

ON THE LONG ROAD BACK TO GOLD

The name "money" originally referred only to coins whose exchange value was determined by their metal content. Coins were simply a convenient form in which to use metal as a medium of exchange. Metals, and especially precious metals, came to be used as money for the practical reason that they are more durable, more alike piece-to-piece, more easily divisible, and have a comparatively higher value per volume or weight than most other things that might be traded.

Many commodities besides metal coins have been used as money in various parts of the world at various times. Cattle, wampum, cigarettes, are some. What made such things money rather than barter goods was that they were accepted for use in subsequent exchanges rather than for direct consumption or for processing (producing) other things.

Written promises to pay money also can be widely accepted for use in effecting exchanges. But such promises are not the money commodity itself because they require performance (on the part of somebody) to discharge the promise. In time, people evidently became so accustomed to using the promises to pay commodity money that the difference between the promise and the commodity itself was no longer widely recognized. Today, all money is a promise to pay. But there no longer is a promise to pay any particular thing other than another similar promise. In the financial world, a "note" is a promise to pay money; today's currency notes plainly are not that.

None of the paper money in your possession contains a promise to pay anything. You will find a cryptic: "this note is legal tender for all debts, public and private."* Today the note issuer (a Federal Reserve bank) does not promise to deliver anything; instead, the power of the Government is embodied in the note to force creditors to accept the notes in discharge of *outstanding* debts stated in terms of dollars.†

* Under the law, a creditor who refuses legal tender in satisfaction of a debt is not due any interest after the tender is made, so long as the tender is in a sufficient amount and made at the proper time and place. Prior to 1933, only gold coins were legal tender in all circumstances in the United States.

† We emphasize "outstanding" because when public doubt about the future buying power of legal tender grows, *new* transactions denominated in legal tender may be refused. At one level, growing refusal to deal in legal tender is illustrated by the "drying up" of the long-term bond market. In the extreme, public doubt about the legal tender can become so great that usual day-to-day transactions are blocked because prospective sellers of goods will not accept legal tender in exchange for them. Even the most ruthless of governments cannot force people to enter new legal-tender contracts; they first will not produce or trade. In his excellent book, *Fiat Money Inflation in France*, Andrew Dixon White reported on the hyperinflationary paper-money assignat experience of the 1790's. He pointed out that after fiat-money price controls known as the "Law of the Maximum" were imposed, merchants and farmers began to demand payment in gold or silver coins. To counter this, the government im-

posed the death penalty on those convicted of "having asked, before a bargain was concluded, in what money payment was to be made." The major effect of the law was to drive more merchants, artisans, and farmers out of business, sinking the economy deeper into depression.

These IOU-nothings (credit is due to John Exter for coining this most appropriate term) are created out of "thin air" when a Federal Reserve bank acquires some asset (usually a Treasury debt security or an IOU of a private bank). By law Federal Reserve officials are free to create or destroy as many of these IOU-nothings as they choose. The legal power of Federal Reserve officials to create as many IOU-nothings (paper dollars) as they determine is an awesome one. Decisions of the Fed officials affect not only banks and other financial institutions but also all Americans acting in their roles of producers, consumers, debtors, savers, and investors. International economic and financial conditions also are affected. And in this Presidential election year, what the Fed does in the next several months could well determine the election results. The 12 members of the Federal Open Market Committee have power indeed.

This power has increased since the Federal Reserve's creation. Incremental increases in the Fed's legal control over the Nation's money-credit system occurred as earlier power was deemed inadequate. That power seemed insufficient when market participants did not act in ways consistent with "official" theory or policy goals. As is typical of government bureaucracy, the more the Fed failed to perform its function, the more tasks and power it was given. Today the Federal Reserve has virtually unlimited power over U.S. money-credit conditions in the short run. And yet the Fed is powerless in the long run. The private market ultimately is king.

There seldom is agreement about what the Fed is actually doing at any given time, or even what policy the Fed's observed past actions have implemented. Usually for every observer who concludes that the Fed's policies were, or are, too "accommodative," another opines that the Fed was, or is, too "restrictive." A fiat-money system perforce requires a large input from "authorities," who are buffeted by all types of conflicting demands. Central banking was not always so impossible, and it need not remain so.

Private banking policy largely is concerned with finding the optimum balance between liquidity and profitability. A bank that held nothing except currency (specie, if a commodity-money system) in its vaults in an amount equal to deposit liabilities would have no source of income to pay its costs unless it charged fees for deposits. Alternatively, a bank that lent and invested all its depositors' funds in order to earn more interest might end up earning less. To meet depositors' withdrawals, the bank might borrow against its

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assets or sell them quickly, but this could be more expensive than keeping some of its assets in more readily available but less remunerative forms. In short, a bank's balance sheet and income statement guide the banker's policy.

Under a fiat-money system, this does not apply to central banks, such as the Federal Reserve. Because the Federal Reserve banks' liabilities are IOU-nothings, the Fed's managers do not need to be concerned about liquidity. They can simply create more IOU-nothings at their own discretion. But then what do Fed officials use as a guide for operating the Federal Reserve system?

That raises the additional question, What are the Fed's goals? The simple answer is that the primary goal of Federal Reserve officials is the same as that of hired managers everywhere: keeping their jobs and advancing their careers. But, unlike private bank managers whose performances are judged by the safety and profitability of their banks, Federal Reserve managers are held accountable for a wide variety of economic conditions. Many of these — such as interest rate levels and changes, the level of employment and economic output, and the purchasing power of the dollar domestically and abroad — are only partly influenced by the Federal Reserve. Compared to a private banker's goals, those of the Federal Reserve managers are ill-defined and subject to wide changes in emphasis.

In a sense, however, the basic questions Fed officials face are similar to those of the private bankers. At any given time, the immediate questions are: Should more or less credit be extended and what rate should be charged on loans?*

WHEN GOLD WAS THE GUIDE

The prototypical central bank, the Bank of England, was a private bank at its inception. Because the private Bank of England never failed to meet its obligations, even during periods of financial turmoil such as the South Sea Bubble, its IOUs (notes) became the most widely accepted in Great Britain and abroad. Moreover, other British bankers shared the public's confidence in the Bank of England and made it the major custodian of funds they needed to make payments to each other and abroad. New balances with the Bank of England could be obtained by delivering specie (coins and bullion) or by delivering "bills" to be discounted (i.e., exchanged for less than face value, the difference being interest when the holder collects from the issuer).†

The Bank of England quickly made two important discoveries. One, its reputation for soundness stemmed from its ready ability to redeem its demand obligations in specie. Two, this ability did not require that a large proportion of specie be held against possible claims as much as it required quick policy response to market changes.

What policy response was clear. When the bank was paying out specie, the discount rate was raised to encourage customers to deposit specie and discourage borrowing. When the bank was receiving specie and its gold inventory

* We are not suggesting here that bankers control the general level of interest rates. They do, however, set the rates on their direct loans to their customers (the discount rate the Fed charges its member banks). Whether customers will borrow more or less depends in part on the member banks' available alternatives, and these alternatives become more or less preferable depending on the rate the Fed charges.

† A bill is a written order by one party (the drawer) ordering a second party (the drawee) to pay a sum of money to a third party (the payee). Space does not permit a discussion of what made a bill an acceptable holding for a banker. Suffice it to say, when banks created notes or deposits for other than "real bills," that is, bills used to finance the offering of marketable goods expected to be sold in the near future, their liquidity was impaired and they invited bankruptcy.

(which did not earn interest) was increasing, the discount rate was cut to provide the opposite incentives. In this respect the guide to policy for the Bank of England was essentially that of other successful banks: specie in, lend more; specie out, lend less. This simple policy guide helped to make the pound sterling the most stable and respected currency in the world for nearly 200 years.

When the Federal Reserve system was established, the essential features of this practice were made legally binding: Federal Reserve liabilities were convertible into gold; the Fed's gold holdings had to comprise a specified minimum proportion of its note and deposit liabilities (40 percent); and the remaining percentage had to be discounted real bills. The external limit of gold and its implied policy guide thus were part of the original U.S. central banking arrangement. This direct link between the money-credit market and official policy incorporated the judgments of all market participants in directing Fed policy.

Faced with the need to raise funds to finance World War I, with chronic deficits during the Great Depression of the 1930's, and then with World War II, the politicians who ultimately controlled the Fed changed the law to allow and encourage the Fed to hold more and more debt of the U.S. Treasury as "backing" for the Federal Reserve's liabilities. The "real bills doctrine" was discarded, and the Fed actively bought and sold Treasury debt to effect credit conditions it thought appropriate.

Nevertheless, as these adverse changes were occurring, official gold holdings increased. They jumped from \$4.0 billion to \$7.4 billion when on January 31, 1934 the dollar was devalued from 25 8/10 grains to 15 5/21 grains of nine-tenths fine gold. The "price" of gold was raised from \$20.67 to \$35.00. The official U.S. gold stock subsequently rose nearly continuously, reaching \$22.7 billion at the end of 1941. These inflows reflected the flight of European capital and European purchases of war materiel in anticipation of World War II. And they provided ample gold "cover" for Federal Reserve liabilities.

During the war, however, the Federal Reserve monetized so much Treasury debt that even the enlarged gold holdings threatened to become insufficient to cover the required 40 percent of liabilities.** Congress reduced the required gold cover to 25 percent in June 1945, when the gold stock was about 575 million ounces. After the war, the amount of official U.S. gold holdings increased to a record 700 million ounces in 1949. As a result, the gold stock remained greatly in excess of that legally required to cover the Fed's liabilities, even though such liabilities (currency and member banks' deposits with the Fed) continued to increase during the postwar period.

INTEREST RATES BECOME THE GUIDE

By this time, open market operations had become the dominant tool of Fed policy. Discounting eligible paper, and changing the discount rate when the Federal Reserve's balance sheet suggested change was appropriate, slipped to a minor role. With its enormous gold hoard, the Fed's managers had little concern for its balance sheet. Yet they needed something to guide their policy actions. They chose interest rates.

Indeed, until March 4, 1951 the Fed agreed to "peg" Treasury securities, i.e., to purchase whatever amount was needed to keep Treasury yields from rising above specified levels. Each purchase provided another inflationary ingestion of money. After the Fed-Treasury "Accord" of that

** Federal Reserve gold holdings went from \$2.2 billion in December 1941 to \$21.0 billion at the end of May 1945.

date, which freed the Fed from a requirement to peg, the Fed decided to conduct its open market operations only in short-term Treasury debt — that is, Treasury bills. This was known as a “bills-only” policy. But the “bills” were not “real” bills, whose volume was dictated by genuine business needs; they were Treasury bills, whose volume was dictated by political considerations.

The Fed’s focus on interest rates permitted a more flexible policy — too flexible as events demonstrated. What was deemed the appropriate target rate of interest was to be determined by a wide variety of factors. At any given time the entire panoply of economic indicators was deemed relevant to the Fed’s simple decision to buy or sell Treasury securities.

This procedure was supported by economic theory, especially that of the followers of John Maynard Keynes. We will not here describe the elaborate theoretical edifice they constructed. However, one fatal flaw in the theory was the notion that at any time there is some single rate of interest most conducive to present and future economic well-being and Fed officials could ascertain that appropriate rate of interest. More often than not, Fed officials decided that the market-determined rate of interest was too high, so they worked to bring interest rates down by monetizing more debt — mostly more Government debt.

As more of the newly created dollar liabilities ended up in foreign central banks (postwar aid programs put some of them there), they were presented to the Fed for payment in gold at the official rate of \$35 per ounce. One result was a massive and persistent outflow of gold during the 1950’s. This signal of an excessively “easy” policy was disregarded. Instead of taking steps to limit the monetization of debt, the historical policy response to an outflow of gold, officials continued to pursue a low-interest rate policy in order to stimulate domestic demand, output, and employment. To stem the outflow of gold, they imposed special taxes and regulations to discourage the outflow of dollars. The “interest equalization tax” was designed to discourage the purchase of foreign securities by Americans. As one of his final acts in office, President Eisenhower prohibited the ownership of gold by U.S. citizens anywhere in the world, rather than just in the United States itself.

Nevertheless, by March 1965 official U.S. gold holdings had dropped to about 425 million ounces. At \$35 per ounce this amount was barely equal to the 25 percent required cover of Federal Reserve liabilities. The markets were clearly signaling that U.S. monetary policy was excessively easy.

Once again, the authorities thought they knew better. Rather than take the steps needed to ensure compliance with this statutory requirement — namely, to adopt a restrictive policy — the “requirement” was changed. Congress totally removed the legal requirement that the Fed hold gold reserves against its deposit liabilities, but it left in place the minimum 25 percent gold backing for the total of Federal Reserve notes outstanding.

Not for long, though. Just 3 years later, in March 1968, the U.S. gold stock had decreased to about 300 million ounces and was approaching the legal minimum. Once again rather than adjust monetary policy to market signals, Congress chose to remove the 25 percent reserve requirement for Federal Reserve notes so the Fed could continue its inflationary ways.

Yet, the Treasury remained committed to redeem dollar liabilities in gold at \$35 per ounce when “official” institutions so requested. This final link to gold was severed when President Nixon reneged on the promise in August 1971. Since then the dollar (and every other currency in the world) has been an IOU-nothing. And for the purposes of

this discussion, the significant aspect was that Federal Reserve officials and other central bankers did not have a useful policy guide.

In an effort to improve its record as one failure after another has become evident, the Federal Reserve has changed its policy focus often. What was deemed the most pressing problem of the moment also played a part in the changes. As for the Fed’s regulatory policy, it has been one of “locking the barn door after the horse was gone.” For example, limitations on interest rates payable on deposits were at first raised and later eliminated only after market participants devised ways to circumvent them.

In 1958, a British economist named Phillips published an article that discussed past relationships between the levels of unemployment and the rate of increases in money wages. Keynesian economists quickly seized upon his findings as “proof” that the twin goals of stable prices and low unemployment were inconsistent. To them the implication was that the market process could not equitably settle this issue and therefore policymakers needed to strike the proper balance between the two goals at any given time.

TRYING MONETARISM

However, by the late 1970’s, after nearly 2 decades of attempting to “fine tune” the economy and strike the right balance between price rises and unemployment, the terms of this alleged “trade-off” had worsened. In the “boom year” 1979, U.S. unemployment averaged 5.8 percent and the Consumer Price Index increased 13.3 percent. By comparison, in the boom year of 1956, unemployment averaged 4.1 percent and consumer prices increased 1.6 percent. Although other factors such as demographic changes and the oil situation were often blamed for the worsening trade-off alternatives, it became increasingly clear that trading “a little inflation” to promote lower unemployment had brought a lot of “inflation” and a worsening employment situation.

With the foreign-exchange value of the dollar falling sharply and with general price indexes, nominal interest rates, and the price of gold rising rapidly in 1979, the policymakers knew they were in trouble. But they were not about to give up their power. Instead, in October 1979 the Federal Reserve Board announced that it was going to use changes in the money stock measures (M1, M2, etc.) rather than the level of interest rates, as the major guide for intervening in the market. This long had been advocated by “monetarists,” the chief of whom is Milton Friedman. The Fed declared its intention to gradually reduce the rate of growth of M1, M2, etc. to a level consistent with price stability.

The degree to which this policy was implemented is unclear. Interest rates did become more volatile, suggesting that the Fed was doing less to keep them stable. But the pre-announced “targets” for the monetary aggregates were often missed, suggesting that the Fed was not using them exclusively as a policy guide. Leading monetarists assert the Federal Reserve’s policies subsequent to October 1979 were not really monetarist policies. According to Karl Brunner, “*Monetary targeting was a hoax, a tactical device to defuse outside pressure on the Fed to initiate a policy of monetary control. . . . The tactical use of targeting designed to protect the traditional range of discretionary policy is well understood by former members of the Fed’s staff and close observers of the scene. This fact explains the prompt appearance of a multiplicity of M’s, the weights assigned to specific M’s shifting with the perceived political convenience and . . . ‘target drift’ Other aspects of the Fed’s behavior may be considered. Its strategic conception*

centered on activist policymaking, and its tactical procedures anchored by the federal funds rate essentially were unchanged.”*

A flaw in the monetarist prescription is that officials cannot dictate what the public uses as purchasing media; people in the marketplace decide that. With the proliferation of easily transferred interest-bearing financial claims (among them, NOW accounts, Super NOW accounts, money market mutual funds, and repurchase agreements) much doubt has arisen concerning whether the reported money stocks adequately measure purchasing media in use.

Monetarists assert that revisions to the definition of the money stock series to make them consistent with the changing items constituting “money” maintain the workability of their policy prescription: a steady rate of growth of “money” over spans of 12 months or more. They declare that after-the-fact revisions to the money stock series – even during the volatile early 1980’s – were not so far different from before-the-fact predictions as to destroy the usefulness of money supply (as initially defined) as a policy target.

Perhaps that is true – but even if it is true, the fact that the targeted money series must be redefined from time to time is fatal to the monetarist prescription. Here is why.

Among the more persuasive work the monetarists have done is to describe the conditions required for an interventionist monetary policy to be useful. Brunner tells us they are “full information and a public interest theory.” “Full information” refers to accurate theory (warranted descriptions) about how all the complex and detailed economic aspects are related *and* accurate information about the current state of all those aspects. By “public interest theory” Brunner refers to a notion “that the full information available will be faithfully exploited for the social benefit.” He goes on to point out, rightly in our opinion, “*But both components of the sufficiency condition are thoroughly contradicted by relevant observations.* Political reality, especially, can hardly be described in terms of a ‘public interest’ theory. Policy bureaucracies and politicians are entrepreneurs in a political market in which information is costly. These political entrepreneurs are deeply involved with their own political interests and influence. Their own preferences dominate the pattern of activist discretion. . . .”†

* “Has Monetarism Failed?”, *Cato Journal*, Vol. 3, No. 1, Spring 1983, p. 53.

† *Cato Journal*, Spring 1983, p. 32.

CATCH 22

Monetarists thus clearly see that politicians will use monetary power for political ends. Monetarists also admit that from time to time the official definition of the money measures used as policy targets in a fiat-money system will require revision. But who will decide what the new definitions will be and when they will be implemented? It can only be the politicians or their monetary handmaidens, the central bankers. In our view, this is an inescapable aspect – and *fata!* flaw – of even the most “nonactivist” monetarist prescription. The money growth-rate rule might be written into the Constitution, but provision will have to be made for redefining the money series to which the growth rates apply because what constitutes “money” changes over time. That gets the political camel’s nose into the tent, and the rest of the camel is sure to follow to take over completely.

Monetarism thus is a Catch 22 situation: a political element – and a rather large one at that, since the pace of financial innovations seems to be rapid – is integral to their regime; yet, when monetarists observe politics influencing money stock definitions or growth-rate decisions, they declare that genuine monetarism is not being practiced. Evidently, genuine monetarism will work only in the classroom; therefore, attention had better turn in another direction to solve the real monetary problems of today.

Other prescriptions have been offered. One is the targeting of “real” interest rates in order to ensure that savers receive a real return and that borrowers incur a real cost. Another is to use changes in the paper-money price of gold as a guide. All such proposals suffer from the fallacy that officials somehow “know best.”

We are convinced that volatility in economic activity, interest rates, exchange rates, securities prices, and prices in general is likely to worsen until and unless the money and banking system again is put directly under the control of market participants. The way to bring this about is to make all monetary liabilities claims on gold and to make the bankers responsible for meeting their obligations. Both supply and demand for money (and credit) thus would be market determined. The only monetary role Government would have would be to enforce monetary contracts. There would be no need for an “official” monetary policy. Every market participant – users and issuers of money – would set his own policy. The collective decision – reflected in market conditions – would be the national monetary policy.

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