions of gold production over centuries shows that it takes a relatively constant rate of application of a certain quantity of capital and labor to produce a constant quantity of gold. Gold production is thus like a metering device, a yardstick by which to gauge equitably the relative productivity, over time, of all capital and labor in an integrated world market economy. The unique characteristics of the conditions of gold production can be established with respect to no other commodity, product, or man-made banking device. These conditions explain why gold has been world money from time immemorial.

The gold standard, finally, may be seen as the way to end the mindless speculation and fluctuation of inconvertible national currencies. In particular, a real gold standard will end unproductive speculation in gold, eliminating the inflationary premium that now benefits only the South Africans and Russians.

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The history of this country and of the West bear witness to the efficacy of a gold standard. After the hyperinflation of the American Revolutionary War and the corresponding economic decline (1775-89), the new constitutional republic was established on the bedrock of a new monetary order. It was Alexander Hamilton who brought about the Mint Act of 1792. By this act, the U.S. dollar was fixed to a gold and silver basis. Economic historians and scholars of the period all note the extraordinary 10-year boom which followed. Low long-term interest rates, rapid growth in the work force, and a stable price level were the hallmarks of a return to convertibility at the birth of the American nation.

Napoleon ended financial catastrophe in France, after the paper money debacle of the French Revolution, by establishing the gold franc. Prosperity followed.

The restoration of the gold standard in England in 1819-21 ended a 24-year financial nightmare of alternating wartime inflation and peacetime austerity and deflation. English economic historians all report that one of England's greatest investment booms followed the restoration of currency convertibility in 1821.

America in 1879 ended 17 years of floating exchange rates and paper money, brought on in 1862 by the outbreak of the Civil War. This period of war and reconstruction had also been characterized by a doubling of the price level, then a peacetime deflation. The gold standard and currency convertibility were restored in January 1879. Real growth of national income averaged 8.4 percent

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annually for the next four years.

These are but a few examples, drawn from the only reliable laboratory for economic experiments, the real history of nations and peoples.

The gold standard is an actuarial guarantee to working people that the purchasing power of money will be approximately the same in the future as it is on the first day of convertibility. Prof. Roy Jastram has shown that the purchasing power of gold was constant for four centuries, from 1540 to 1940. Permanent inflation and high interest rates are ruled out by the gold dollar. Thus are expectations stabilized and the inflation premium in interest rates eradicated.

Our grandparents lent their long-term savings to American railroads for 50 to 100 years at 3 percent under the international gold standard. They did so, and we shall do so again, because only the gold monetary standard will restore our faith that the savings we lend to business today will yield us and our grandchildren future rewards paid in honest dollars of similar purchasing power.

When I forecast 4 to 5 percent mortage interest rates under a modernized gold standard today, some of my younger friends are incredulous. But it was only 14 years ago, in 1968, when I was 30, that I obtained my first home mortage at 5½ percent. Even then, in the waning days of the Bretton Woods gold-linked exchange rate system, long-term interest rates were low and reasonably stable compared to today.

Faith in the integrity of money will be restored with a gold standard. Savings now held at short term will pour into new, long-term debt and equity investments. At first, the rush of a great new supply of long-term savings will exceed the demand, and long-term interest rates will fall. The demand for low-cost financial capital will rise — to build businesses and homes. As the investment boom in technology, plant and equipment gets underway, the demand for labor will rise rapidly. Unemployment will fall.

After the monetary reform, economic growth will approach 7 percent a year and will last for at least four years. A decade of growth averaging at least 5 percent will be under way. Tax revenues will pour into the Treasury. For each 1 percent the unemployment rate falls, the federal budget deficit will fall $30 to $40 billion. Long-term interest rates on high quality private debt would fall to 6-7 percent within 12 months of the monetary reform. For each 1 percent fall in the rate of interest, the Treasury could save $10 billion in service costs. The goverment debt could be refinanced at about half current interest rates, saving the Treasury $60 to $70 billion annually. At 5 percent unemployment, the Treasury would save at least $200 billion. The budget would be balanced.

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Until 1934, the integrity of the dollar rested upon the right of every American to bring precious metal to the mint to have it freely coined into standard money. Free coinage gave rise to the right to convert all paper and bank deposit claims, such as Federal Reserve notes and checking accounts, into the monetary standard. Thus was the dollar referred to as a convertible currency.

But in 1933 Franklin D. Roosevelt repudiated the government's covenant to convert Federal Reserve notes into standard gold coin held in reserve for those who trusted the guarantees of the Constitution. Moveover, in 1933, lawful gold money held by American citizens was forcibly confiscated by the government without due process.

As the integrity of our domestic currency was destroyed in the 1930s, its international substance was eviscerated in 1971 when Richard Nixon unilaterally repudiated the contractual right of foreigners, enshrined in the Bretton Woods Agreement of 1944, to claim gold dollars for undesired paper and deposit dollars. The present era of financial disorder, marked by alternating cycles of inflation and unemployment, originated in these monetary repudiations of 1933 and 1971.

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Now is the time for America to launch a new gold standard era of open world trade, peace and prosperity. Only the United States has the power to do so. For the United States is the natural leader of the free world economy.

Of course, the experts complain about the difficulty of establishing the gold standard.

We have to ask ourselves and our monetarist and Keynesian friends, as well as the socialists and our foreign allies one practical question: Are the problems of establishing the gold standard and a new international monetary order greater than living with the high real interest rates, inflation, and unemployment characteristic of our catastrophic paper and credit money system?

A reasonable person might answer that establishing the gold standard is not easy. But it is simpler, safer and entails fewer unpredictable consequences than the continuing disasters of the past 10 years of government-managed money.

Therefore, the president should now announce that in January 1985 the United States will establish, by law, a fixed value for the dollar measured as a specific weight of gold.

During the next two years, the stabilization period, the president should also propose a specific balanced-budget amendment to the Constitution, to become effective in 1989. He should propose a statutory reform of the Federal Reserve System prohibiting the Fed from manipulating the monetary standard, its value or its quantity.

During the stabilization period market participants would gradually cease to hedge against inflation or to speculate for a deflation. Gold would begin to settle at a more stable, paper-dollar price as the Jan. 1, 1985, convertibility date drew closer.

Ninety days before the end of the stabilization period, Oct. 1, 1984, the president, after consultations with the appropriate legislative and executive officers, should propose the statutory gold weight of the dollar, or the "price of gold." Congress would set the price, or gold weight of the dollar, in The Gold Standard Act of 1985.

Setting the price would require great care. It should be related to the free market price of gold at that time, but must be set high enough so that the average wages paid to workers do not fall because of the reform. When Britain returned to a gold standard in 1925, the price was set too low, resulting in high unemployment.

In January 1985, after Congress acted, we would be on the true gold standard. All who wanted coined gold dollars could bring their bullion, paper money or checks to the mint for conversion at the established rate.

Most important, the president should now call for an international monetary conference under the leadership of the United States, to begin in January 1984. Here, the terms of the new international gold standard agreement would be established by treaty, just as at Bretton Woods in 1944. The free world would once again have a common currency free of sovereign manipulation. If the other capitalist nations decline to join us at the outset, our success with the gold standard will soon compel them to emulate us.

A gold-based international exchange rate regime would rule out the protectionist anarchy and competitive depreciations caused by floating rates. And it would end the privileges and burdens of the reserve currency status of the paper dollar.

Yes, even without the restoration of sound money, we shall still survive as a country. It is the lot of working people and businessmen to survive, especially in America. But to what end? To subsidize a cartel of high-rolling, big city bankers and undisciplined Third World elites? In an armed camp? Amidst conditions of permanently high unemployment, inflation, and 10 percent interest rates? Increasing bankruptcies? Wage and price controls? Is this the stuff of the American dream?

We can attain the goals of financial order and full employment, and thereby restore the American Dream. But only with real leadership and real money. In President Reagan we have the potential leadership to end inflation, rebuild our economy and balance the budget.

Now, for real money.

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