ON THE OCCASION OF THE 100TH ANNIVERSARY OF THE BIRTH OF JACQUES RUEFF

Address by
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at the

PARLIAMENT OF FRANCE
(Assemble Nationale)

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Distinguished Leaders of France:

In what I <u>now</u> say to <u>you</u>, I draw from the speeches, the writings, and the letters of the greatest economist of the twentieth century. Your courtesy may require you to hear politely the words <u>I</u> now speak. But I beg you to believe me, that all the arguments I shall make in your presence are distilled from the wisdom of the master himself. The ideas I set before you originate in the proven genius of an extraordinary teacher, a selfless servant of the French people, and a peerless citizen of the world -- in the words of General de Gaulle -- "une poète de finance."

I speak of Jacques Rueff.

As a soldier of France, no one knew better than Jacques Rueff that World War I had brought to an end the preeminence of the classical European states system; that it had decimated the flower of European youth; that it had destroyed the European continent's industrial productivity. No less ominously, on the eve of the Great war, the gold standard – the gyroscope of the Industrial Revolution, the proven guarantor of one hundred years of price stability, the common currency of the world trading system – this precious institution of commercial civilization was suspended by the belligerents.

The Age of Inflation was upon us.

The overthrow of the historic money of commercial civilization, the gold standard, led, during the next decade, to the great inflations in France, Germany, and Russia. The ensuing convulsions of the social order, the rise of the speculator class, the obliteration of the savings of the laboring and middle classes on fixed incomes, led directly to the rise of Bolshevism, Fascism, and Nazism – linked, as they were, to floating European currencies, perennial budgetary and balance of payments deficits, central bank money printing, currency wars and the neo-mercantilism they engendered.

Today, three quarters of a century later (1996), one observes -- at home and abroad -- the fluctuations of the floating dollar, the unpredictable effects of its variations, the abject failure to rehabilitate the dollar's declining reputation. Strange it is that an unhinged token, the paper dollar, is now the monetary standard of the most scientifically advanced global economy the world has ever known.

In America, the insidious destruction of its historic currency, the gold dollar, got underway in 1922 during the inter-war experiment with the gold-exchange standard and the dollar's new official reserve currency role. It must be remembered that World War I had caused the price level almost to double. Britain and America tried to maintain the pre-war dollar-gold, sterling-gold parities. The official reserve currency roles of the convertible pound and dollar, born of the gold-exchange standard, collapsed in the Great Depression and so did the official foreign exchange reserves of the developed world – which helped to cause and to intensify the depression. Franklin Roosevelt in 1934 reduced the value of the dollar by raising the price of gold from $20 to $35 per ounce, believing the change to be a necessary adjustment to the post World War I price level rise.

But it must be emphasized that it was twelve years earlier, in 1922, at the little known but pivotal Monetary Conference of Genoa, that the unstable gold-exchange standard had been officially embraced by the European financial authorities. It was here that the dollar and the pound were first confirmed as official reserve currencies to supplement what was said to be a scarcity of gold. For those of you who remember his writings, Jacques Rueff warned in the 1920s of the dangers of the Genoa gold-exchange system and, again, predicted in 1960-61 that the Bretton Woods system, a post-World War II gold-exchange standard, flawed as it was by the same official reserve currency contagion of the 1920s, would soon groan, under the flood weight of excess American dollars going abroad. Rueff in the 1950s and 1960s forecast permanent U.S. balance of payments deficits and the tendency to constant budget deficits, and ultimate suspension of dollar convertibility to gold. After World War II, he saw that because the United States was the undisputed hegemonic military and economic power of the free world, foreign governments and central banks, in exchange for these military services and other subsidies rendered, would for a while continue to purchase, (sometimes to protect their export industries,) excess dollars on the foreign exchanges against the creation of their own monies. This was the inevitable result of the dollar's official reserve currency status. But these dollars, originating in the U.S. balance of payments and budget deficits, were then redeposited by foreign governments in the New York dollar market which led to inflation in the U.S., and inflation in its European and Asian protectorates which were absorbing the excess dollars. Incredibly, during this same period, the International Monetary Fund authorities had the audacity to advocate the creation of Special Drawing Rights, SDRs, so-called "paper gold," invented, as International Monetary Fund officials said, to avoid a "potential liquidity shortage." At that very moment, the world was awash in dollars, in the midst of perennial dollar and exchange rate crises. Jacques Rueff casually remarked to Le Monde that the fabrication of these SDRs by the International Monetary Fund would be as gratuitous as "irrigation plans implemented during the flood."

The dénouement of post-war financial history came at the Ides of March, in 1968, when President Johnson suspended the London Gold Pool and, mercifully, abdicated his candidacy for reelection. And so after a few more disabling years, Bretton Woods expired on August 15, 1971. The truth is that Monetarists and Keynesians sought <u>not</u> to reform Bretton Woods, as the gold standard reform of President DeGaulle and Jacques Rueff did, but <u>rather</u> to demolish it. The true gold standard, indeed any metallic currency basis, was passé among the cognoscenti. I shall give you just one example of the obtuseness of the political class, which happened at the height of a major dollar crisis. A friend of Jacques Rueff, the renowned American banker and policy intellectual, Henry Reuss, Chairman of the Banking and Currency Committee of the United States House of Representatives, went so far as to predict in <u>The New York Times</u>, with great confidence and even greater fanfare, that when gold was demonetized, it would fall from $35 to $6 per ounce. (I am not sure whether Congressman Reuss ever covered his short at $800 per ounce in 1980.)

President Nixon, a self-described <u>conservative</u>, succeeded President Johnson and was gradually converted to Keynesian economics by so-called conservative academic advisers, led by Prof. Herbert Stein. Mr. Nixon had also absorbed some of the teachings of the MonetaristSchool from his friend Milton Friedman -- who embraced the expediency of floating exchange rates and central bank manipulation and the targeting of the money stock. Thus it was no accident that the exchange rate crises continued, and on August 15, 1971, after one more major dollar crisis, Nixon defaulted at the gold window of the western world, declaring that "we are all Keynesians now." In 1972, Nixon, a republican, so-called free market President, imposed the first peacetime wage and price controls in American history – encouraged by some of the famous "conservative" advisers of the era.

In President Nixon's decision of August 1971, the last vestige of monetary convertibility to gold, the final trace of an international common currency, binding together the civilized nations of the West, had been unilaterally abrogated by the military leader of the free world.

Ten years later at the peak of another inflation crisis, the gold price touched $850. At the time, Paul Volcker, chairman of the Federal Reserve declared that the gold market was going its own way and had little to do with the Fed's monetary policies. The gold market is but "a side show," added Professor Wallich, a prominent Federal Reserve Governor. Secretary of the Treasury William Miller, who had been selling United States gold at about $200 in 1978, announced solemnly that the Treasury would now no longer sell American gold. Presumably Secretary Miller, an aerospace executive, meant that whereas, more than one-half the vast American gold stock had been a clever sale, liquidated at prices ranging between $35 and $250 per ounce -- now, in the manner of the trend follower, the Secretary of the Treasury Miller earnestly suggested that gold was a "strong hold" at $800 per ounce.

On January 18, 1980, Henry Wallich, a former Yale Economics professor, explained Federal Reserve monetarist policies in an article appearing in the Journal of Commerce:

> "The core of Federal Reserve…. measures," basing "control upon the supply of bank reserves," he said, "gives the Federal Reserve a firmer grip on the growth of monetary aggregates ..."

Subsequent events showed, the Federal Reserve promptly lost control of the monetary aggregates. The bank prime rate rose to 21%. As all of Jacques Rueff's experience as a central banker had taught him, what his monetary theory and his econometrics demonstrated was, in fact, that no central bank, not even the mighty Federal Reserve, can determine the quantity of bank reserves or the quantity of money in circulation -- all conceits to the contrary notwithstanding. The central bank may influence indirectly the money stock; but the central bank cannot determine its amount. In a free society, only the money users -- consumers and producers in the market -- can determine the money they desire to hold. It is consumers and producers in the market who desire and decide to hold and to vary the currency and bank deposits they wish to keep; it is central banks and commercial banks which supply them.

During the past twenty-five years, the important links between central bank policies, the rate of inflation, and the variations in the money stock have caused much debate among the experts. It is still generally agreed by neo-Keynesian and some monetarist economists and central bankers that the quantity of money in circulation, and economic growth, and the rate of inflation can be directly coordinated by 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 systemically acted on it in the market, is any longer solvent. But I do confess, that the neo-Keynesian and monetarist quantity theory of money still hangs on -- even if its practitioners in the market cannot. But the economists at the Federal Reserve have been 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 rose only 1%. Indeed in 1979, the quantity of money, M-1, grew about 5% in the United States while the inflation rate rose 13%.

If then, a central bank cannot determine the quantity of money in circulation, what, in Rueffian monetary policy, can a central bank realistically do? To conduct operations of the central bank, there must be a target. If the target is both price stability and the quantity of money in circulation, one must know, among other things, not only the magnitude of the desired supply of money, but also the precise volume of the future demand for money in the market -- such that the twain shall meet. It is true that commercial banks supply cash balances, but individuals and businesses -- the users of money -- generate the decisions to hold and spend these cash balances. Thus, the Federal Reserve must have providential omniscience to calculate correctly, on a daily or weekly basis, the total demand for money -- assuming the Fed could gather totally reliable statistical information -- which it cannot; and even if the Fed's definitions of the monetary aggregates were constant -- which they are not.

Jacques Rueff, himself the Deputy Governor of the Bank of France, clarified this fundamental problem in the form of an axiom: -- Because the money stock cannot be determined by the Federal Reserve Bank, nor can it determine a constant rate of inflation, the monetary policy of the central bank must not be to target the money supply or the rate of inflation. The Federal Reserve Bank simply cannot determine accurately the manifold decisions to hold money for individual and corporate purposes in order to make necessary payments and to hold precautionary balances. Neither, may I say, with respect, can the leaders of the great Bundesbank; nor even the geniuses at the Banque de France.

But, if the true goal of the central bank were long run stability of the general price level, the operating target of monetary policy at the central bank must be simply to influence the supply of cash balances in the market, such that they tend to equal the level of desired cash balances in the market. To attain this goal, the central bank must abandon open market operations and simply hold the discount rate, or the rediscount rate, above the market rate – when, for example, the price level is rising -- providing money and credit only at an interest rate which is not an incentive to create new credit and money. Indeed, if the target of monetary policy is long run price stability, the Central Bank must supply bank reserves and currency only in the amount which is equal to the desire to hold them in the market. For if the supply of cash balances is approximately equal to the demand for them, the price level must tend toward stability. If there are no excess cash balances, there can be no excess demand, and, thus, there can be no inflation.

Professor Rueff shows in "l'Ordre Social" why an effective central bank policy must reject open market operations. He shows further that, in order to rule out inflation, and unlimited government spending, the government Treasury must be required by law to finance its cash needs, including a sometimes-limited Treasury deficit, in the market for savings, away from the banks. That is, a government Treasury, in deficit, must be denied the privilege of access to new money and credit at the central bank and commercial banks, in order also to deny the government the pernicious privilege of making a demand in the market without making a supply – the ultimate cause of inflation. This exorbitant privilege is a necessary cause of persistent inflation. It is also a necessary cause of unlimited budget deficits and bloated big government.

You can see that the monetary theory and policy of Jacques Rueff finally does come to grips with, indeed it modifies, the famous Law of Markets of Jean Baptiste Say, building of course on Say's insights, but perfecting the flawed Quantity Theory of Money. Jacques Rueff reformulated the quantity theory of money, definitively, in the following proposition: aggregate demand is equal to the value of aggregate supply, augmented (+/-) by the difference between the variations, during the same market period, in the quantity of money in circulation and the aggregate cash balances desired. This is a central theorem of Rueffian monetary economics. Rueff demonstrated that Say's law does work, namely, that supply tends to equal demand, provided, however, that the market for cash balances must tend toward equilibrium. Any monetary system, any central bank, which does not reinforce this tendency toward equilibrium in the market for cash balances destroys the first law of markets, namely, overall balance between supply and demand, the necessary condition for limiting inflation and deflation.

Now it is conventional wisdom that Milton Freedman and the Monetarists try to regulate the growth of the total quantity of money through a so-called money stock rule designed to constrain the central bank monopoly over the currency issue. In practice, the central bank has failed and will fail to succeed with such a flawed, academic, and impractical rule. But the much simpler, more reliable, market-biased technique, proven in the laboratory of history, as Professor Rueff demonstrated, would be to make the value of a unit of money equal to a weight unit of gold, in order to regulate, according to market rules, the same central bank monopoly. But academics have argued for a century that a monetary "regulator", such as gold money, absorbs too much real resources -- by virtue of the laborious process of gold production-- and is therefore, in social and economic terms, too costly.

Whatever the minor incremental economic cost of a convertible currency, it is a superior stabilizer, as all occidental history shows. The empirical data also show that it is a more efficient regulator of price stability in the long run. This is no accident. The gold standard was no mere symbol. It was an elegantly designed monetary mechanism -- carefully orchestrated over centuries by wise men of great purpose -- who developed convertibility into a supple and subtle set of integrated financial institutions organized to facilitate rapid growth and a stable price level of free economic institutions. Thus did the international gold standard become a gyroscope of rapid economic growth during the industrial revolution. Who can deny that a generation of floating exchange rates, and discretionary central banking, have burdened the world with immense inflation costs, orders of magnitude greater than the comparatively modest cost of mining gold.

Therefore, in order to bring about international price stability and long run stability in the global market for cash balances, the dollar and other key currencies should be defined in law as equal to a weight unit of gold -- at a statutory convertibility rate which insures that nominal wage rates do not fall. Indeed, nothing but gold convertibility will yield a real fiduciary currency, un vrai droit, as Professor Rueff called it.

As we approach the millennium, the world requires, indeed, it is begging world leaders to create a real monetary standard to deal with the monetary disorder of undervalued, pegged, currencies and manipulated floating exchange rates -- the diabolical agents of an invisible, predatory mercantilism. Despite all denials, the currency depreciations of today, are, without a doubt, designed to transfer unemployment to one's neighbor and, by means of undervalued currency, to gain share of market in manufactured, labor intensive, value-added, world traded goods. If these depreciations and undervaluations are sustained, floating exchange rates will, at regular intervals, blow up the world trading system. Great booms and busts, inflation and deflation must ensue.

To head off the mercantilism of present floating exchange rates, and the exchange rate disorders caused by official dollar reserves, an international monetary conference is indispensable. The present high rates of unemployment and perverse trade effects, associated with floating exchange rates, require an efficient and lasting international monetary reform. A European Monetary Union may be necessary; but it is not sufficient.

Now we see clearly, what before we saw in a glass darkly -- the dollar's official reserve-currency status still gives an exorbitant privilege to the United States. Jacques Rueff spoke of American "deficits without tears," because the American budget deficit and balance-of-payments deficits were -- they still are -- almost automatically financed by the Federal Reserve and the reserve-currency system -- through the voluntary (or coerced) buildup of dollar balances in the official reserves of foreign governments. These official dollar reserves were, and still are, immediately invested by foreign authorities, directly or indirectly, in the dollar market for United States securities, thus giving back to the United States, at subsidized rates, the dollars previously sent abroad as a result of the persistent United States balance-of-payments deficit and budget deficits. To describe this awesome absurdity, Jacques Rueff invoked the metaphor of an overworked tailor to the King, yoked permanently to fictitious credit payments by His Majesty's unrequited promissory notes.

There is not sufficient time to dwell on all the intricacies of the superior efficacy of the balance-of-payments adjustment mechanism grounded in domestic and international convertibility to gold. But it can, I think, be shown that, in all cases, currency convertibility to gold is the least imperfect monetary mechanism, both in theory and in practice, by which to maintain global trade and financial balance, a reasonably stable price level, and to insure budgetary equilibrium. This proposition has been proven in the only laboratory by which to test monetary theory -- namely, the general history of monetary policy under paper and metallic regimes, and, in particular, the history of the international gold standard, 1813-1914.

Whereas, by contrast, when one country's currency -- the dollar reserve currency of today -- is used to settle international payments, the international adjustment and settlement mechanism is jammed -- for <u>that</u> country -- <u>and</u> for the world. This is no abstract notion. During the past 12 months alone, (1996) 100 billion dollars of foreign exchange reserves have been accumulated by foreign governments which have been directly invested in U.S. Treasury securities held in custody at the New York Federal Reserve Bank -- thus financing the U.S. current account and U.S. budget deficits.

It is essential to understand the nature of this ongoing process of currency degradation -- because the dollar's reserve-currency role in financing the U.S budget and balance of payments deficits did not end with the breakdown of Bretton Woods in 1971.

The anomaly of perennial U.S. budget and balance of payments deficits still persist because there is, today, <u>no</u> <u>efficient</u> <u>international</u> <u>monetary</u> <u>mechanism</u> to forestall the United States deficits. Indeed, Professor Rueff argued over and over that if the official reserve role of the dollar, i.e. the dollar standard, were abolished, and convertibility restored, the immense U.S. budget and current account deficits must end -- a blessing not only for the U.S., but for the whole world.

The reality behind the “twin deficits” is simply this: the greater and more permanent the official reserve currency facilities for financing the United States budget and trade deficits, the greater will be the deficits and the growth of the U.S. Federal government. All administrative and statutory attempts to end the United States deficits have proved futile, and will prove futile, until the crucial underlying flaw -- namely the absence of an efficient international monetary mechanism -- is remedied by international monetary reform and a new international gold standard.

That is why Professor Rueff and President De Gaulle, in the 1960s, called for a new international monetary system which we now need, above all, to solve the additional problems of manipulated floating exchange rates inaugurated in 1971-1973.

Broadly speaking, three essential steps toward convertibility could be taken by French, American and other great power authorities.

(1) President Chirac should request the Bank of France to cooperate with, say, the Group of Five to stabilize the value of key currencies at levels consistent with balanced international trade among national currency areas. That is to say, exchange rates should be stabilized at approximately their longer-term purchasing power parities, based largely upon comparative unit labor costs of standardized world traded goods. To do this, indexes of purchasing power can be agreed upon within the Group of Five and, thus, an optimum and fair value determined for convertibility of national currencies. But how should the value of the gold monetary standard be determined? The optimum value of the gold parity should reflect a gold price correctly positioned within the hierarchy of all prices; that is, a price proportional to its underlying cost of production. This dollar price of gold, or more properly, the defined gold weight of the monetary standard, must be set above the average of the marginal costs of production of gold mines operating throughout the world. This price would provide for steady output of the gold monetary base (about an average of 1.5% to 2% increase per year over a long run, as centuries of available monetary statistics show). Such a gold price would also prevent any decline in the average level of nominal wages -- avoiding, for example, the British problem of gratuitous underemployment in the 1920's caused by an overvalued pound. <u>Under existing conditions</u>, <u>during the present market period</u>, <u>I have estimated</u>, <u>based on empirical data, that the optimum convertibility price of gold is not less than $600</u> per ounce. (1996)

(2) President Chirac should recommend to the Group of Ten, that convertibility regimes take effect at a fixed date in the future, perhaps <u>three</u> years from <u>now</u>, just after the European monetary union is created. The gold dollar and the European gold currencies should become the monetary standards of Europe, of the United States, of the world, just as the gold standard should again become the common money of world trade and finance.

Then, to simplify, if the United States government creates too many or too few dollars, under conditions of gold convertibility, it will be forced in a relatively short period to change, because market participants will exchange paper dollars for gold, or gold for paper, to bring the quantity of money in circulation into balance with the desire to hold these dollar cash balances.

Moreover, domestic monetary reform in the United States, France, and elsewhere, would also mean that only gold and domestic, non-government, short-term self-liquidating securities, convertible at maturity to gold, could serve as collateral, or backing for new currency issues such as, for example, Federal Reserve Notes or French bank notes. Gold coins, minted according to the statutory standard, should be generally circulated in the market to be held by all working people, so as to guarantee that neither the monetary standard, nor the wages and savings of working people, will be arbitrarily abridged by inflationary governments. Such a regime, among other purposes, eliminates the advantage of clever speculators over middle income people and those on fixed incomes.

(3) The new international monetary system would rule out, by treaty, the official reserve currencies which so plagued the entire financial history of the Twentieth Century. Existing official dollar-reserves could be consolidated and refunded and then gradually amortized over the long term, even to a certain extent refunded through the rise of the official value of gold above the last official revaluation ($42.22 per ounce).

This was and is the Rueff plan, brought up to date to deal with the exigencies of 1996. May I say, it is an intellectual scandal that such a solution is today regarded as impractical. For if we and our former adversary, Russia, can share capsules in space, why can the United States and its trading partners not agree to restore monetary convertibility, the indispensable condition for stable currencies, world economic growth, and free trade?

By pinning down the future price level by gold convertibility, the immediate effect of international monetary reform will be to end currency speculation in floating currencies, and terminate the immense costs of inflation hedging, thus channeling immense new savings out of financial arbitrage and speculation, into long-term financial markets (and, incidentally, ending the predatory reign of speculators, and Federal Reserve dealers, with inside knowledge of Treasury and central bank operations.)

Increased long-term investment, improvements in world productivity will surely follow, as investment capital moves out of unproductive hedges and speculation, seeking new and productive outlets. Naturally, the investment capital available at long term will mushroom, inspired by restored confidence in convertibility because the long run stability of the price level will be pinned down by gold convertibility -- as history shows to be the case in certain, previous, well-executed monetary reforms of the past two hundred years. Along with increased capital investment will come sustained demand for unemployed labor to work the new plant and equipment.

Indeed, domestic and international monetary reform, i.e. the gold standard -- a common, neutral, non-national currency, is the only true and lasting road to full employment. This is the reform plan set out for us by Jacques Rueff two generations ago. It is the outcome he looked forward to in his "combat pour l'ordre financier."

Fondly do we hope, fervently do we pray that some great statesman -- will arise to lead the free world toward the age of financial order, clearly set out for us long ago by a great statesman of France, Jacques Rueff.