To end the Age of Financial Disorder,

Forward to a Modernized Gold Standard

By: Lewis E. Lehrman
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Thank you, James.
James and I have been together on a program of Monetary Reform, please believe me, for 35 years. As you can read in Grant's <u>and</u> you can see now, the campaign continues with James Grant the leader.

Now, let us turn to the present:

Between 2009 and 2010 we have experienced a major, emerging market equity and economic boom -- but at the very same time, sluggish growth in the United States. Foreign authorities are now reacting to inflation, raising interest rates, just as relative growth shifts to the U. S. I believe we will witness during this year, a Fed-fueled economic expansion, above consensus, in the United States. Why such a sluggish, then quickening sequence in the U.S.? Because, at first, the vast Fed credit creation of 2008 to 2010 could not be fully absorbed by the U.S. economy -- coming as it did, after wild panic and deep recession. However, the unparalleled Fed credit expansion, beginning in late 2008, did flood into U.S. stocks, bonds, and commodities. But the excess credit also went abroad, causing not only a fall in the dollar, but also the emerging market financial boom -- because the financial authorities abroad purchased the incoming flood of excess dollars against the creation of their local currencies -- the new money being put to work promptly, creating a rise in almost all financial claims in the developing world.

Today I should like to argue that here is little new in this latest four year panic-bust-new boom cycle, associated as all of these cycles have been, with the unstable post-war Bretton Woods monetary system, followed in 1971 by the termination of the last vestige of gold convertibility. - <u>After</u> <u>1971</u> the rise of the world dollar standard engirdled the globe.

Expansive Fed credit policy -- above all, Federal Reserve and foreign financing of the U.S. balance of payments deficit and the <u>government</u> <u>budget</u> <u>deficit</u> -- has been behind almost every boom and bust cycle since the end of World War II -- engineered often unwittingly by the combined operations of the Fed, foreign central banks, and the opaque workings of the official reserve currency system. First came the post-war Bretton Woods gold-exchange system, then after 1971, the disorder of floating-pegged exchange rates, both leading to an overvalued dollar and the diminution of our dominant manufacturing sector. These floating exchange rates have caused huge upward and downward currency moves, which re-price abruptly the entire productive machinery of all nations subject to the float, rendering whole economic sectors unprofitable, and thus steady long-term investment and output very difficult. Such underinvestment leads unavoidably to scarcity booms, fueled at the beginning by Fed subsidized credit to the bank and the Treasury. But many countries have pegged their currencies to an overvalued dollar in order to subsidize and sustain their export production machines -- the ancient practice of mercantilism.

It is obvious that this current Fed credit cycle, coming out of the bust, did quicken to life a major equity and commodity boom. But who will reasonably doubt that the ultimate source of the equity and commodity inflation is the Fed monetization of insolvent U.S. mortgage backed securities and the Treasury deficit. This outpouring of Federal Reserve credit at home then leaks abroad, to be absorbed by foreign governments, and monetized as official foreign exchange reserves. These foreign official dollar reserves are recycled into the market for U.S. Treasury securities, whereby they finance the perennial balance of payments deficit and the rising budget deficit. For example, in addition to the planned Fed purchases of 600 billion dollars of U.S. government securities in a mere eight months, foreign financial authorities have to date purchased, in total, at least $3.5 trillion dollars of U.S. government securities, against which these foreign central banks created new domestic money and credit -- the penultimate trigger of past booms and busts in their home countries. This foreign credit financing of the U.S. Treasury deficit comes in addition to the more than one trillion dollars of government securities purchased by the Fed against the issuance of new money and credit. With limitless financing available, we can foresee that the Treasury deficit will continue to expand -- so long as there is unrestrained Fed and foreign credit available. This is the infamous “deficit without tears.”

However, all of us must observe that U.S. economic policy causes not only financial effects, but also unstable and inequitable social effects. In a word, the monetary system has been a primary cause of the increasing inequality of wealth in American society. But first, let us ask what is the mechanism of Federal Reserve open market operations which, I believe, is at the epicenter of this social disorder -- inflation, speculation, boom, bust, and their consequences. Simplified, and focusing on today only, this is the sequence. In order to finance the government deficit, the Treasury now sells bills and bonds at a rate of about $120 billion a month, that is, about $1.5 trillion per year -- about equal to the present annual Treasury deficit. The Federal Reserve, the banking system, and foreign central banks purchase these Treasury bills and bonds against the issue of new money and credit. But, <u>during</u> <u>this</u> <u>same</u> <u>market</u> <u>period</u>, the newly created money to finance the U.S. government deficit, is <u>not</u> associated with the production, by the Treasury, of any new goods, new services, new equities. Thus, <u>during</u> <u>the</u> <u>market</u> <u>period</u> in which the Treasury spends the newly issued money, total monetary demand, or purchasing power, exceeds, in the same market period, the total value of the supply of goods, equities and services -- at prevailing prices. Prices <u>must</u> rise -- in the most recent period, equities and commodities. But some of the Fed created excess dollars go abroad, creating a boom in financial claims in emerging economies. However, if there is unemployed labor, prices will rise faster than wages. Then, of course, profits rise. Then new production kicks in. That is where we are now.

The cyclical expansion, financed by the Fed and the world dollar standard, is now underway. But the long term inflationary process can take a decade or more to produce its full general price level effects. For example, the booms and busts of the decade of the 70s followed from the explosive central bank and official reserve currency policies of the decade of the 60s. With them came the euphoria of suppressed U.S. inflation in the 60s. Then despair in the 70s.

Let us return to the markets of this very day.

In this inflationary process, bankers and speculators have been, and are, the first in line, along with the Treasury, to get the near zero interest credit from the Federal Reserve. They are, also, first to get bailed out with new Fed money. Then with the new money, as we have observed, they finance depressed stocks, bonds and commodities -- front running, as in the past, an <u>advertised</u> Fed created financial boom. For example, the Fed's most recent <u>marketing</u> plan <u>to</u> <u>raise</u> <u>equity</u> <u>prices</u>, with QE2, appeared late last year in the *Washington Post*. In each boom cycle, prices rise first for scarce and volatile goods, this time especially stocks, commodities, and financial claims, not least because they are relatively liquid vehicles for speculators, brokers, and banks. The bulls congratulate themselves. The lost tribe of the bears is decapitated. But in other credit cycles, the excess Fed created money will move into real estate, or internet stocks, or emerging market equities, or, into whichever sector, scarcity and romance entices investors and speculators with cheap, new Fed credit.

The gradual and insidious process of inflation is hidden <u>at first</u> from the vast majority of working people -- at home and abroad. For example, inflation is muted in the U.S., at the consumer price level, by high unemployment and unused production facilities -- both inherited from the last panic and bust -- also caused by monetary policy. Combined with falling real incomes of the average American household, consumer prices will be sticky in the present market period.

But over many inflation cycles, the social effects of financial disorder and undervalued currencies have brought about increasing inequality. The near-zero interest rates, now maintained by the Fed, have primarily benefitted preferred banks and their financial clients. A nimble financial class, in possession of cheap credit, can maneuver to protect itself against inflation. Euphoria, born of incipient inflation and credit fueled bull markets, takes over in the financial sector. Then it is advertised, worldwide, by bubble-vision.

Monetary reform is again put on the shelf. But the vast population of middle income professionals and workers, on salaries and wages, and those on fixed incomes and pensions, are impoverished by this very same volatile, inflationary process. Worse yet, average American savers, those on fixed or stable nominal incomes, will earn a negative return on their savings. Thus, they save less. Thus, new investment will once again come to depend increasingly on bank debt, leverage, and speculation. Inequitable access to cheap Fed credit was everywhere apparent during the government bailout of favored brokers and bankers in 2008 and 2009, while millions of not so nimble citizens were forced into bankruptcy. This ugly chapter is only the most recent in a very long century of disruption of the international monetary system.

Our era of financial disorder was actually inaugurated in 1914 by the onset of World War I. The Great War, as it was called, had brought to an end the preeminence of the classical European states system. It had decimated the flower of European youth. It had destroyed the European continent's industrial primacy. On the eve of the Great War came the end of the gold standard -- the monetary gyroscope of the Industrial Revolution and its extraordinary economic growth, the proven guarantor, also, of one hundred years of price stability. The general price level, almost literally, wound up at the same level in 1914, as it was, one century before.

With the onset of World War I, the Age of Inflation was upon us.

Strange it is today that an unhinged token, the paper dollar, is now the monetary standard of the most scientifically advanced global economy the world has ever known anchored as it is by global standards, for example, global telecommunications and accounting standards.

How and when did the international economy start down this road to the paper dollar standard? It was in 1922, at the little known, but pivotal post-World War I Monetary Conference of Genoa, that the gold-exchange standard had been officially embraced by the academic and political elites. It was here that the dollar and the pound were confirmed as official reserve currencies, that they might substitute for what was said to be a scarcity of gold. But there was no true scarcity, only overvalued national currencies -- overvaluation maintained despite the doubling of the general price level during World War I. Professor Jacques Rueff warned in the 1920s of the dangers of this flawed official reserve currency system, designed "in camera" by the experts supposedly to economize the true gold standard. The former central banker warned of the coming collapse of this newly rigged monetary system. It did collapse, in 1929-1931, with catastrophic effects. Rueff again predicted in 1960-61 that the Bretton Woods jerry-rigged dollar system, a post World War II form of the official reserve currency system, would collapse. In newspapers and books, Rueff predicted that the world would groan under the flood-weight of excess American dollars going abroad. During the 1950s and 1960s, he said that Federal Reserve credit policy, combined with the official reserve currency status of the dollar, would cause permanent U.S. balance of payments deficits and the tendency to constant Federal budget deficits. For, under the world dollar standard, these twin deficits would be financed, at home and abroad, by new central bank money and credit. In April of 1961, in Fortune magazine, he foretold the coming end of gold convertibility of the dollar -- unless there were a reform of the monetary system. His prescience was confirmed by President Nixon's suspension of convertibility in August of 1971.

Now, let us go for a moment to the booms and busts of the 1970s -- subsequent to the 1971 suspension of convertibility. It is in this period, we can see the future, in a glass darkly. In 1980 at the peak of a double digit inflation crisis, the gold price touched $850. At that time, Paul Volcker, chairman of the Federal Reserve, in similar words to the present Fed Chairman, declared that the gold market had little to do with the Fed's monetary policies. But unlike his predecessors, Volcker did act. Volcker engineered a draconian credit contraction, a 20% Fed Funds rate, 15% long-term U.S. Treasury rates, leading to near 11% national unemployment and a decline in inflation.

During this entire period, the important links between central bank policies, the rate of inflation, the variations in the money stock, and economic growth caused much debate among economists and experts. It is still generally thought by some neo-Keynesian and monetarist economists, and central bankers, that the quantity of money in circulation, the economic growth rate, and a stable price level can be directly coordinated by the commissars of central bank credit policy. May I now firmly say that, to the best of my knowledge, no one who believes this hypothesis, and, as an investor, has systematically acted on it, is any longer solvent. But I do confess, that the neo-Keynesian and monetarist quantity theories of money still hang on -- even if its academic practitioners in the market cannot. In the end, neo-Keynesian and monetarist economists at the Federal Reserve were required to accommodate to a reality in which, for example, during 1978, the quantity of money in Switzerland grew approximately 30%, while the price level was stable at 1%. In the United States, the quantity of money, M-1, grew in 1979 about 5% while the inflation rate rose 13%.

In sum, the inflation rate, the rate of economic growth, and the growth of the money stock, cannot be precisely coordinated by Federal Reserve manipulation of the money supply. What a central bank is not able to do, it must not try.

So, if the <u>problem</u> of the post-war monetary system has been extreme booms and busts -- an unstable world reserve currency, inflation and deflation, and incipient <u>currency wars</u> -- what is the solution? The historical and empirical data show that gold convertibility is <u>the least imperfect</u> regulator of general price stability <u>in the long run</u>. In monetary and economic policy, there is only one laboratory for experiment, the laboratory of empirical evidence in human economic history. Perfect stability is, of course, unattainable in human affairs -- except in a University classroom. But <u>blackboards</u> at the University of <u>Chicago</u> and at <u>Cambridge</u> University will not do, to sustain the social and economic order. The gold standard was <u>no</u> blackboard exercise, no mere mathematical symbol on the blackboard. It was an elegantly designed institutional set of monetary mechanisms -- carefully orchestrated over centuries of experience by merchants and bankers of great purpose -- who developed monetary convertibility into a supple and subtle set of integrated financial and credit institutions -- organized to facilitate <u>economic growth</u>, <u>job creation</u> for an increasing population, a <u>rising</u> standard of living, and a <u>stable</u> price level -- above all, to <u>maintain</u> a certain <u>social stability</u>, amidst the hurly burly of free economic institutions. These free market institutions were designed to mobilize the free price mechanism and the international monetary system in order to act as <u>the balance wheels</u> of rapid economic growth of an increasingly integrated world economy. International trade among different cultures, different national currencies, competitive nations, was firmly grounded, despite all culture and language differences, on a common monetary standard. All countries traded according to <u>one</u>, <u>objective</u> yardstick of value. Under the rules, <u>no one</u> should arbitrarily <u>depreciate</u> the yardstick, to 29 inches.

The world now tries to embrace global <u>standards</u> in accounting, telecommunications, and computers. For an even greater purpose, who will reasonably deny the world needs a common, monetary standard?

Therefore, in order to restore long-term international price stability, and a sustainable and equitable market for growing world trade, <u>the dollar and other key currencies must again be defined in law as a precise weight unit of gold</u> -- at a statutory convertibility rate which insures that nominal wage rates do not fall -- this stipulation necessary to avoid the unwitting deflations ensuing after World War I. Indeed, <u>nothing but gold convertibility</u>, <u>a true gold standard without</u>

official reserve currencies, will yield a real fiduciary monetary standard for the integrated world economy. Such a true fiduciary standard provides simultaneously all the necessary functions of money -- domestic and international -- that is, to say, a long-term store of value for saving, the stable means of exchange for trading, and the stable unit of measure by which to compare all other articles of wealth in the market. Like every standard of measurement -- the yardstick, the meter, the liter -- the monetary standard must be constant in order to maintain an equitable and growing economic order.

Only such a common, non-national monetary standard can rule out manipulated floating exchange rates -- themselves, the diabolical agents of predatory mercantilism. Despite all denials, undervalued currencies and currency depreciations of today, are, without a doubt, designed to subsidize exports, and to transfer unemployment to other nations, to beggar thy neighbor, and, by means of an undervalued currency, to gain share of market in manufactured, labor intensive, value-added, world traded goods. If these competitive depreciations and undervaluations are sustained, floating exchange rates, combined with the twin budget and trade deficits will, at regular intervals, blow up the world trading system. The gradual diminution of property rights will follow.

Unlike the paper dollar, created at will by the authorities of one country at zero marginal cost, the gold standard effectively puts control of the supply of money into the hands of a democratic people, because central bank excess creation of credit and paper money can be redeemed for gold by free people and businesses, both at home and abroad, at the fixed statutory convertibility price. If today we know that excess cash balances are the necessary cause of inflation, the monetary authorities under the gold standard are required by law to limit the creation of excess credit in order to preserve the guaranteed value of the currency. Such a straightforward but subtle mechanism causes the banking systems to bring the quantity of money in circulation into balance with the desire to hold it and to use it for productive purposes. Under the gold standard, there can be no sustained, extreme surfeit of excess cash balances. Thus, there can be no sustained, extreme inflation and deflation of the general price level. Wars may interrupt the constancy of the gold standard. But resumption is always availing.

In a few words, dollar convertibility to gold, a proven non-national global standard, is the solution. But dollar convertibility to gold must become a cooperative project of the major powers.

To accomplish this reform, the U.S. must lead: first, to announce future convertibility, on a date certain, of the U.S. dollar -- the dollar itself to be defined in statute as a weight unit of gold.

My research suggests that the convertibility price, during the present market interval, given the hierarchy of relative prices and the all-in costs of gold production, should approximate $2,000 per ounce. Any substantial delay will occasion a different estimate of the sustainable, convertibility price. Second, a new Bretton Woods conference must be convened to establish mutual gold convertibility of the currencies of the major powers. Third, the curse of official reserve currencies must be ruled out, while at the same time a consolidation of official dollar reserves must be organized -- into long-term debt, to be funded in the way Alexander Hamilton funded the volatile national and state debts at the birth of the American republic.

I believe a dollar as good as gold is the way out of this monetary maze. This is also the road to restoration of real and substantial American savings, the indispensible means to global competitiveness, without inflation. The gold standard is, above all, the global standard by which to restore America's financial self- respect, to regain its needful role as the equilibrium leader of a growing world economy.

Lewis E. Lehrman is Chairman of the Lehrman Institute.