It's Not the Debt Ceiling – It's the Dollar

June 9, 2011

The missing issue of this Presidential election is monetary policy — America's need for a stable dollar. But massive Federal Reserve credit expansion, QE1 and QE2, has forced the volatile dollar down to such a depreciated level on the foreign exchanges that, absent QE3, a reversal of trend should appear with rising interest rates by the upcoming Presidential election.

Even more confusion pervades the public controversy over the future of the world dollar standard and its alternative — the true gold standard. The international debate focuses on the longevity of the dollar as the world's official reserve currency. The debate stems from two, recent, contradictory events. On the one hand, an unstable dollar, caused by the Federal Reserve credit contraction of 2005-2007, led to the deflation of 2007-2009. On the other hand, the steady rise of the gold price — also caused by the subsequent Fed expansion of QE1 and QE2 — has signaled the threat of inflation. The painful economic consequences of alternating deflation and inflation have refocused the historic American monetary debate. Americans must choose between paper money and gold. The choice will be either: (1) floating paper currencies mixed with pegged exchange rates for key currencies — such as a fixed link between the paper dollar and the paper Euro; or (2) on the other hand, a non-national, neutral American monetary standard such as gold, i.e. a dollar defined in statute by a stable, fixed weight of gold.

To choose the gold standard and a stable dollar entails an American self-denying ordinance by which to reject the privilege and the burden of the official reserve currency role of the dollar. To choose floating paper currencies with a pegged dollar-Euro exchange means continued systemic inflation and deflation, caused by unconstrained Federal Reserve and foreign central bank manipulation of the official dollar reserve system.

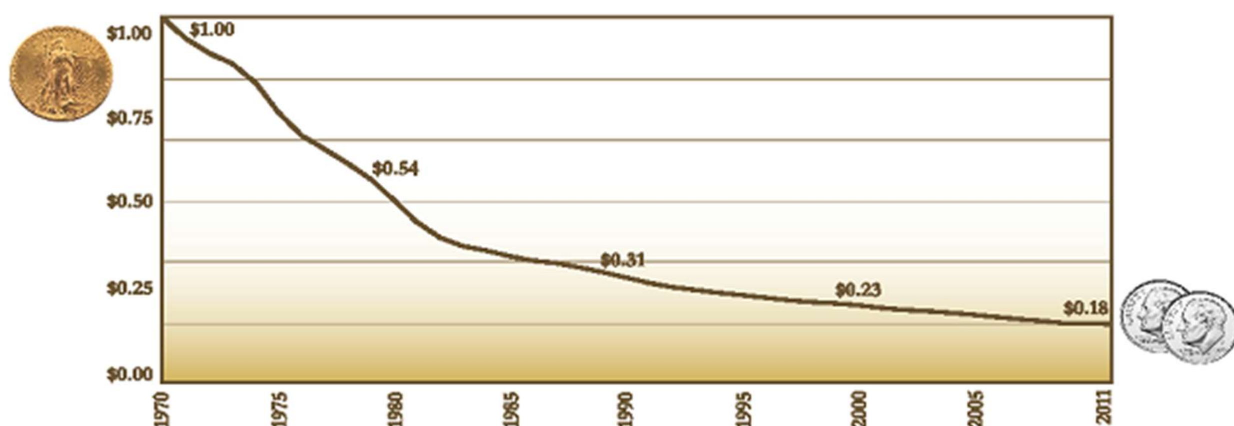
Dollar instability has engendered a near-universal loss of confidence in the world dollar standard. But there is no equally liquid currency alternative for national reserves. Two generations of collapsing pegged exchange rates and unhinged floating currencies have turned trust in official dollar reserves into mistrust and contempt, not least because dollar volatility and near-zero interest rates primarily benefit the subsidized bankers and Wall Street speculators. It is their lobby that welcomes near zero interest rates and the profit-making volatility of speculative markets — the very same volatility that deranges sound, long-term business planning and destroys the savings of working families.

A world standard of monetary measurement that is extremely unstable is no trustworthy standard at all. Take an example from uniform weights and measures, such as the yardstick, which is defined everywhere as 36". All contracts made according to such a standard of measure are based on the agreed definition of the yardstick and thus rely on the stability of the standard. No government agency, no person, has the authority to manipulate the yardstick and to manage it toward 33" tomorrow, 39" next year. The economic consequences of such arbitrary volatility would be enough to deconstruct all industries that depend on a stable standard of measure. Floating exchange rates are like floating yardsticks. Floating exchange rates abruptly distort entire national economies, radically repricing in world trade the value of national labor and national factors of production, thereby forestalling investment and inducing intermittent inflation and deflation — boom, panic, recession, and unemployment.

Given the instability of the dollar, the once-trusted measuring rod of value in world trade, a single question should dominate the present monetary debates: Does a dollar convertible to gold at a fixed price, i.e., a dollar defined in law as a weight unit of gold, rule out systemic inflation and deflation better than the Fed manipulated, inconvertible paper and credit-based dollar of today? The answer to this question, given the historical evidence, is yes. (See Table I and discussion below.) Can any proposed further pegging of key currencies produce anything but more pegged currency financial crises of the kind we have experienced in the past? These crises include the 1971 collapse of the Bretton Woods dollar exchange rates pegged to European currencies, followed by a decade of stagflation; the collapse of pegged European currency exchange rates

before the onset of the Euro in 1999; the near total collapse in 1996-2000 of pegged dollar exchange rates in Asia, along with the collapse of the Asian economies and other emerging economies. Moreover, the pegged undervalued Chinese-American exchange rate has helped to deindustrialize America and to encourage mercantilism — generating inflation in both countries. These are but four profound examples of the consequences of floating and pegged currency exchange rates that still orbit unpredictably around the unstable world dollar standard.

Ultimately, America will choose either dollar convertibility to gold at a fixed price, or continue with the Fed run paper-credit dollar that has lost 80% of its purchasing power since 1970 (see Graph I).



Graph I: The Dollar Deflated by the CPI. See Testimony, Lewis E. Lehrman, March 17, 2011 before Congress.

On the basis of experience and evidence, Americans should make this choice. Reviewing the history of American monetary standards since the Coinage Act of 1792, an act which established the gold and silver monetary standards at the Founding of America, the evidence suggests that the classical gold standard is the least imperfect American monetary standard of our history (see Table I).

U.S. Consumer Price Index, Long-term stability and short-term volatility, By period and monetary system: 1800–2009	Long-run stability (average annual change)	Short-run volatility (standard deviation annual change)	Memo: Maximum price change (High vs. low)	Stability rank (weighing both criteria equally)
1800–1834: Domestic silver standard (interrupted 1812–17 by domestic paper standard)	-1.5%	5.2%	76%	4
1834–1861: Domestic gold standard	-0.4%	3.5%	36%	2
1862–1879: Domestic paper standard	+0.1%	8.8%	74%	3
1879–1914: International gold standard	+0.2%	2.2%	20%	1
1914–1944: Interwar international gold-dollar-sterling standard	+1.9%	7.2%	99%	5
1944–1971: Bretton Woods international gold-dollar standard	+3.1%	3.1%	130%	4
1971–2009: International paper dollar standard (1971–1981 1981–2009)	+4.5% (+8.5%) (+3.1%)	2.8% (+2.7%) (+1.2%)	432% (125%) (137%)	4

Table I: See John D. Mueller, Redeeming Economics (ISI Books, 2010)

In a word, over the long run the gold standard produces the most stable dollar. This stability was the key to long-term savings and long-term investment, which underwrote the unprecedented industrial revolution and economic growth in America of the 19th century.

Of course, no monetary system can be flawless in the world of human affairs. But empirical evidence of two hundred years of American monetary history shows that the true (or classical) gold standard has the least imperfect record as a stable monetary standard, because the dollar convertible to gold acted as the stable gyroscope of rapid economic growth.

Neither the unstable, pegged exchange rate system of the 1920s, based on sterling and the dollar; nor the crisis prone, dollar-based, post-World War II Bretton Woods pegged-exchange rate system; nor especially the volatile floating-pegged dollar system of the past forty years — none of these floating and pegged exchange rate arrangements measure up, by empirical stability tests, to the classical gold standard period of American history (as Table I shows). Both American and modern history also suggest that monetary systems based on mutually convertible currencies to gold produce the most stable international price level over the long run. This is so because the classical gold standard requires prompt adjustment and settlement of deficits and debt. Indeed, the institutional discipline of gold convertibility, without reserve currencies, limits inflationary U.S. current account deficits and endless federal deficit spending — both financed by the Federal Reserve and foreign central banks which monetize the flood of dollars arising from these twin deficits.

My colleague, John Mueller, and I have often recommended Table I as some of the evidence for the superior stability of the gold dollar. The data show that the stability of the U.S. dollar has varied widely in its history. This variation is explained by two factors: (1) the monetary standard chosen for the dollar, and (2) whether other countries have simultaneously monetized the dollar, embracing therefore the world dollar standard, and used securities payable in dollars, as their official reserves — the essence of the official reserve currency system of today.

The United States has alternated between two kinds of standard money: inconvertible paper money and some precious metal (silver and gold). The dollar was an inconvertible paper money during and after the Revolutionary War (1776-92), the War of 1812 (1812-17), the Civil War (1862-79), and again from 1971 to the present. In 1792-1812 and 1817-34, the gold eagle was standard money, but the dollar in circulation was a weight of silver. The circulating dollar was a defined weight of gold in 1834-61 and 1879-1971. The dollar was not used by foreign monetary authorities as an official monetary reserve asset before 1913, but the dollar has been an official "reserve currency" for many countries since World War I, and for most countries since 1944, especially since the end of Bretton Woods in 1971.

Applying these two criteria divides the monetary history of the United States into distinct phases. We can compare the stability of these monetary regimes by examining the variation in the Consumer Price Index (as reconstructed back to 1800) by two simple measures: long-term CPI stability (measured by the annual average change from beginning to end of the period of each monetary standard) and short-term CPI volatility (measured by the standard deviation of annual CPI changes during the period). Weighting these criteria equally, the classical gold standard from 1879-1914 was the most stable of all U.S. monetary regimes (Table I).

As Table I suggests, the fundamental purpose of the true gold standard was to establish a stable dollar over the long run, as it did for almost a century before 1914. Indeed, under the classical gold standard, the American general price level rested at almost the exact same point in 1913 as it did in 1879 — despite the enormous economic growth of the industrial revolution during this period. Compare this record with the 80% paper dollar depreciation, during a similar length of years (Graph I).

The fundamental monetary issue of our time is not only whether the gold price is rising or falling, nor whether the dollar is falling or rising, nor even that the Fed produces both inflations and deflations. Instead, the key political and economic problem is the world financial disorder of the dollar, giving rise globally to manias, panic and bust, deflation and inflation — even unemployment mixed with Fed created financial booms.

What are the institutional monetary arrangements by which to mitigate this dollar disorder and to establish a reasonably stable American monetary standard? It is no mitigation to forecast, as some do, above consensus economic growth in 2011 and 2012; for as in the past, it will be but a brief period of euphoria for all but the unemployed. The question remains, how does America establish a stable dollar for the long run?

The empirical data of Table I recommends the classical gold standard, the least imperfect American monetary standard of American history.