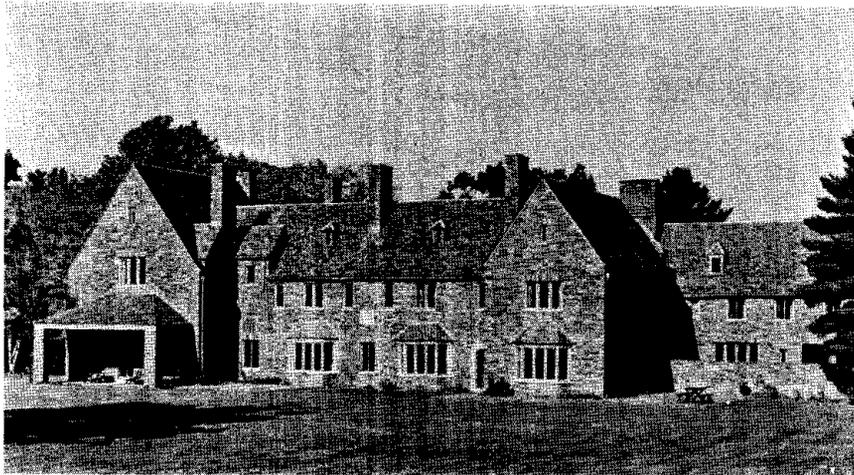


PLANS TO REVIVE THE GOLD STANDARD

by

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I.

GOLD, MARKETS, AND MONEY

After many years of being denigrated, ridiculed, and assigned to the dustbin by modern monetary "experts," the role of gold in a monetary system is beginning to receive some serious consideration once again. No doubt the miserable record of paper, no-thing monetary units and of their international counterpart, flexible exchange rates, during the past decade has generated the present new glimmer of public respect for the usefulness of gold. Already a terrible price has been paid by this generation for ignoring the lessons plainly evident in numerous earlier experiments with paper monetary units, and almost surely the cost will run much higher before the current paper-money experiment is finally terminated.

Some of the pernicious effects of paper money are now widely recognized, even if they are not yet as broadly attributed to the proper source. Among the deleterious consequences now of concern to many are: rapidly depreciating purchasing power of the monetary unit domestically, embezzlement of the wealth of savers, with a special burden on retired persons; promotion of current consumption at the expense of investment; excess use of debt; substitution of speculative activities for productive activities; and highly volatile foreign exchange rates. Less generally recognized are more destructive effects: chronic economic stagnation; social disintegration, as various groups in society imagine themselves the victims of other groups; virulent economic nationalism and isolationism, as citizens of different countries act to "protect" themselves from perceived inequitable treatment in international transactions, giving rise to blockages to the international flow of merchandise and capital; and finally, the possible rise to power of a despotic ruler (either Communist or Fascist) and the loss of freedom for the remainder of humanity that now has it and the responsibility to pass it to future generations.

These severe ills fostered by prolonged inflating are no less uncertain than the early-stage harmful consequences that modern monetary "experts" earlier denied would develop but now admit are deeply troubling problems. Unless human nature has changed radically with reference to the tendency to blame others for one's problems, and there seems to be little evidence of such a change, the most noxious effects described above must be expected. In instance after instance when the monetary system was excessively abused, such disintegration was part of the scene.

Since at least the mid-1930's, and probably since early in World War I, monetary arrangements have retrogressed throughout the world. Probably in large part because this retrogression began from a monetary situation that was essentially sound in its basic elements and because departure from this situation was slow in the earlier phases, the worst consequences have not yet occurred. Western civilization still has an opportunity to abandon its inflationary course and thus to avoid its own destruction. Recent increased awareness of the part that gold would play in a reversal of the road to destruction is a hopeful sign that mankind will save itself from worse things.

ARTIFICIAL OR GENUINE?

As the promised cures for bodily illnesses offered by patent-medicine men and quack doctors are sure not to be realized, so too will reformed monetary arrangements

fail to achieve a reversal in the trend toward destruction if the reform incorporates merely a pseudo-role for gold. After the price of gold had jumped from about \$400 per ounce to \$800 per ounce from late last year to early this year, which constituted a stark signal that confidence in paper monetary units was fading swiftly and that gold was becoming a more preferred store of wealth, some past ardent opponents of an official monetary role for gold made comments that implied they altered their view about gold. The revisions, however, are insignificant for their useful aspects.

One of the former opponents of gold who has taken a different tone is Robert V. Roosa, now a partner in a major investment banking firm but earlier one of the leading architects of U.S. paper-money policies. In *The Wall Street Journal* of February 12, 1980, he was reported as now opposing official gold sales by the U.S. Treasury and the International Monetary Fund (IMF). According to that newspaper account, Roosa's view is, "In this terribly uncertain world, gold always has some sort of grip on the minds of men" and as a result it "lends a little mythical support to central banks." Presumably by "central banks" Mr. Roosa was referring to the paper money issued by them.

About the same time, the IMF officially supported the idea of giving gold a role in its "substitution account," into which account its members could deposit paper dollars in exchange for the IMF's international paper unit, Special Drawing Rights (SDRs). In 1975 the IMF, as part of a plan to phase out gold from official monetary accounts, announced a program to sell 25 million ounces of the roughly 150 ounces of gold it held and return another 25 million ounces to its member countries. A new role for gold in the substitution account would not further the aim of phasing it out.

Also early in the year, a private group of influential persons under the chairmanship of former West German Chancellor Willy Brandt issued a study called, "North-South: A Program for Survival." Many of the persons constituting this group had earlier participated in the attempt to "demonetize" gold. Yet, in this report, they proposed that the IMF use its gold as collateral to guarantee repayment of private bank loans to the already over-indebted "less developed countries."

Although these proposals seem to admit gold again to the list of respectable monetary assets, the proposals by these former opponents of gold were notable for their failure to suggest that national monetary units again be made weights of gold and that currencies again be made redeemable in gold. This is a necessary condition to give gold its genuinely useful role, rather than an artificial, cosmetic role. Gold redeemability of currency places the public in more direct control of monetary authorities and their political sponsors by offering every individual the opportunity to constrain official actions by withdrawing the ultimate monetary reserve, gold. The type of proposals mentioned above would not provide the public with access to official gold and thus could not be used to check profligate policies. The more probable result of such pseudo-roles for gold would be to falsely reassure the public that a return to sound money is being pursued, and thereby to retain for a time longer the public's unwarranted confidence in paper currencies.

In contrast with schemes that would permit the perpetuation of inflating are genuine proposals for linking the dollar and gold. These proposals would make the dollar a weight of gold and would make U.S. currency a redeemable claim on gold. Two programs for again making the dollar as "good as gold" are printed in the later pages of this bulletin. One of them is in the form of a bill (S. 3181) introduced by Senator Jesse Helms of North Carolina, a leading congressional supporter of sound economic and monetary policies. This bill is called the "Gold Reserve Act of 1980," and Senator Helms credits Professor Arthur Laffer for the design of the program. In all key features, Senator Helms' bill is the same as Prof. Laffer's economic study entitled "The Reinstatement of the Dollar: The Blueprint." The other program for remonetizing the dollar that we have printed herein, "Towards True Monetary Reform and a Sound Currency," is the proposal of Lewis E. Lehrman. Mr. Lehrman is President of the Lehrman Institute (42 East 71st Street, N.Y., N.Y. 10021), a nonprofit private operating foundation established in 1972 to encourage the study of public policy, and he is Chairman of Rite Aid Corporation.

We invite readers to peruse these two proposals before reading the remainder of our comments.

GOLD POWER

Readily apparent in both Laffer's and Lehrman's proposals is the re-establishment of the dollar as a unit of gold and the restoration of convertible dollar claims. ("Dollar claim" is differentiated from "dollar" in that the latter would be a weight of gold of specified fineness and the former would be a claim to gold, as for example from holding currency or a demand obligation of the banking system.) These conditions are necessary for providing the public with an effective check over the monetary authority's money-creating power, short of the ultimate restraint of refusing to hold the official money, which happens when a flight from currency occurs.

Even in the relatively short run, the monetary authorities cannot control the money supply, or at least they have not been able to achieve their stated targets. As Lehrman points out, the Federal Reserve banks (Fed) can determine only the amount of their obligations (liabilities), or the amount of Federal Reserve Credit. Whether the commercial banks' counterpart to the Fed's liabilities, the commercial banks' reserves, are utilized to support demand liabilities (which are part of the money stock narrowly defined, M-1A or M-1B, or the stock of purchasing media, in our terminology) or are utilized to support time and savings liabilities (which are not part of purchasing media) is determined by the public's preference.

Lehrman describes the public's control in a different way. At the end of his second paragraph, he says, "Ultimately, the *demand* [emphasis ours] for money is determined in the market by the users of money." Elsewhere Lehrman expands his description of the relationship: "The central bank has only a regulatory monopoly over the *supply* [emphasis ours] of currency and commercial bank reserves. . . . Monetary policy therefore may *influence* the demand for money, but the total *demand for real* [emphasis ours] cash balances is determined largely by the preferences of the money users in the market. These users vary their cash balances in response to many influences — e.g., income levels, price levels, interest rates, and expectations about the future real value of money. As long as the supply of money does not exceed the

demand for it in the market, money will retain a stable purchasing power. If the government or the central bank sustains, over the long run, an undesired expansion of the nominal supply of money for whatever purpose, without offering a commensurate real value in the market, the purchasing value of money will of course depreciate and the general price level will rise."¹ A nominal increase in income will tend to increase the desired nominal money supply, even though the desired real money supply might be unchanged.

Jacques Rueff, whom Lehrman credits for many of his ideas, described "desired cash balance" as "all cash [we should say purchasing media] that its holder does not wish to replace by wealth of nonmonetary nature."² Rueff differentiated desired cash balances held "for making settlements relating to transactions effected in the market. . ." from balances held for "possible contingencies."³ The latter he also labeled "cash balances hoarded." To us, hoarded or idle balances should not be included in the stock of purchasing media in use because the economic effects of changes in such balances are far different from those related to changes in transactions balances. Unfortunately the official procedure for estimating the stock of money does not provide for a separation of these balances. We have attempted to estimate the balances related only to transactions, calling the figure "purchasing media in use," but our procedure is admittedly "rough."⁴ Other analysts are in a worse plight as they attempt to differentiate types of demand for money without an estimate of the amounts of each type.

For our purposes here, we simply note that the reported money supply probably is not the same as the supply of purchasing media in use and that the public determines the latter, not the monetary authority. If this is the situation, that is, if the public ultimately determines the money supply, why is there a useful role for gold, inasmuch as the purported benefit is to provide a check on the money-issuing power of the central bank? The answer is that a monetary unit that is gold provides an earlier restraint on the authorities and thereby reduces the possible economic distortions and their related corrective costs fostered by abuses of the monetary mechanism. In other words, gold helps to contain and force correction of monetary abuses before they become more damaging. In the extreme, a return to gold would prevent hyperinflation and its attendant collapse of social order.

Gold provides early benefits in at least two ways. One, the presentation of currency claims for gold itself not only signals the monetary authority that it is issuing too many claims but also, by virtue of legal minimum required ratios between gold and monetary liabilities, forces a contractionary policy on officials if changes in the legal gold reserve ratio are to be avoided. A second benefit from a gold redeemable currency is that as the more astute market participants perceive incipient inflationary trends, they would be able to claim gold and thus protect their interests. These astute market participants would constitute the nucleus of wealth holders that could launch a renewal of economic progress once in-

¹David P. Calleo, editor, *Money and the Coming World Order*, New York University Press, 1976, p. 107.

²Jacques Rueff, *Balance of Payments*, the Macmillan Co., 1967, p. 139.

³*Ibid.* p. 140.

⁴See "The Redefined Monetary Aggregates," our *Research Reports*, April 7, 1980.

flating was terminated and sound arrangements again were restored. A monetary unit that is a weight of gold thus disperses monetary power among the people, enabling each and every market participant to register his confidence or lack of confidence in official monetary policies and to protect himself in accordance with his judgment. If one has concluded that the combined judgment of market participants reflected in free markets fosters sounder economic decisions than does special-privilege power given by government force to a few persons, one should expect improved economic conditions to result from adoption of gold as the monetary unit. Yet, Monetarists, like Milton Friedman, vigorously support free markets in all areas except money.

HOW CLOSE A LINK?

Although Laffer and Lehrman agree that a monetary unit of gold would help to end inflating and its extensive deleterious effects, their proposals differ dramatically in the suggested connection between gold and official operating procedures. Laffer's proposal would utilize market forces to establish the new gold weight of the dollar (the official "price" of gold) and to determine the degree of freedom Fed officials would have to change the monetary base. Increases in the official gold stock could be expected if the general level of prices decreased absolutely in the United States or in relation to prices in other major countries. Decreases could be expected if general prices changed in the opposite direction. In either event, Laffer's proposal would prescribe ranges within which Fed officials would be required to change the monetary base, and these changes would tend to induce general price changes in the opposite direction, tending to maintain a stable price level (exchange ratio between most things and gold) in the long run.

In our view, a fatal deficiency of the Laffer blueprint is its focus on changes in the general price level as an indicator of unsound monetary conditions. As Lehrman points out, changes in the money supply do not foster systematic or predictable changes in the general price level immediately thereafter or even with a predictable lag. Depending on such unpredictable aspects as inflationary expectations applied to domestic and international commodities prices and interest rates, as consumers' saving-spending decisions, as producers' investment decisions, and so forth, creation (cancellation) of excess purchasing media can be reflected, more or less, in domestic price level changes, in patterns of foreign trade and financial flows, in domestic output changes, in prices of a limited number of domestic assets, for example real estate and securities, and probably in a number of other ways. Moreover, these various effects can occur with varying time lags.

During the 1920's, inflating (the creating of purchasing media in excess of the amount required to represent the gold-exchange value of gold and newly produced things offered in markets) fostered an unsustainable securities market and real estate boom that promoted an unsustainable general economic boom. The price level represented by wholesale and consumer price indexes changed little; nevertheless, the 1930's depression was the inevitable aftermath. Inflating during the 1950's (largely related to the bringing into use of purchasing media created during World War II but hoarded during that period) was reflected in a large outflow of capital to foreign countries and in a large outflow of gold. The domestic general price level changed little, and output rose at an encouraging rate. Inflating during the 1960's (largely related to the

monetization of Government debt and private noncommercial, that is, non-self-liquidating, debt) was reflected in continued international payments deficits, in official intervention to prevent the outflow of gold and capital (the gold pool and the interest-equalization tax), in continuing output increases, and in slowly (by today's standard) accelerating price increases. Inflating in the 1970's (largely attributable to the monetization of Government debt and, especially in 1973, of private speculative inventory borrowing) was reflected in more rapidly rising prices, the abandonment of fixed exchange rates, repeated monetary crises, a sharp rise in the price of gold, signs of developing "beggar-my-neighbor" trade policies, but only little in output growth.⁵

If the price level is used by officials or by the public at large as a sign of inflating, many of these other troubling economic distortions fostered by inflating may be well rooted and vigorously growing before the inflating is realized. Their later correction, initiated by a withdrawal of gold and a concomitant decrease in the monetary base under Laffer's proposal, would be a painful experience for many. The desire to avoid these short-term adverse effects of deflating probably accounted for the earlier almost imperceptible incremental removal of the monetary restraints that were a part of the monetary system at the beginning of World War I. Professor Laffer's program provides for a "gold holiday" during which the market would establish a new "price" for gold, that is, a new weight of gold per dollar. The loose link in his proposal between gold and the ability of bankers to create purchasing media increases the possibility that such devaluations of the dollar and their related upheavals would occur.

Although the Lehrman proposal printed herein is phrased in terms of seeking a stable price level, elsewhere Mr. Lehrman has indicated that inflating and a rising price level are not synonymous, that a rising price level is only one possible symptom of inflating, and that the objective of monetary practices should be to avoid inflating (that is the creation of too much money), in which event a stable price level will be one of the beneficial consequences. If a stable price level is not to be the operating target, what is? In Lehrman's view, the policy target should be to adjust gradually the supply of cash balances in the market to the demand for them. If this is done (see paragraph 5 on page 12) "[s]ince the supply of cash balances tends to equal the demand for them, no one in the market will desire to make a purchase with existing cash balances until he first produces a new sale in exchange for existing cash balances. In a word, no one will demand without first making a supply. When the market for cash balances tends toward equilibrium, no one will consume anything more unless he first produces something more." If we might be permitted to translate Lehrman into our language, he seems to be saying that purchasing media should be created (and thus provide the borrower with an ability to make additional effective demand in the market) only to represent newly produced things offered in the market ("first produces something more"; "first making a supply").

Purchasing media created in connection with loans made to fund things offered in markets is the essential aspect of the "real-bills doctrine," or of "sound com-

⁵ For a detailed description of inflating and its effects, including its late 1920's effects, see *Cause and Control of the Business Cycle* by E. C. Harwood, American Institute for Economic Research, 1974.

mercial banking.” Such loans were considered to be *self liquidating* because in the normal course of events their sale provided the wherewithal to repay the loan and thus to remove from circulation the purchasing media created when the goods were offered in the markets. *Self liquidating* is different from *liquidity* in that the latter simply refers to the ability to convert an asset into cash quickly without substantial loss; the asset need not be offered in the market in the usual course of events. For example, a loan to carry securities on margin might be viewed as liquid, but it would not be self liquidating.

The reason that purchasing media created in the process of making sound commercial loans is not inflationary is that at the same time additional money is created, additional things are available to be purchased; thus balance is maintained between purchasing media and things to be purchased.

This essential aspect of sound commercial banking is the one often neglected in modern descriptions of classical banking practices. “Liquidity” often is substituted for “self-liquidating.” Rueff, Lehrman’s mentor, was guilty of this mistake: “The fundamental condition [that a monetary system must satisfy if it is to be capable of checking inflation] is to admit to monetization only true assets, i.e., assets that can be sold on the market for the value at which they have been monetized.”⁶ Moreover, according to Rueff, “Should it be desired . . . to give the monetary system a self-regulating character in both directions, it is sufficient to limit the *maturity* [emphasis ours] of bills eligible for discount.”⁷ Lehrman appears to adopt Rueff’s erroneous position by admitting to discount (i.e., as suitable for supporting new money creation) “authentic self-liquidating tax anticipation bills of less than a year’s maturity (paragraph 2, page 12). He also emphasizes “solvent consumers” and “credit worthy borrowers” (subsequent paragraph). Of course, we may be misinterpreting Lehrman.

Lehrman was forced to limit the types of credits suitable for discount and rediscount (and, implicitly, for monetization) once he specified that discounts and rediscounts should automatically be granted but only at rates higher than the market rate (for commercial bank discounts) and the bank rate (for central bank rediscounts). If there were no such limitation, bankers would be tempted to make high-risk loans on which they could earn more than “the” market rate (however specified) and thus transform the intended central bank penalty discount rate into a subsidy rate for dubious loans.

Of course, in a regime of gold convertibility, any resulting inflating eventually would be detected by the public and would give rise to widespread demand for gold in exchange for currency claims. This would cut short the inflating, but only after many economic distortions probably would have accumulated. Insolvent commercial banks would be one outcome. When such banks encountered outflows of deposits as individuals sought gold, the banks would be unable to collect on their many high-risk loans, even if they might have been short-term, and thus they would be forced to cease operations. For the government to prevent these unsound private banks from failing (in order to avoid the associated economic hardship) would underwrite inflating, and for the government to substitute legal regulations on the types of loans qualifying for bank portfolios for the regulation of the market would undermine the efficiency of the market.

⁶ Rueff, p. 176.

⁷ Rueff, p. 177.

Lehrman has seen the need for bankruptcy: “Moreover, to require the central bank, or any bank of issue, to guarantee unlimited currency convertibility into gold of a fixed weight deters any inflationary increase in the money supply with the threat of bankruptcy. When a commercial bank cannot meet the monetary claims for conversion into gold by its creditors, the end result is liquidation and extinction. For any central bank which creates excess supplies of money the failure to satisfy international claims for conversion results in the suspension of gold payments and subsequent national currency depreciation. The discipline of bankruptcy in a free and open market is the unavoidable penalty of financial excess.”⁸

THE CLOSEST PRACTICABLE LINK

Some advocates of a gold-based monetary system, including Henry Hazlitt and Murray Rothbard, assert that the *only* asset suitable for supporting the creation of purchasing media is gold itself. According to such supporters of a 100-percent gold standard, only by holding gold in the vault equal to 100 percent of the amount of dollar claims outstanding can a bank be assured of meeting any and all claims that might be presented for redemption and only in this way can excess creation of purchasing media be prevented for certain. Their proposed link between gold and purchasing media would be the closest possible, but would it be the most useful link?

We agree that 100-percent-gold money would preclude any inflating. However, if the function of purchasing media is to facilitate efficient exchanges and thus optimum sustainable economic growth, rather than simply to prevent inflating, a 100-percent-gold reserve system probably would not be most useful for performing this function.

During the decades following the U.S. Civil War, production of things humans desired increased at an unprecedented rate. In only a human lifetime, about 70 years, the volume and exchange value of things passing through markets in the United States multiplied more than 50 times, but the Nation’s gold stock multiplied only 10 times. If 100-percent-gold-reserve banking were practiced, economic exchange and production probably would have been impeded, the rate of economic growth would have been less, and the general price level probably would have trended downward at a rate in excess of that warranted by productivity gains. Such a downward trend would substantially increase the exchange value of gold and induce a larger flow of resources into the production of gold. Inasmuch as the object of human productive effort is consumption, and inasmuch as the production of gold for a gold-based monetary system largely is not for consumption but for effecting exchanges of other things for consumption, a massive application of resources to the production of gold would be an uneconomic use of resources. At least it would be uneconomic if alternative arrangements could offer the nearly equal assurance of preventing inflating and its associated problems at a markedly lower resource cost.

As the need for purchasing media increased rapidly during the decades after the Civil War, the problem was solved by trial and error. Unplanned evolutionary development in free markets accomplished a task that might well have seemed impossible to anyone who could have foreseen the need. By the early 1900’s, sound commercial banking had evolved to the point where increasing real output provided its own means of purchase as long as the

⁸ Calleo, p. 103.

output was available in the markets. Moreover, once the output was purchased, the associated purchasing media were canceled.

The purchasing media used were primarily checks and paper currency with a relatively small amount of coins. The numerous markets were, in effect, baggage check rooms where things were left temporarily to be offered in exchange for claim checks. The claim checks could be used to claim anything having the value indicated on the claim checks offered. Thus the money claim checks differed from the familiar claim checks widely used to reclaim baggage left by individuals, which entitled the holder to obtain his own particular suitcase or parcel. Under the gold-standard money-credit system the currency and checking account claim checks entitled the holder to claim *not* a particular item but a specified gold-exchange value of things. In short, the claim checks, or purchasing media, were denominated in gold, by weight. Paper currency labeled \$100, when used as a claim check to buy in the markets, was the equivalent of approximately 5 ounces of gold.

Gold thus was used as the standard of value, in terms of which the exchange value of all things offered was assessed. As long as the gold-exchange values of things were accurately judged, there would be no incentive to prefer gold to the other innumerable things offered.

An essential part of the market mechanism was provided by the commercial banks. They also were comparable to baggage check rooms in that they held gold in storage available on demand to whomever offered claim checks (purchasing media) in exchange.

Each monetary unit of purchasing media was used as a claim check to buy in the markets (or baggage rooms) as though it were gold, but only a portion of the claim checks in use actually were gold coins or paper currency representing gold in the banking system. Most of the purchasing media, although used for exchange purposes as though they were gold, actually represented the gold-exchange values of other things in the markets.

The evolution of sound commercial banking made possible the continuing dynamic balance between the purchasing media available in the hands of prospective buyers for use as claim checks in the markets and the gold-exchange values of all newly produced things available for purchase.

In order for such a dynamic balance to be maintained, purchasing media had to be created or issued to represent the gold-exchange values of things sent to market. Moreover, as things in the markets were sold, the purchasing media received by the sellers had to be removed from circulation.

FEATURES OF SOUND BANKING

Sound commercial banking, including a gold monetary unit, provided the mechanism or procedures for creating and maintaining the dynamic equilibrium described above. The principal features were:

1. For gold received the commercial banks issued:
 - a. Gold coins equal in gold content to the bullion received. (To the extent that deliverers of bullion took gold coins, the gold did not remain in the banks); or,
 - b. Gold certificates, that is, paper currency specifying that it represented gold placed in the banks. This was, in effect, a warehouse receipt that could be used for all purchases as the holder might desire; or,
 - c. A credit to the checking account of the person who delivered gold to a bank. (Note that the amount credited was not deducted from someone else's account.)

This account was denominated in dollars, which were by law one-twentieth of an ounce of gold in an alloy nine-tenths fine. By writing checks, the owner of such an account could buy things in any of the markets, including gold bullion (or coins) continually being offered by the commercial banks.

2. For things other than gold processed by farmers, miners, manufacturers and others, the banks issued purchasing media (claim checks) representing the gold-exchange values of things sent to the markets. Except for the inconvenience, these processed things could have been taken by the bank (as banks took gold) when the new purchasing media were created, and the banks then could have continuously offered all of these things, in addition to the gold they held, in exchange for their claim obligations outstanding. As long as the exchange values of all things thus taken by the bank were judged accurately, the bank could redeem in equivalent gold-exchange value all of its purchasing media obligations. The process in practice avoided the deposit of all things, other than gold, with the banks.

a. The purchasing media were created by the commercial banks, which discounted the notes to manufacturers, for example, who had shipped things to markets. Thus a manufacturer borrowed from his bank (had credited to his account) newly created purchasing media equal in gold-exchange value to the things sent to market. (Note again that the banker did not deduct the amount of the credit from someone else's account; a net increase in checking accounts occurred.)

b. The manufacturer then distributed the claim checks (purchasing media) to suppliers of raw materials, wage earners, salaried workers, as dividends, etc. When those who thus obtained purchasing media bought whatever they chose, the manufacturer received the proceeds of sales, perhaps from his own dealers or others to whom his products had been shipped. He then repaid his borrowings by having the banker debit his checking account and destroy his note, thereby removing from circulation the purchasing media created earlier.

c. Some of those who processed things for markets were almost continuously producing. Their successive borrowings gradually became recognized by the banks concerned as justifying a nearly permanent "line of credit." As the evolution of sound commercial banking continued, some manufacturers such as those producing automobiles, paid off their bank loans only once a year. The rest of the time they maintained a continuous flow of borrowed purchasing media that paralleled the flow of things they processed to the markets. However, as long as the new purchasing media created by the commercial banks corresponded closely in dollar amount with the gold-exchange values of things sent to the markets, transactions could continue in dynamic equilibrium.

Occasionally, the commercial bankers in one area overestimated the gold-exchange values of local products. Local processors perhaps had been too optimistic in assuming that larger quantities produced could be sold without reducing prices, and their bankers had discounted notes and credited their accounts. Inflating thus occurred.

When the things were offered in the local markets of area A at relatively high gold-exchange prices, prospective buyers went elsewhere. They bought in other markets such as those in areas B, C, etc., and their claim checks (purchasing media) were deposited in other banks where they constituted claims on the local banks of area A. In order to settle these claims of other banks, the banks in area A had to ship gold. The outflow of gold warned the

bankers that an error had been made, lending policies were reviewed, and local processors were forced by developments in the markets to revise their prices downward in order to remain competitive. This principle applied whether the areas concerned were nearby towns, different states, regions, or even nations.

For the most part, such errors on the part of processors and bankers were relatively minor. In free markets, the consequences of such errors became apparent quickly. The errors, instead of cumulating and fostering major distortions across the Nation or the world, were more localized. Gold served as an automatic governor flowing away from the area where errors were made, thereby forcing early and automatic adjustments. When individual banks refused to make appropriate adjustments, they eventually would be forced into bankruptcy. The customers of those banks would have suffered, but the owners, managers and customers of soundly managed banks would not have suffered with them. The economy as a whole was not adversely affected.

Bankers' errors in judging the gold-exchange values of things monetized were minimized by the practice of monetizing only newly produced things offered in the markets. Monetization of financial assets constituting a claim to things expected to be offered in the future introduced an opportunity for much greater misjudgment. Insofar as purchasing media created to represent the estimated gold-exchange values of such assets were used to bid for currently offered output rather than for other types of financial claims to future exchange, current increases in output and/or prices would be fostered, which in turn would appear to give added present value to the future claim, which in turn could "justify" another injection of purchasing media that would promote further excess purchases and valuations. Such a process could continue until prices became so absurd that a substantial number of shareholders (or bankers) would recognize the overvaluation and began selling (or refusing to finance) the shares. This, in fact, was the procedure behind John Law's famous Mississippi Bubble inflationary boom and bust in France in 1719-20 and behind this country's late 1920's boom and the subsequent 1930's collapse.

As for the monetization of government securities, even short-term tax anticipation bills, that, too, could begin the spiral of distortions, inasmuch as the associated newly created additional purchasing media would enable the government to bid for things offered in the markets without there being a coincident addition to the gold-exchange value of things offered there for purchase.

Through trial and error, private and central bankers had learned to apply these sound practices by early in this century. Indeed, the original Federal Reserve Act incorporated the essential aspects, and all major countries had adopted more or less similar arrangements. It was a system of dispersed power, of reliance on market participants. Bankers across the country and world expanded and contracted the supply of purchasing media as gold flowed in and out of private and central banks and as more goods were offered in markets and taken from markets. When bankers erred such that excess purchasing media were created, holders of purchasing media could claim gold from the banks instead of other goods offered in markets. Locality by locality, region by region, country by country, the most perceptive of market participants thus compelled early correction of incipient inflating and its associated distortions. Major misjudgments causing bankruptcies thereby were localized, as were tendencies for the development of unsustainable consumption and

output levels. This arrangement originated and operated from the "bottom up" not from the "top down."

DANGER OF A PREMATURE RETURN TO GOLD

Banking practices and the monetary system have now retrogressed so far from those that seem to be sound that few so-called monetary experts are even aware of them and the economy has become highly distorted from the decades of inflationary policies pursued in this country and among nearly all, if not all, Western countries. Public expectations for full employment, for high consumption levels, for massive transfer programs, for high Government spending levels create a political climate unreceptive to even cyclical contractions. Longer-term debt obligations (of business firms and households) and other contracts, such as labor contracts, have been entered into on the expectation of continued rapid depreciation of the monetary unit and rising nominal incomes. To impose in this environment a return to gold convertibility of dollar claims and the necessary accompanying end to inflating (the monetization of Government debt and noncommercial private debt) in order to maintain that convertibility, probably would result at first in marked decreases in output and employment and little if any slowing in price rises. Such is the situation in England, as the Thatcher government has attempted merely to slow the rate of inflating, not to stop it. And as in England, there probably would develop in the United States substantial public outrage at the early adverse effects unaccompanied by any evident beneficial effects. The risk would be high for a premature abandonment of the effort to stop inflating, and the idea of a gold-based monetary system again would be stained with the label "unworkable in a modern economy."

Both Laffer and Lehrman evidently realize that an attempt to restore the dollar as a unit of gold and to stop inflating would require a comprehensive set of policy changes. As for Laffer, his monetary blueprint must be viewed as the monetary counterpart to his advocacy of supply-side fiscal policies, i.e., a cut in Government income tax rates, a reduction in Government spending as a percent of aggregate spending, a removal of Government interference in the economy, and so on. Unfortunately, although both his monetary blueprint and supply-side ruminations have some sound aspects, in their details (and thus in their chances of producing the promised results) they have less scientific basis. Americans are not guinea pigs for testing inadequately grounded theories. This country now is suffering from the hasty adoption of Keynes' grand but unwarranted theories. A repetition is not needed.

Lehrman obviously understands that the issue is complex and comprehensive: "The gold standard, to be desired authentically, must be desired along with all those values in the absence of which it will be destroyed. It means a government in which plain folks, working people, have confidence in its promises and in all its policies. It means a respect for the value of work and the unique characteristics which make a truly functioning market endure, namely, that before you make a demand in society, you must first make a supply."⁹ Yet he apparently believes that monetary leaders will become re-educated about the essential aspects of a sound monetary system and the need for them, and that after re-education they will impose

⁹ *Men and Money*, August-September 1980, the Committee for Monetary Research and Education, Inc., p. 4.

the requisite institutional changes from the "top down."

We believe that the task of designing and implementing a sound monetary system is beyond the abilities of the most knowledgeable individual or small group of individuals. Between now and the time when adequate re-education has occurred, indeed, as part of the re-education process, we believe efforts should be made to encourage the development of gold-based banking and monetary practices to compete with the paper monetary system. Whatever practices prove to be the more useful, we should expect them to be more widely adopted; those that prove to be less useful, will be discontinued.

In our opinion, sound commercial banking, including a monetary unit of gold, would be re-evolved. After central bankers and private bankers again could see the key elements of a gold-based, market-based monetary system, the necessary legal framework could be created with more confidence that the results would be beneficial. No "do or die" national experiment would be required. Incremental applications of experimental practices, with say, gold-deposit certificates and gold-guaranteed loans, might reveal the way toward more useful approaches. The damage done by unsound experimental practices would be as limited as the experimental practice itself. Monetary practices would be extended or contracted on their merits.

Evolution toward a sound monetary system would be encouraged if the United States were to begin minting gold coins designated only by the weight of the pure gold content. The coins need *not* be "legal tender"; yet, con-

tracting parties could use them to specify claims and liabilities. This could be accomplished with only minor changes to the Treasury's gold medallion sales program now underway. Perhaps within a decade, private transactions specifying amounts of paper dollars probably would decrease in number as the contracts in terms of gold were recognized to be more advantageous.

The Federal Government could further accelerate the evolution toward a sound monetary system by issuing gold bonds with principal and interest payable in the new gold coins. The price of such bonds, in paper dollars, would be whatever the current free-market price of gold happened to be on the day of issue. A vast market for such bonds yielding only 1 to 3 percent, depending on maturity dates, probably would develop. Within several years, the Government thus could refinance its debt and save much of the present \$80 billion *annual* interest charges. If the smaller total Federal expenditures with given revenues produced surpluses that were used to reduce the debt, the funds thereby made available to the capital markets would help finance the needed revitalization of industry.

No guarantee can be provided that a catastrophic flight from the paper currency could thus be avoided; the United States has gone far on the road to ruin. But if the worst does happen, an increasing supply of the new gold coinage would be available to provide a firm foundation for recovery from the debacle. To reduce the chance of such a debacle, efforts should be made now to increase the use of gold.

II.

GOLD RESERVE ACT OF 1980

S. 3181

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled.

Short Title

Sec. 1. This Act may be cited as the "Gold Reserve Act of 1980."

Findings

Sec. 2. The Congress finds that—

(1) maintenance of the value of the dollar is necessary for the economic independence and security of the individual and the family;

(2) monetary policy should provide for price stability, thus assuring maintenance of the value of the dollar;

(3) monetary policy is not a proper or effective tool for reaching economic or social goals, other than assuring price stability;

(4) the destruction of the value of the dollar through chronic inflation is caused by monetary policy;

(5) the failure to contain inflation demonstrates that discretionary monetary policy must be tempered by a monetary standard;

(6) failure to maintain the value of the dollar has led to international economic disorder;

Note: Senator Helms' office supplied us with a copy of this bill, from which this section is taken word for word. Senator Helms invites comment on this bill. Write to: Senator Jesse Helms, United States Senate, Washington, D.C. 20510.

(7) experience in other countries as well as in the United States, over long stretches of time, has shown that a gold monetary standard has superior ability to maintain the value of currency; and

(8) a gold standard can provide a monetary system that maintains price stability in a growing economy.

Definitions

Sec. 3. As used in this Act—

(1) the term "standard price of gold" means the average price of gold bullion at New York for immediate delivery prevailing during the five business days ending on the 180th day after the date of enactment of this Act, as determined and proclaimed by the Secretary of the Treasury, except that if a gold holiday is proclaimed under the provisions of section 7 of this Act, the standard price of gold then in effect shall cease to apply, and the "standard price of gold" shall mean the average price of gold bullion at New York for immediate delivery prevailing during the five business days ending on the 90th day after the proclamation of such gold holiday as determined and proclaimed by the Secretary of the Treasury;

(2) the term "gold reserves" means the value, at the standard price of gold, of the aggregate amount of gold held by the Federal Reserve banks or held by the Treasury in custody for such banks;

(3) the term "monetary base" means the aggregate of liabilities (excluding capital accounts) of the Federal Reserve banks;

(4) the terms "upper reserve limit" and "lower reserve

limit" mean 175 per centum and 25 per centum, respectively, of the target reserve quantity;

(5) the term "gold holiday" means the 90 days following proclamation of such holiday by the Board of Governors of the Federal Reserve System pursuant to section 7 of this Act; and

(6) the term "target reserve quantity" means that total value of gold, at the standard price of gold, which bears the same proportion to the monetary base as gold reserves bore to the monetary base on the 181st day after approval of this Act or, if a gold holiday shall have been proclaimed, on the 92nd day after proclamation of such holiday.

Transfer of Gold Reserves

Sec. 4. Upon the enactment of this Act, the gold certificates issued and outstanding under the provisions of section 2(a) of the Gold Reserve Act of 1934 (31 U.S.C. 441) shall be cancelled and every right, title, interest, and claim of the United States to the gold represented by such certificates shall pass to and are hereby vested in the several Federal Reserve banks holding such certificates. All gold so transferred, not in the possession of the Federal Reserve banks, shall be held in custody for the banks and delivered upon the order of the Board of Governors of the Federal Reserve System. The Secretary of the Treasury shall take such action as may be necessary to assure that such gold shall be so held and so delivered.

Revaluation of Gold Reserves

Sec. 5. Any increase or decrease in gold reserves due to a change in the standard price of gold shall be credited or debited to a special capital account to be established on the books of account of the Federal Reserve banks, but no credit balance shall be distributed to any stockholder or to the United States.

Gold Purchases and Sales

Sec. 6. (a) Each Federal Reserve bank shall sell gold on demand at a price equal to 100 $\frac{7}{10}$ per centum of the standard price of gold, and shall accept in payment therefor only Federal Reserve notes, whether issued by itself or another Federal Reserve bank, or drafts on reserve accounts or other deposits held by it.

(b) Each Federal Reserve bank shall buy gold when offered to it at a price equal to 99 $\frac{3}{10}$ per centum of the standard price of gold, and shall issue in payment therefor only Federal Reserve notes or deposit credits in that bank.

(c) Nothing in this section shall be deemed to require any Federal Reserve bank to buy or sell gold in any quantity less than that quantity having a value of \$10,000 at the standard price of gold, except as provided in section 10 of this Act.

(d) The provisions of this section shall become effective on the 182nd day after the approval of this Act.

Restrictions on Changes in the Monetary Base

Sec. 7. Notwithstanding subsections (b) and (c) of section 12A of the Federal Reserve Act (12 U.S.C. 263 (b) and (c)) or any other provision of law, the monetary base—

(1) shall not be permitted to increase during any period in which gold reserves are less than 75 per centum of the target reserve quantity;

(2) shall be decreased by 1 per centum per month during any period in which gold reserves are less than 50 per centum of the target reserve quantity;

(3) shall be increased by 1 per centum per month during any period in which gold reserves are more than 125 per centum of the target reserve quantity; and

(4) shall be increased by 2 per centum per month during any period in which gold reserves are more than 150 per centum of the target reserve quantity.

Gold Holiday; Proclamation; Prohibited Actions

Sec. 8. (a) If gold reserves become less than 25 per centum, or more than 175 per centum, of the target reserve quantity, the Board of Governors of the Federal Reserve System shall proclaim a gold holiday.

(b) Upon proclamation of a gold holiday under subsection (a), the standard price of gold then in effect shall cease to apply, and a new standard price shall be determined in accordance with section 2 (a) of this Act.

(c) Notwithstanding any other provision of law, during the period of any gold holiday proclaimed under subsection (a)—

(1) no Federal Reserve bank shall purchase gold for, or sell gold from, its gold reserves; and

(2) the monetary base shall not be permitted to increase or decrease by more than 1 per centum from its value at the time the gold holiday is proclaimed.

Rules and Regulations

Sec. 9. The Board of Governors of the Federal Reserve System shall prescribe rules and regulations to carry out the provisions of this Act other than section 9.

Coinage

Sec. 10. The Secretary of the Treasury shall mint and issue gold coins of .900 fineness in such denominations and of such sizes and weights, but not less than one-fourth of an ounce, as he determines to be appropriate to meet public demand. Coins minted under this section shall be subject to the requirements of section 3517 of the Revised Statutes (31 U.S.C. 324), and shall bear such other patriotic designs, symbols, or inscriptions as the Secretary determines to be appropriate.

Repeal of Existing Laws

Sec. 11. (a) Sections 5, 6, and 7, and the last sentence of section 15 of the Gold Reserve Act of 1934 (31 U.S.C. 315b, 408a, 408b, 444) are repealed.

(b) Section 11(n) of the Federal Reserve Act (12 U.S.C. 248 (n)) is repealed.

Section-by-Section Summary of the Gold Reserve Act of 1980

Section 1. Short Title. "Gold Reserve Act of 1980."

Section 2. Findings. Maintenance of the value of the dollar is the sole proper goal of monetary policy. A gold standard is necessary to success in such policy.

Section 3. Definitions.

"Standard price of gold"; "gold reserves"; "monetary base"; "upper reserve limit" and "lower reserve limit"; "gold holiday"; "target reserve quantity."

Section 4. Transfer of gold reserves. All gold certificates evidencing gold held by Treasury as reserve for Federal Reserve System are cancelled, and the ownership of all the gold so evidenced reverts to the Federal Reserve, upon enactment. This exactly reverses the action taken by the Gold Reserve Act of 1934.

Section 5. Revaluation of gold reserves. When U.S. gold reserves are transferred to the Federal Reserve and valued at market (instead of, as at present, being valued at the artificial price of \$42.22/fine troy ounce), there

will be a substantial increase in Federal Reserve assets. To balance this on the other side of the books, a capital account is established which cannot be distributed to member banks holding Federal Reserve stock.

Section 6. Gold purchases and sales.

(a) and (b). Provide for sale and purchase, respectively, of gold by the Federal Reserve banks, on demand, payments to be made only in Federal Reserve notes or drafts on Federal Reserve liabilities (such as reserve accounts). Prices of transactions are set at 7/10 of one per cent on each side of the standard price of gold, which is essentially the market price of gold for immediate delivery in New York in the week before resumption of gold transactions under this Act.

(c) Federal Reserve banks shall not be required to deal in quantities of gold of value less than \$10,000, except for gold coins.

(d) Resumption of gold transactions will occur on the 182nd day after enactment of this Act.

Section 7. Restrictions on changes in the monetary base. The Federal Reserve System will be required to expand or contract the aggregate of its liabilities (thereby, through bank reserves, expanding or contracting the money supply) whenever the value of the gold reserves deviates substantially from the target reserve quantity. This target is set to maintain the same percentage of gold backing for Federal Reserve liabilities (including Federal Reserve notes and reserve accounts) as obtained on the day before resumption of gold transactions under this Act. Full discretion is allowed if gold reserves are between 75% and 125% of the target; the base may not be increased if reserves fall below 75% and must be decreased by 1% per month if they fall below 50% of the target. If reserves are above 125% of target, the monetary base must be increased 1% per month, and they must be increased by 2% per month if reserves are above 150% of the target.

Section 8. Gold holiday; Proclamation; Prohibited actions.

(a) If gold reserves deviate beyond 25% or 175% of the target, the Board of Governors of the Federal Reserve System is required to proclaim a gold holiday.

(b) During a gold holiday, for a period of 90 days, there will be no transactions in gold, and then a new standard price of gold will be established and gold transactions resumed on the 92nd day. The purpose of this provision is to prevent the entire economy from having to adjust, through inflation or deflation, to some extraordinary occurrence affecting the underlying supply or demand for gold. For example, discovery of the cyanide process for recovery of gold meant that the "natural" price of gold should decline. There is no economic purpose to having the entire monetary base and the economy adjust to this, so this provision would permit establishment of a new price standard.

(c) During the period of a gold holiday, there would be no gold transactions and the monetary base would not be permitted to vary by more than 1% from its value at the beginning of the period. Thus, the gold price will be established by the market and not be affected by government monetary actions.

Section 9. Rules and regulations. The Board of Governors of the Federal Reserve System is granted the usual authority to prescribe rules and regulations to carry out the Act.

Section 10. Coinage. Provides for gold coinage in sizes and weights to meet public demand, such coins to be determined by the Secretary of the Treasury, but not in size less than ¼ ounce.

Section 11. Repeal of existing laws. Repeals various parts of the Gold Reserve Act of 1934 that are inconsistent with the present Act, and section 11(n) of the Federal Reserve Act (pertaining to authority of the Secretary of the Treasury to seize gold).

III.

TOWARDS TRUE MONETARY REFORM AND A SOUND CURRENCY

First, some general observations on central bank policy and the measures of money supply.

The Federal Reserve System does not determine the money supply, all superstition to the contrary notwithstanding. It influences *indirectly* the volume and composition of the total money stock; but the central bank does not determine it. The money users – consumers and producers – are sovereign. Consumers and producers demand currency and bank deposits in the market; the central bank and commercial banks supply them. M-1, M-2 (and all the other M's which bankers and economists use to measure the money supply) are, at best, first approximations of the money stock. Moreover, definitions of the M's change, as the staffs and chairmen of the Fed change. The statistical data, used to define the M's, are unreliable, as we know from experience, and subject to constant and substantial revisions. Even after defining the money stock and revising the data, one must cope with the variable relationship between the quantity of the money stock, M-1, and the rate at which it turns over in order to finance a given volume of economic transactions at a specified price level. The rate of turnover of money, its velocity (V), is as much beyond the control of the Fed as the money stock itself. Finally, all the M's have a supply *and a demand side*. These M's are thereby only in varying degrees influenced by (supply-oriented) central bank exhortations, open market operations, reserve requirements, and discount rate policies. Ultimately, the demand for money is determined in the market by the users of money.

If the Federal Reserve does not alone determine the level of M-1 and M-2, it determines, within limits, as do all enterprises, the amplitude of its own balance sheet. A balance sheet has assets and their counterpart, equal liabilities. The Fed largely determines the volume and composition of its own financial assets, the monetary counterparts of which are, among others, commercial bank deposits and currency, that is to say, the Fed's liabilities. The Federal Reserve is, first and foremost, a "bank." It is not the experimental laboratory of the Department of Economics at Yale University. Nor is it a classroom at the University of Chicago. More precisely it is the "Bank of Issue." It has a balance sheet and it has an income statement. As a banking institution it can perform no magic. It buys assets with the resources provided by its liabilities. Within limits, the central bank varies the composition of its financial assets, Federal Reserve Credit, as it pleases. Unlike the M's, there is nothing imprecise about Federal Reserve Credit. It is a fixed and measurable item to be determined in the footings of the balance sheet.

In these respects, the central bank is just like every other bank. But it is unique in that, among other things, it is the clearing bank for commercial bank members. It is the Bank of Issue for legal tender currency which it sup-

plies upon demand. Moreover, it has certain monopoly powers delegated to it by Congress under the Constitution. These monopoly powers are euphemistically referred to as "regulatory authority over the banking system."

During the past twenty years, the relationship between the Federal Reserve, the rate of inflation, and the variations in the money stock has engendered much discussion. It is generally agreed by modern bankers and economists that the quantity of money and the rate of inflation are related. In various forms, they resurrect the classical quantity theory of money. If M is the quantity of money (or M-1, or M-2), it is generally argued that its rapid increase leads to inflation. But M is not a measure only of the *supply* of money. What of the *demand* for money? During part of 1978 the quantity of money in Switzerland grew approximately 30% while the price level rose only about 1%. Even if inflation rates in Switzerland have accelerated with a lagged effect, inflation persisted at a modest fraction of the growth in the quantity of money. In the U.S. in 1979 the quantity of money, M-1, grew about 5% while the CPI inflation rate rose 13%.

Now, what kind of close correlation between the growth of the money stock, M, and the price level, P, do these dramatically opposed examples provide, even if one assumes a monetarist lag? Certainly too loose a correlation to use for forecasting accurately. And especially too loose to gauge with precision the crude operating techniques of the central bank which intervenes in the market for cash balances to bring about results which can only be known one to two years in the future under new and different circumstances. Under these conditions, reserve requirement adjustments, hyperactive open market operations, or other central bank operating techniques geared to the monetary aggregates, M-1 or M-2, *may* achieve results. But only fortuitously. The Swiss and U.S. examples, among others, show that they do not produce a *specific* level of money supply growth consistent with a predictable inflation rate. One observes in the real world, with or without lags and during whichever short or long intervals chosen, substantial variations between a certain quantity of money, M, and a price level, P.

Authorities Cannot Control

Accordingly, one can have little faith in the ability of the Federal Reserve to determine the quantity of money in circulation. This is no criticism of the Fed. On the contrary, it is merely to acknowledge the limits of the human mind and the paucity of precise and ready information. This problem of imperfect and rapidly changing information illustrates the problem of monetary policy and central banking. To conduct the operations of the central bank, there must be a goal. If the goals are both price stability and a certain supply of money, M, one must know, among many other things, not only the magnitude of the supply of money *but also the volume of demand for money in the market*. If individuals, businesses and other entities largely generate the demand for money, the Fed must have providential omniscience to calculate correctly, on a daily or weekly basis, the total demand for money, even if it could gather reliable statistical information and

Note: This section is quoted from "Monetary Policy, The Federal Reserve System, and Gold," by Lewis E. Lehrman, January 25, 1980, printed in an investment research memorandum of Morgan Stanley and Co., pp. 28-43. We have added the sub-headings. According to the author, "this entire section draws its inspiration and some of its basic definitions from the works of R. G. Hawtrey, Walter Bagehot, and especially from those of Jacques Rueff."

even if its definitions of money were correct and constant.

The fundamental problem can be stated quite simply. Because the money stock cannot be controlled effectively by the Fed, the goals of the Fed's monetary policy must *not* be to control them. The Fed simply cannot determine accurately the demand for money. Neither does the Fed possess the information, the operating techniques or the perfect foresight to bring about a certain level and rate of growth of M. As we know from experience, open market operations are blunt instruments. Moreover, no stipulated level of M during a specific market interval – in the U.S., Switzerland, Germany, or elsewhere – is necessarily correlated with a specified rate of inflation, or deflation; nor is it with price stability.

Yet we do know that the Fed does determine the footings of its own balance sheet. By purchasing securities or by providing discounts (advances), it does increase credit to the commercial banks. Now if these open market operations unwittingly create excess cash balances in the market, the price level will thereby rise. But if the goal of the central bank were price stability, then the Fed must promptly reduce the volume of credit it has made available to the commercial banks. As credit contracts, so does the money stock. As a result, excess cash balances will be absorbed until the level of actual cash balances is strictly equal to the amount of desired cash balances. At that moment excess demand, created by undesired cash balances, will dissipate and the price level will gradually stabilize.

In this context, one defines cash balances *in the market* as currency and checking account deposits, i.e., the money held by participants in the market. Consider now that *new* cash balances, under the present monetary system, can be provided only from “outside” the market. In concrete terms, it is the commercial banks and the central bank, given our existing set of monetary institutions, which create *new* money for the market. In this specific sense banks are financial institutions outside the market, as it were, away from the market participants holding *existing* cash balances. One distinguishes therefore between the bank rates of interest *outside* or *away* from the market and the interest rates *in* the money market, namely, the interest rates for commercial paper or bankers' acceptances among others. Under changing conditions of supply and demand, the intersection and divergence of the bank rates and the rates in the money market first join and then disengage the rates in the money market and the rates at the banks. When joined to the rates in the market, the bank rate may be conceived as the threshold rate *outside* the market, at which level the market participants may gain access to *new* cash balances.

The Discount Mechanism

As I have argued, if the goal of the central bank is price stability the operating target of monetary policy at the central bank must always be to make the supply of cash balances equal to the demand for cash balances – demand as it is determined in the market place at prevailing interest rates. To achieve this goal, the central bank must simply hold the discount rate above the market rate when the price level is rising, providing money and credit only at the discount rate, as it is demanded. This is the correct target of monetary policy. It is a correct policy because it can succeed. If the target of Fed policy is the money stock, then as we have seen, it fails, because the Fed *cannot* determine the supply *and* the demand for money. It can only determine its own assets. But to supply only the new cash balances demanded by the market (our correct

Fed policy) means simply that the Fed adds new assets to its portfolio (securities and discounts) while simultaneously it increases equally its liabilities (bank reserves and currency). Under the rigorous new target of monetary policy, the Fed will supply those bank reserves and currency in an amount which is strictly equal to the demand for them from the market. Now, if the supply of cash balances is strictly equal to the demand for cash balances, the price level must tend toward stability. That is to say, there can be no excess cash balances. If there are no excess cash balances, there is no inflation.

Such a remobilized discount rate is an artful instrument, properly proportioned to the limited knowledge and intelligence of mortal man. Its effective use requires little discretion on the part of central bankers and economists. Moreover, the discount rate merely requires for its effective use the limited information available to *all* participants in the market for cash balances. To oversimplify but to briefly demonstrate this point, consider that the discount rate is a bank rate. It is the threshold level at which some buyers of cash balances (in this case, the banks) may gain access to new money “outside” or away from the market (that is, at the central bank).

Now, in a given market period, if actual cash balances are equal to desired cash balances, market interest rates must be stable. If in a subsequent period the demand for cash balances exceeds their supply in the market, money market interest rates on bankers' acceptances and commercial paper begin to rise toward the level of the bank rate outside the market. If the demand for cash balances in the market remains unsatisfied, money users will eventually gravitate to the bank, when the market rate finally intersects with the bank rate. If the demand for money persists, then the bank rate will begin to rise in tandem with the market rate. But under a correct monetary policy, the *discount rate* hovers slightly over the *bank rate*, as the bank rate itself hovers slightly over the *market rates*. As soon as the banks exhaust their ready cash balances, the commercial bank rate itself will levitate toward the discount rate of the central bank. At the point where the commercial bank rate intersects with the central bank discount rate, creditworthy commercial banks may then cross the critical threshold. Thereby, they gain access to *new* cash balances at the central bank outside the market. The central bank's willingness to discount eligible paper as the “banker of last resort” provides the necessary cash balances still demanded but previously unavailable in the money market outside the banks. There is still no inflation, because the banking system, as a whole, supplies a quantity of money strictly equal to the amount demanded in the market. The money stock goal is met, because market participants obtain all the money they need.

In the context of the new Fed target, as defined above, reserve requirements are therefore innocuous and may be abandoned. More importantly, one terminates open market operations because the central bank cannot know all the data in the market and therefore cannot know in what precise volume and at what precise interest rate it should supply credit by buying and selling securities. Open market operations are a crude intervention; and, as experience has shown, generally result in a surfeit or paucity of cash balances supplied to the market. As a result, open market operations in the past have tended to cause unpredictable variations in the price level. In fact, history shows that open market operations lead to secular extension of credit and a sustained rise in the price level. Is there really so great a difference between *neo-Keynesian fiscal fine tuning* – through tax and budget

policy — and *Monetarist fine tuning* — through continuous open market operations in the market for cash balances? What are continuous open market operations if not an effort to fine tune the money stock, according to a predetermined rule, a rule which may or may not give rise to an equilibrium level of cash balances during a given market period?

Previous experience in the market gives one little confidence in central bankers who, even following a fixed quantity rule, have the monopoly power to manipulate — on a day-to-day basis — the interventionist tool of open market operations. First, each market period is unique. Does the Open Market Committee know enough about the peculiar origins of disturbances in the market for cash balances in a given market period? Second, financial information is neither perfect, nor is it instantaneously available. Nor are the causes and effects of the variations in the demand for cash balances, in any one market period, sufficiently well-known. Open market operations, even in the hands of intelligent men of good will, are at best nothing more than poorly educated guesses and at worst rank speculations. These guesses are hardly the stuff of a responsible monetary policy. They will not give rise to an “efficient tool” for the implementation of monetary goals, even if the rule or goal itself is efficient and simple.

Therefore, the correct policy prescription is to cease open market operations and to require the Treasury to finance its cash needs *in the market*, away from the banks, except for authentic self-liquidating tax anticipation bills of less than a year’s maturity, made eligible thereby for rediscounting. As a result, monetary regulation in the banking system would henceforth be achieved through the supremacy of the central bank discount rate. If we wish to avoid the evils of an overly “managed currency,” then it is uniquely the discount rate mechanism, alone among the tools of central banking, which achieves this goal. The discount rate is a tool scaled to the wit of men. It requires little of central bank “currency managers” who might otherwise desire to fine tune the money stock growth, according to a quantity rule, with the full panoply of their powers. The monetary policy of the future will therefore distinguish between ends and means, calibrating the latter to the former.

If we seek an end to inflation, then we seek a stable price level. We do not seek a specified quantity of money. But if the supply of money equals the demand for money at prevailing interest rates, then the price level must remain stable, and people and businesses will have all the money they desire — because, in a free and open society, the demand for money is determined by the sovereign users of money, the consumers and producers. How many *solvent* consumers in a market economy make a demand for money which is not supplied? *None*. The participants in the market create the demand for money. The commercial banks and the central bank, by guiding the bank rate and the discount rate and deftly hovering over the market, must simply be prepared to supply creditworthy borrowers without limit; and, *in extremis*, to be the banker of last resort.

As a result of this new policy target, the supply of cash balances in the market must always be gradually adjusted to the demand for them. Then there can be no inflation. The reason being that since the quantity of actual cash balances supplied is made strictly equal to the amount of money desired, the market for cash balances as a whole will be stable. Excess cash balances, the cause of inflation, have been ruled out. The money market, under these conditions will tend toward equilibrium; and, under

the new operating target, will tend to remain there. The consequences of such a monetary policy will have pervasive effects throughout the economy. Since the supply of cash balances tends to equal the demand for them, no one in the market will desire to make a purchase with existing cash balances until he first produces a new sale in exchange for additional cash balances. In a word, no one will demand without first making a supply. When the market for cash balances tends toward equilibrium, no one will consume anything more unless he first produces something more. Under such conditions the price level will vary moderately around unity. That is to say, there will be no inflation arising from excess cash balances created by the central banking system through open market operations, since the banks will supply only the money which is demanded in the market.

As defined here, such a monetary policy comes to grips with, indeed it modifies, Say’s Law of Markets and the inadequate Quantity Theory of Money. One reformulates: aggregate demand is equal to the value of aggregate supply, augmented (+/-) by the difference between the supply of actual cash balances and the level of desired cash balances.*

The Prescription

The new monetary doctrine for a sound currency is now clear: First, Fed open market operations must cease. Second, the discount rate of the central bank must be remobilized so that it ceases to be a subsidy rate, which in the past gave rise to credit expansion, excess cash balances, and inflation. The discount rate becomes instead a market-related rate and generally hovers, during periods of economic growth, above the bank rate, thus providing no profit (or subsidy) incentives to commercial banks to expand cash balances (credit) beyond the demand for them.

To be sure, Monetarists would claim to fix the total quantity of money, through a specified money stock rule, in order to regulate the government monopoly (the Federal Reserve Board) which supplies cash balances to the market. Yet the simpler, market-related technique would be to make the value of a unit of money equal to a weight unit of gold, in order to regulate the same monopoly. Some would argue that such a monetary “regulator” absorbs an excess of real resources, namely the laborious process of gold production, in order to sustain it, and is therefore, in social and economic terms, too costly. Whatever the minor incremental social cost of a convertible currency, it is nevertheless a superior stabilizer and a more efficient regulator of price stability *in the long run*. One test is history, and Roy Jastram’s scholarship proves, in *The Golden Constant*, that convertible currencies yield price stability in the long run. For that matter, the goal of an enduring social order, unlike that of the individual, must not be to maximize welfare in the short run, but rather, in the long run. It is not an excessive cost to society to allocate a minor share of its real resources to the regulating mechanism of its money supply. Nothing else will assure the indispensable virtue of long run *trust* in its monetary unit.

Therefore, in order to bring about *long-run* stability in the market for cash balances, the dollar must be defined in law as equal to a weight unit of a real commodity, such as gold, at a statutory convertibility rate which insures that nominal wage rates do not fall. Nothing less will yield a real fiduciary currency. Such a gold converti-

* This formulation of the quantity theory of money expresses the basic theorem of Jacques Rueff’s monetary economics.

bility plan at a fixed rate is virtually a constitutional guarantee of the purchasing power of money and therefore of the future value of savings. The legal framework of a convertible currency makes of money an *enduring* political institution. As the U.S. has the oldest written political constitution, it is now time to offer the world a real money, underwritten by the constitutional guarantee of gold convertibility.

As a result, no bank, not even the central bank, could expand credit beyond the demand for it in the market. An excess supply of money would cause the general price level to rise, but the gold convertibility price would remain the same. Therefore, the fixed gold price would fall relative to the rising general price level. Elasticity of demand for the relatively cheap gold would create an increasing demand for a limited supply of it in exchange for the excess cash balances now offered for gold to commercial banks and the central bank. The failure to redeem these excess dollars for gold would, under convertibility rules, threaten the bankruptcy and dissolution of a commercial bank. A default by the Federal Reserve System would result in the breach of a solemn legal obligation and therefore violate the Constitution of the U.S. Depreciation of the currency would follow, and inflation would be a direct result. Constrained, therefore, by law to redeem excess dollars with specified weight units of gold, the central bank, as the price level rose, would *have* to reduce the growth of credit and money — until once again it supplied no more money than the market demanded. As the banks contracted credit, excess cash balances would be reabsorbed, and demand for gold at the banks would cease. Convertibility would prevail. And, the threat of bankruptcy would be forestalled. The price level would descend; inflation gradually would end. Stable prices would now prevail, even though the banking system, in order to increase profits, may have wanted to expand money and credit faster than the rate of growth of production.

At all times these institutional arrangements under the new monetary regime will assure that the supply of cash balances will be made equal to the demand for cash balances, at varying interest rates *determined by participants in the market for cash balances*. What matters is that the level of cash balances and the level of interest rates are determined in the open market, *not* in the Open Market Committee of the Federal Reserve System. So long as the discount rate hovers above the bank rate, and the bank rate above the market rate for eligible paper, the market for cash balances will yield in any given period a closely related cluster of interest rates. The variations in these market rates, as they intersect with and disengage from the bank rates, will tend to create an equilibrium level of

the money stock. There is little need in such a market for trying to fine tune the money stock through continuous open-market operations. An efficient money market, and simple institutional rules governing banking system discount rates, will tend to give rise to the *necessary* rate of growth in the supply of cash balances. Above all, this growth rate would be consistent with the rate of real economic growth (say 4%) and with changes in the velocity of money as determined by economic activity and the technology of the payments mechanism — *because the new target of monetary policy is to supply only the quantity of money demanded in the market*. As the target is hit, the goal of monetary policy will be fulfilled: namely, a stable price level.

In sum, the present inflationary impasse requires a number of specific remedies: (1) Remobilize the discount rate. (2) Admit that the central bank cannot control the money supply, even though it can control Federal Reserve Credit. (3) Therefore, abandon hyperinterventionist open market operations, as they cannot achieve a stable money supply. (4) Stand ready at the central bank to supply, at an unsubsidized rate, all the money demanded by *solvent* commercial banks: (5) After achieving the first four goals, herald the restoration of dollar convertibility (in 12 to 18 months) at a fixed rate, to be determined over time largely in the market; but at a level which, under no circumstances, will reduce nominal wage rates. (6) Finally, convoke an International Monetary Conference, under the leadership of the U.S., with the goal of establishing a true gold standard, one which would rule out the special privilege of *official* reserve currencies and thus remedy the most profound defect of the Bretton Woods exchange-rate regime.

The Benefits

The effects of true monetary reform would appear immediately. The price of gold would fall to its equilibrium level, emptied of a value based on inflationary expectations. The price level would stabilize rapidly. Long term interest rates would fall 700-800 basis points. At lower interest rates there would be a vast demand for investment capital. With a stable price level, a stable dollar, and lower relative tax rates the sluice-gates would open and a flood of savings would flow into the market. Equity and debt capital would once again pour into business enterprise. The nation's productive plant would be rebuilt. Therefore the demand for labor would rise. Unemployment would decline.

The true onset of the "American Century" will have arrived, coincident with the end of inflation in the Western World.

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