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Golden Antidote to High Interest

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The threat of inflation and punitive interest rates is the transcendent economic issue of our times. This financial disorder is to our generation what depression and the tragedy of unemployment were to our parents and grandparents. Searching the 200-year history of the Industrial Revolution to find *a full decade* of average interest rates as high as those during the period of 1974 to 1984, it is necessary to go back to the French Revolution and the total financial collapse of France in the years 1789 to 1799. The modern history of interest rates shows that in periods such as ours there has been only one way to return to relatively low, long-term interest rates, and that is by a monetary order based on a gold-backed currency.

For example, the period of the American Revolution was a time of paper-money hyperinflation, immense budget deficits and high interest rates (for example, 26% to 40% on long-term government bonds in 1787). As a result of this experience, the founders in 1789 established the new constitutional republic upon the bedrock of a currency and credit reform—largely the initiative of Alexander Hamilton. Through the Coinage Act of 1792 he refinanced the public debt and established a convertible dollar, based on a gold-and-silver standard. As a result, low fixed interest rates of 6⅓% to 7½% for long-term government bonds became commonplace. After the monetary reform, between 1792 and 1801, budget deficits were actually exceeded by budget surpluses. A decade of economic boom without inflation followed domestic monetary reform.

Restoration of Gold Franc

By means of a very similar monetary reform—restoration of the gold franc—Napoleon ended the French revolutionary period of inflation, floating exchange rates and high interest rates (average yields of 34% in 1799 on government bonds). These high interest rates, like our own, had been brought about by government-manipulated "assignats," the inconvertible paper-money issues of the French revolutionary government. The return to gold convertibility brought down interest rates to 6% (or lower) on government bonds from 1806—with a few years' exceptions—until World War I.

As recently as 1959, after two decades of a flexible franc and comparatively high interest rates, French President Charles DeGaulle and Prof. Jacques Rueff reformed the domestic monetary system and launched the Fifth Republic on a decade of economic growth, exceeding even Germany's growth. The Rueff reforms restored a franc convertible to gold, ended France's inflation, lowered interest rates, led to a balanced budget and linked the gold franc to the Bretton Woods system of fixed exchange rates.

A century and a half earlier in Britain, the 1819-1821 restoration of the gold standard had ended an era of comparatively high interest rates, floating exchange rates and parliamentary paper-money experiments. These experiments also had begun during the Anglo-Napoleonic wars—a 24-year financial nightmare (1795-1819) of alternating wartime inflation and peacetime austerity and deflation. For example, British long-term government bonds yielded 3% to 4.5% from 1735 to 1785. From 1795, when pound convertibility was suspended, yields almost doubled, peaking at nearly 7% in 1798. But in expectation of the return to gold convertibility of the paper pound in 1819, yields declined almost 50%, and continued to decline thereafter. The capital markets of London revived, undergirded by sterling convertibility to gold, and offered interest rates of 2% to 4% for British government bonds for almost a century.

In 1879, the U.S. officially ended a 17-year epoch of inconvertibility and financial disorder. The Civil War and Reconstruction period, with its paper money ("greenbacks") and floating exchange rates, was also marked by comparatively high interest rates. For example, the average yield on long-term government bonds during the 1850s was 4.33%. In the first year after the suspension of dollar convertibility in 1861-62, yields ran about 50% higher, to average about 6.5%. Peak rates also occurred in 1861-1862—6.75% as measured in greenback yields, higher if measured in gold prices.

During Reconstruction, in expectation of the return of gold convertibility in 1879, market yields on long-term government bonds declined to 3.75%, a 40% decline from the peak in 1861-1862. During the decade after dollar convertibility was restored (1879-1889), average yields declined radically to 2.13% in 1889, averaging 2.71% for the entire decade. The U.S. monetary reform of 1879 had reestablished a necessary condition of low interest rates—the gold dollar—and linked it to the international monetary order of the day, a general system of multinational currency convertibility and free trade, upheld at the center by the convertible, gold-backed British pound.

Why do free convertible currencies and an international monetary order, based on the gold standard, produce such positive financial effects? Because only a fixed value for any unit of measurement can bestow reliability and trust on the chosen standard. Faith in a just and lasting value for an objective standard of economic measurement and exchange, namely money, is crucial for commerce. Confidence in the fixed value of the monetary standard, the measuring rod of economic value, is similar to our enduring trust in the fixed value for the principal measure of length, the yardstick—always 36 inches. Who would arbitrarily depreciate the value of the yardstick to 30 inches tomorrow or gradually augment its value to 40 inches one year from now?

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That is precisely the arbitrary power we give today to the Federal Reserve—to depreciate and appreciate the value of the monetary yardstick, the dollar. That's because there is no longer any legal requirement to maintain the value of the mone-

tary standard—that is, a stable dollar, a convertible currency. And because of universal floating exchange rates, the Fed is in fact free, through open-market operations, to increase or decrease the supply of credit and money without limit. The financial markets are fully aware of this fact, reminded as they are by the open-market operations of the New York Fed at 11:45 a.m. almost every day. Indeed, total Federal Reserve financial-market purchases and sales of government securities have reached $2 trillion in a single year. Imagine the destabilizing effect of $2 trillion of government purchases and sales in the market for any other product.

By means of open-market operations, the Fed creates and destroys bank money without creating or removing new goods and services during the same market period. Thus, on the one hand, too expansive open-market purchases of government securities by the Fed cause demand to exceed supply at prevailing prices and inflation gets under way, as happened between 1977 and 1980. Or, on the other hand, open-market sales of government securities by the Fed often reduce credit too abruptly and cause demand to fall short of supply, and a drift toward deflation gets under way. This happened in the fourth quarter of 1981 and more recently in the third week of this past May when, just after the collapse of Continental Illinois, the Fed sold $4.1 billion of government securities leading to the largest ever weekly drop in Federal Reserve credit. Uncertainty about such Fed operations has raised the risk premium in interest rates.

Only a fixed monetary standard can abolish this risk premium in long-term interest rates and renew faith in the fixed value of all future money payments on borrowings (bonds, mortgages, stocks and other long-term financial contracts). Confidence in the stable future purchasing power of a convertible dollar leads directly to a boom in the supply of savings offered for long periods at fixed, low rates. This new supply of savings will tend to lower the price of credit, i.e. interest rates. Only a real currency, legally convertible to gold at a fixed rate, can bring about these effects in the capital markets. That is why the Constitution of our country—originating as it did in 1789 after a catastrophic inflation of the previous currency of the Continental Congress ("not worth a Continental")—upholds a gold- or silver-backed currency.

In this general understanding, a comprehensive economic reform, containing the solutions to the related problems of inflation, the budget deficit, high interest rates and the hidden threat of deflation follows directly from the analysis:

1) Reduce as rapidly and humanely as possible the federal budget deficit. But the president cannot currently control the deficit without using an indiscriminate, broad-brush veto of multibillion-dollar appropriations bills. The president needs the line-item veto he has requested and the legal forces of a constitutional amendment in order to require Congress to balance the budget annually in the future.

2) The economic-reform program also should include a renovation of the federal tax structure—a low, simple, fair flat tax. This would create compelling incentives for more work, saving, investment, new jobs and the production of new goods, and therefore tend to balance supply-and-demand conditions in the market through economic growth, without creating disincentives by raising tax rates. In truth, an authentic demand for a balanced budget and low interest rates can only mean a demand for raising tax revenues through rapid economic growth without inflation.

New Monetary Philosophy Needed

3) At the same time, the Fed must abandon its failed quantitative monetary targeting. A new Federal Reserve monetary philosophy must be adopted—one that will supply, at market rates, the new money and credit currently needed by small enterprises, farms and entrepreneurs for the profitable production of new goods and services. So long as new money is borrowed at market rates to create new goods and services, there can be no inflation. If the ratio of new goods to new credit stays approximately in balance over the long term, it does not matter how much new credit and money is created.

4) This new Fed target should be part of a domestic and international monetary reform designed to restore a gold-backed dollar.

We know that sustained economic growth and full employment require a long-term investment boom and the rebuilding of a competitive American economy. And that a long-term investment boom requires the means to finance it. To restore ample long-term bond markets at low, fixed interest rates, we must ensure the value of all future money payments to those willing to lend their savings for the long term. This means, by every careful study of history, a true and reliable monetary standard, and only a gold or silver-backed currency has been the honest money of history.

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