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OPINION | COMMENTARY

Still Paying the Price of Keynesian Currency

Fundamental monetary reform—restoring gold reserves—would be a boon to the U.S. and world trade.



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Donald Trump has denounced giving President Obama trade-promotion authority on the grounds that trade deals do not address “currency manipulation,” which he claims is the reason “we get beaten in trade.” It is true that the international monetary system since 1971—when Richard Nixon ended the dollar’s convertibility to gold—has been corrupted, as in the 1930s, by countries devaluing their currency to boost their exports and economies.

But Mr. Trump and all the other presidential candidates must consider the appropriate and effective means necessary to correct the problem. That is fundamental monetary

reform—replacing official foreign-exchange reserves with gold reserves, and the restoration of all currencies as weights of gold at mutually agreed parities. In other words, stable exchange rates. Tariffs and other forms of protectionism are no solution. They invite retaliation, inhibit trade, and make things worse.

When the Federal Reserve was signed into law in 1913, the world trading system was underwritten by the balancing mechanism of the international gold standard. Measured by objective criteria—average price stability, strong economic growth, and minimum volatility in the consumer-price index and real economic growth—this was the best monetary system in both U.S. and world history.

That same year, however, John Maynard Keynes argued that whether a central bank holds reserves in gold or foreign exchange “is a matter of comparative indifference,” and an international conference in Genoa (1922) endorsed his proposal for “economizing on the use of gold by maintaining [official] reserves in the form of foreign balances,” namely pound-sterling and dollar IOUs. This replaced the gold standard with the “gold-exchange standard.”

The new standard was not for the better, as French economist and central banker Jacques Rueff explained a decade later. Once a country, France for example, accepts dollar-based claims, and not only gold money, as part of its reserves, its ability to expand credit is increased without a corresponding decrease in the U.S., as would have to be the case under a gold standard. This “duplication,” as Rueff called it, distorted the world economy: As we have shown elsewhere (including our recent books), the timing of expansion and contraction of foreign official dollar reserves exactly matched the 1920s boom in U.S. stock market prices, and the 1930s deflationary bust.

Rueff’s analysis of the gold-exchange standard explains a number of interconnected U.S. economic problems, including chronic inflation and deflation, the loss of federal budget discipline, and the steady decline in the U.S. international investment position.

First, as far back as we have data, U.S. consumer and housing price inflation have been determined by the World Dollar Base: U.S. currency in circulation and commercial bank reserves plus foreign official dollar liabilities. Its expansion and contraction helps to explain the timing and magnitudes of the Great Depression of the 1930s; the demise of the post-World War II Bretton Woods system in 1971, followed by a stock-market collapse and recession; and the housing bubble and oil-price spike to \$150 a barrel that triggered the Great Recession of 2007-09.

Second, the Federal Reserve's and foreign central banks' enormous expansion of "high-powered" dollar reserves by purchasing U.S. public debt (recently with "quantitative easing") has destroyed the incentive for federal budget discipline. The Constitution never had a balanced-budget amendment, because the constitutional metallic standard was a perfectly written balanced-budget amendment. The federal budget had an average 0.5% of GDP surplus during the periods of a metallic currency, but has had an average 2.7% of GDP deficit when the monetary system permitted the supply of inconvertible paper currency to increase significantly. State budgets have had deficits averaging 0.3% of GDP since 1979 while under the same conditions the federal deficit averaged 3.4%—not because state legislators are more virtuous than members of Congress or senators, but because states can't issue paper money.

Third, the U.S. international investment position declined from about positive 10% of GDP in 1976 to minus 40% of GDP in 2014, almost exactly matching the decline in U.S. net monetary reserves (official monetary reserves including gold, minus the official dollar reserves owed to foreign central banks). Yet the books of U.S. private residents stayed near balance with the rest of the world. The main problem, in short, is not lack of discipline by private Americans (who are subject to bankruptcy laws), but federal profligacy fed by basing the world monetary system on U.S. public debt.

Keynes, in short, was wrong to claim that a reserve currency, rather than gold reserves, was "a matter of comparative indifference." The world's reserve currency is now the U.S. dollar—but the world dollar standard has led to systemic and recurring problems for the U.S. economy and the world trading system.

The solution to America's economic problems is to be sought through fundamental monetary reform—not by protectionism, currency devaluation or nativism. We do not mean to fixate on Mr. Trump; other current presidential candidates, not to mention politicians throughout U.S. history, have proposed similarly mistaken policies.

Now, as in 1929 and 2008, Americans need real protection from economic harm. But this harm is not caused by immigrants or foreigners, but by the reserve currency scheme of John Maynard Keynes, and the currency wars which his scheme has caused for a century.

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