Conference on a Stable Dollar: Why We Need It and How to Achieve It
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We are gathered in this quiet hall, still focused on the world outside, engulfed as it is by gradual financial disintegration. Today, the economic crisis we endure is only the latest chapter in the century-long struggle to restore financial order -- the success (or failure) of which is inextricably bound up with American prosperity and the promise of the American way of life.

So it was, too, in the early twentieth century. The historical causes of the great world wars of the twentieth century <u>compel</u> me to believe that global financial disorder and competitive currency wars have again become the occasion for violent social disorder, revolutionary civil strife abroad, and alternating inflationary and deflationary consequences worldwide. It is well to remember that natural resource rivalry, monetary depreciations, mercantilism, and <u>war</u> <u>clouds</u> have appeared together from time immemorial. As a result, American national security risks are today high and rising.

Let us first review briefly how we got <u>here</u> -- into the maelstrom -- and then, how we get from here to <u>there</u> -- that is, to a stable monetary and fiscal order. (This is the theme of my new book.)

Between 2009 and 2011, all of you know we experienced an emerging market equity and economic boom -- but at the very same time, sluggish growth in the United States. Why such a sluggish sequence in the United States, despite 3.5 trillion dollars of Treasury and Federal Reserve subsidies to the banking cartel and favored corporations? The answer is: because the vast Fed credit creation of 2008 to 2011 could not be fully absorbed by the U.S. economy -- coming as it did after wild panic, deep recession, and deflation -- economic growth having been preempted by the drive for solvency and debt repayment.

It is too easy to forget that the newly created money by the Fed flooded primarily into U.S. stocks, bonds, and the dollarized world of commodities. But excess Federal Reserve credit also cascaded offshore, igniting not only a fall in the dollar, but the superboom in emerging markets. The transmission mechanism in both cases is the role of the dollar as the worldâ€™s primary reserve currency.

What is the reserve currency monetary mechanism which links unrestrained Fed credit expansion and a falling dollar to emerging market financial and economic booms? It is simply this: the financial authorities in the emerging countries, usually their central banks, purchase, by new issues of their local currencies, the incoming flood of Fed-created excess dollars. This they do to keep their currencies from rising and to accumulate dollar reserves. In emerging markets, the new local money is then put to work promptly -- first, of course, in liquid assets, creating a boom in all financial instruments and commodities, and then a boom in the local economy. This is an ineluctable arbitrage -- born of the world reserve currency system based on the dollar.

After the catastrophe of World War I the official reserve currency system was <u>first</u> adopted by the Great Powers in order to suppress the classical pre-war gold standard. The new system was known as the gold-exchange standard -- a perverse and profoundly flawed corruption of the pre-war classical or true gold standard. Thus, during the interwar period, the pound sterling and the dollar became the official reserve currencies -- used to settle payment imbalances -- in place of gold.

Equally perverse, a similar, dollar-based Bretton Woods gold-exchange system was adopted in 1944. After Nixonâ€™s suspension of convertibility in 1971 came the much-heralded floating-pegged exchange rate arrangements, which envelop the world to this very day. The key financial point is that both the Bretton

Woods system and the emergence of the world dollar standard, led to excess demand for the dollar to carry out international transactions and to accumulate official dollar reserves in foreign central banks in the form of ever-rising U.S. debt. Excess demand for the dollar, the dominant world currency -- about 65% of the worldâ€™s currency reserves; 85% of commodity and currency trading, and 65% of export invoicing -- this excess demand led to relative overvaluation of the dollar in world trade. The U.S. open market thus became the target for foreign export machines -- using undervalued currencies as their battering rams. Moreover, as countries abroad gained dollar reserves, the counterpart was ignored -- namely, increasing foreign held U.S. Treasury debt -- the form in which foreign countries held the bulk of their official reserves. The exorbitant privilege of the reserve currency, entailing excess demand for the dollar, which has led to relative overvaluation of the dollar in world trade, diminished our great manufacturing sector. Thus, the so-called exorbitant privilege gradually became, as it is today, an insupportable burden.

In a word, the reserve currency role of the dollar and unrestrained Federal Reserve credit policy cause manifold perverse financial effects. Above all, they permit the United States to finance its budget and balance of payments deficits by issuing, without limit, its own currency. This is the so-called exorbitant privilege of the dollar. Thus, the deficits have been perennial. And they will continue in the absence of profound monetary and fiscal reform. Even worse, they cause unstable and inequitable social effects -- the dollar-based world monetary system being a necessary cause of the increasing inequality of wealth in the American social order.

So let us also inquire what are the precise financial mechanisms set in motion by hyperactive Federal Reserve open market operations and the international settlement procedures under the reserve currency system. Both are at the epicenter of perennial balance of payments deficits and budget deficits -- engendering alternating inflation and deflation -- speculation, boom, bust, and their consequences.

Simplified, and focusing on QE1 and QE2, this is the sequence: -- In order to finance the government deficit, the Treasury sold bills and bonds at a rate of about $120 billion a month, that is, about $1.5 trillion per year -- as you can see, about equal to the annual budget deficit. But the Federal Reserve system, the world banking system, and foreign central banks purchase these Treasury bills and bonds -- against the issue of new money, or newly created domestic credit. Since 2008, the Fed has added over two trillions of U.S. government and mortgage-related securities to its portfolio. Foreign central banks now own at least 3.5 trillion of U.S. government securities, held in custody at the Federal Reserve. Now, consider that the Fed and foreign central bank purchases of U.S. government securities reduce their supply in the market, while at the same time increasing the quantity of money in circulation. But, the Fed created money -- used to finance the U.S. government deficit; combined with the new money issued by central banks abroad to purchase excess dollars in their banking systems -- is not associated in the same market period with the equal production of new goods and services.

Thus, during the global market period in which the Treasury and foreigners spend the newly issued central bank credit and money, total spending, or purchasing power, must exceed, in that same market period, the total value of available goods and services -- at prevailing prices. Of course, prices must rise when total demand exceeds the total value of supply. The result is secular inflation, punctuated by bouts of debt deflation.

This insidious process of monetary inflation is hidden from the vast majority of working people -- at home and abroad -- not least by a fictitious Consumer Price Index. But, the social effects of inflation, financial volatility, and the overvalued dollar have intensified inequality in America. The near-zero interest rates, maintained by the Fed today, subsidize the banker class and their financial clients. And so it is, that a nimble financial class, in possession of cheap credit, and close proximity to the Fed and Treasury, can maneuver to protect itself against inflation -- as well as to mitigate the subsequent effects of deflation. But the vast population of middle income professionals and workers -- on very lagging salaries and wages, as well as those on fixed incomes and pensions -- are impoverished by the very same volatile, inflationary and deflationary markets.

The same process goes on abroad. Worse yet, sensible and careful American workers and savers, especially those on fixed incomes, earn today a negative return on their savings. The prudent are dispossessed. The reckless are bailed out. Thereupon the tea party arrives, born of injustice. Without a comprehensive financial reform to increase true savings, new investment will once again come to depend increasingly on bank debt, leverage, and speculation with similar consequences.

Ours is but the latest ugly chapter in a century of inflation and financial disorder.

Where did the first chapter of the Age of Inflation and of official reserve currency systems begin?

The age of inflation was 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 European states system. It had decimated the flower of European youth. It had destroyed the European continentâ€™s industrial primacy. The belligerents in World War I had suspended the classical international gold standard.

This action was surely the unmistakable herald of a century of financial disorder. Indeed, the classical gold standard had been the monetary gyroscope of the Industrial Revolution, the pilot of its extraordinary, economic growth -- marked by one hundred years of general price stability. For example, under the classical gold standard the general price level in America wound up at the very same level in 1914 as in 1879, even at the same level it was in 1834.

Compare this to the 40-year period since 1971, the year President Nixon suspended dollar convertibility to gold. Adjusted for the CPI, the dollar has in fact lost about 85% of its purchasing power since 1971, 98% of its purchasing power in gold prices -- gold prices having a mere 3,000 year history to recommend them. Strange it is today that an unhinged token, the paper dollar, is now the unstable monetary standard of the most scientifically advanced global economy the world has ever known, a world increasingly dependent on reliable and trustworthy standards -- in technology, telecommunications, and accounting.

It was in 1922, at the post-World War I Monetary Conference at Genoa that the gold-exchange standard -- the first modern official reserve currency system -- was officially embraced by the Great Powers -- and by the international academic, banker, and political elites. It was at Genoa that the dollar and the pound were confirmed as official reserve currencies -- in order that these national currencies might substitute for gold as the means to settle residual balance of payments deficits. There was said to be a scarcity of gold. But there was no true gold scarcity, only overvalued national currencies relative to the pre-war gold price. For example, British currency overvaluation was maintained after World War I despite the vast rise of the general price level in national currencies during the Great War. The result was the deindustrialization of England, financial disorder, and during 1930 to 1931, the collapse of the official reserve currency system â€“ a primary cause of the Great Depression.

Let us now travel quickly to World War II.

Under the Bretton Woods System, after World War II, the U.S. financial authorities -- now backed up by 50% of world output -- embraced the Fischer-Keynesian theoretical conceit that the important links between central bank money, the rate of inflation, the variations in the money stock, and economic growth could be managed, or manipulated, by the mandarins at the Federal Reserve and the Treasury. It is still generally thought by academics and central bankers, and by neo-Keynesian and some monetarist economists that the quantity of money in circulation, the economic growth rate, the level of employment, and a stable price level can be controlled by the commissars of the central bank. May I now firmly say that, to the best of my knowledge, gained during 50 years in the markets, 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 academics and bureaucrats who embrace neo-Keynesian fiscal and credit theories, and monetarist quantity theories of money, still hang on. Long ago their theories were falsified by a reality in which, for example, during 1978, the quantity of money in Switzerland grew approximately 30%, while the price level was stable. In the United States, the quantity of money, M-1, grew in 1979 about 5% while the inflation rate rose 13% and the economy stagnated.

In a word, the empirical evidence shows that the inflation rate, the rate of economic growth, and the growth of the money stock, cannot be centrally controlled by Federal Reserve manipulation of the money supply. What a central bank cannot do, it must not try; or the people are made poor.

So, if the problem of the dollar-based, reserve currency system, combined with an unconstrained Federal Reserve credit policy, has been extreme booms and busts -- an unstable dollar, abrupt cycles of inflation and deflation, undeclared mercantilism and currency wars -- what is the solution?

The historical and empirical data show that currency convertibility to gold, without reserve currencies, is the least imperfect regulator of economic growth and general price stability in the long run. 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 blackboards at the University of Chicago and at Cambridge University will not do.

The classical gold standard of the Industrial Revolution -- that is, the true gold standard fully integrated with, and guiding, the modern credit super-structure -- was no blackboard exercise, no mere mathematical symbol drawn from a university monograph. The international gold standard was an elegantly designed set of institutional monetary and credit mechanisms. Carefully orchestrated during centuries of experience, merchants and bankers of great purpose integrated national currency convertibility to gold with a supple and subtle set of market-based credit institutions. During the industrial revolution these gold-based credit institutions facilitated price level stability and secular economic growth, different in scope and duration from any previous period of economic history.

Above all, in order to protect the least among us, to insure a certain social stability amidst the hurly burly of free economic institutions, the gold standard stabilized the value of wages of working people, that is, a dollar of stable purchasing power over the long run -- both for saving and investment -- and to provide for their familyâ€™s future needs and retirement.

So, if a stable dollar is the issue, what does the evidence tell us about the stability of the dollar throughout American history?

Let us summarize the data from my book. Applying two criteria divides the monetary history of the United States into distinct phases. We can compare the stability of different monetary regimes by examining the variation in the Consumer Price Index (as reconstructed back to 1800), using two simple measures: long-term CPI stability (measured by the annual average change from the beginning to the end of the period of each monetary standard) and short-term CPI volatility (measured by the standard deviation of annual CPI changes during the full period). What do we conclude? Weighting these two criteria equally, the classical gold standard from 1879-1914 provided the most stable dollar of all U.S. monetary regimes (as John Muellerâ€™s table shows in my Congressional testimony of March 17, 2011).

So, how do we get from here -- namely, the volatile paper dollar standard, the anarchy of floating exchange rates, and a perverse official reserve currency system -- to there, that is a stable dollar and stable exchange rates?

First, may I be so bold to recommend my book for this purpose? Even its five step program? (Not twelve steps, but five.)

Briefly, to restore long term price stability, stable exchange rates, and global economic growth, surely the United States must lead.

The dollar must again be defined in law as a precise weight unit of gold -- at a statutory convertibility rate which insures that nominal wage rates do not fall -- this latter stipulation necessary in order to avoid the deflations ensuing after World War I. Indeed, nothing but gold convertibility, a true gold standard without official reserve currencies, will yield a stable monetary standard for an integrated, growing, world economy -- based as it must be on stable exchange rates. Without strong global growth, nations will falter in succession, or succumb to beggar-thy-neighbor policies. For two generations, policy makers have ignored at their peril the proposition that free trade, without stable exchange rates, is a fantasy.

Thus, the United States must also lead by convening an international monetary conference to restore stable exchange rates.

Only stable exchange rates, based on a common, impartial, international monetary standard, can rule out manipulated, floating exchange rates and unconstrained central banks -- the agents of predatory mercantilism. Despite all political 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 competitive depreciations and undervaluations continue, floating exchange rates, combined with the U.S. twin budget and balance of payments deficits, will at regular intervals blow up the world financial system.

It is, I believe, incontestable that all the celebrated monetary gods of the twentieth century â€" originating in the conceits of twentieth century academics, bankers, economists, and politicians -- have failed. The central bankers and the Keynesians are, as the economic facts and circumstances suggest, emperors with no clothes.

But we do have available the tested, the proven monetary gyroscope which underwrote the extraordinary Industrial Revolution -- still awaiting its opportunity to be remobilized.

In my new book, The True Gold Standard: A Monetary Reform Plan Without Reserve Currencies, I chart a road to get from here -- a world of financial disorder, to there -- the remobilization of the gold standard. But I do emphasize that if the United States takes the lead to re-establish dollar convertibility to gold, the project should become a cooperative effort of the major powers.

To accomplish such a reform, first the United States announces future convertibility of the U.S. dollar -- the dollar itself to be defined in statute, on a date certain, as a weight unit of gold. Second, a new Bretton Woods conference must be convened to establish mutual gold convertibility of the currencies of the major powers -- the U.S., as leader, proceeding to convertibility unilaterally. Third, the curse of official reserve currencies born of the 1922 Genoa and 1944 Bretton Woods agreements must be ruled out -- gold alone designated to settle residual balance of payment deficits. At the same time a consolidation of official dollar reserves must be organized into long-term debt -- to be funded in the very way the Founders funded the volatile national and state debts at the birth of the American republic.

A sound and stable dollar -- the historic American monetary standard -- is the way out of the financial maze into which we have ensnared ourselves. If we have eyes to see and ears to hear, we know that where there is no vision, the people perish. The American Founders did give us, in the constitution, the necessary vision. Theirs was a sound doctrine. Article I, Section 8 of the U.S. Constitution ordains that Congress has the power â€œto coin moneyâ€ , to regulate foreign money, and to fix the standard of weights and measures. The

U.S. Constitution in Article I Section 10 further ordains that the states shall make nothing but gold and silver coin a legal tender. The founders intended that the constitutional American monetary standard should be a standard weight and measure of gold (or silver), gold having proved itself over a long testing period as the least imperfect monetary standard.

To you, my respected colleagues all, I say that in this crisis of economic policy, to restore the gold standard is the one essential thing: It was not only the cornerstone of American financial integrity and balanced budgets. It was also the trusted monetary standard by which America rose from 13 impoverished colonies by the sea to the leadership of the world.

It is a great lesson of American history that the classical, or the true gold standard, a dollar defined as a weight unit of precious metal, is in fact the constitutional American monetary standard. Let us uphold the constitution and thereby inaugurate a new industrial revolution, rebuild Americaâ€™s financial self- respect, and with our constitutional monetary standard, restore American financial integrity.

As with individuals, so it is with nationsâ€¦. Character is the all decisive. With the restoration of American Financial Integrity, we can restore American prosperity, and American leadership.