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How To Cope With A Flight From The Currency

The founder and Director Emeritus of the Institute, E. C. Harwood, recently wrote the report that follows in response to questions asked by the office of a U.S. Senator. In view of the recent skyrocketing price of gold in terms not only of the dollar but also of all major paper currencies, the message is most timely. We do not assert that the recent price action of gold reflects the beginning of a flight from currencies. In our view, this is a possibility but is not yet highly probable. However, if a flight from currencies is in the early stages, the implementation of E. C. Harwood's suggestions perhaps would halt or at least retard it in the United States.

E. C. Harwood does not propose immediate restoration of gold redeemability of the dollar. His plan would have the United States promote competition between the paper dollar and gold as a monetary unit by making available U.S. gold through a procedure that would foster some deflating (removal of excess purchasing media from circulation) and thereby enhance the acceptability of paper dollars remaining in use. Along with the implementation of other suggestions, this procedure eventually might restore gold as the U.S. monetary unit, but that need not occur immediately to prevent the collapse of social order that almost certainly would accompany a worldwide flight from currencies. The availability of gold as an alternative "money" could facilitate continued functioning of the U.S. economy in spite of chaotic conditions elsewhere.

A detailed description of the Institute's views concerning many policies that would promote sound economic progress in the United States will be presented in a forthcoming Economic Education Bulletin.

Prolonged inflating usually has terminated in a flight from the currency. A nation's citizens gradually discover that their money buys less and less; then they find that their savings and life insurance have been embezzled, in effect, by the nation's money managers; and finally they are able to buy little of value with the paper money. At this stage, all the usual channels of trade are disrupted, and the economy collapses. Social order breaks down. Most such developments during the long span of recorded history have ended in bloody revolutions followed by dictatorships of the left or right.

That the United States and much of the rest of the world have been on a prolonged inflating spree since the final years of the Great Depression and including World War II is beyond any doubt. For the first three decades (the 1940's, 50's, and 60's), the consequences of continued inflating were discernible but not striking. As inflating has accelerated in more recent years, its consequences have become more obvious. By the end of 1978 the total of savings and life insurance thus embezzled from American citizens had become an awesome amount exceeding two *trillion* dollars. The rate of depreciation of the dollar (loss of its buying power as prices rise) in recent months has reached 15 percent annually.

Not only in the United States but also in most other nations inflating has had consequences now painfully apparent to many. The recent rapid rise in the prices of gold and silver may be the earliest indication that a worldwide flight from paper currencies has begun. If so, it could become a stampede reflecting justified fears that the money managers of most nations would be unable to cope with the situation.

This raises a vitally important question: Is there any action that the United States could take to restore confidence in its currency at an early stage in a flight from most world currencies? Unless there is something that the United States can do alone, little basis remains for hope of avoiding serious social disorder, perhaps within several months and probably before many more years have elapsed. Relying on concerted action by the member nations of the IMF, for example, seems futile. Thus far in their prolonged departure from money-credit sanity they have been able to agree only on the silly SDRs as a proposed solution to the problem. Monetary "gimmicks" may for a time quiet the public's fears, but in the longer run would add fuel to the flames of inflating and augment distrust in paper currencies.

The basic monetary problem is that "for integrity there is no substitute." Can the modern money managers learn this lesson that French citizens attempted to emphasize by hanging their bankers from the lamp posts 200 years ago? If there is any evidence that today's money managers are capable of learning the obvious lesson, it has not come to my attention. Nevertheless, one can suggest how a return to honest money could be effected, then hope for the best.

Toward Sound Money

The first step would be for the United States to resume minting gold coins designated only by the weights of pure gold each contained. Coins having a pure gold content of ¼, ½, and 1 full troy ounce would be suitable; or coins containing pure gold weighing 10, 20, and 30 grams probably would be equally acceptable. The word "dollar" or some multiple thereof would *not* be applied to the coins, nor need they be given the status of legal tender. U.S. citizens already have freedom to own gold and to write contracts using gold as the quid pro quo. Such contracts already are legally enforceable and so would continue.

Having announced the minting of coins at the maximum rate practicable, the U.S. Government then should offer to sell the coins, in other words redeem its paper currency with the new coins, at *the market price of gold* (in paper dollars) established daily in the London

market from day to day as the coins came from the mints. Details of the program might be:

1. Presumably, the rate of minting could be on the order of 20 to 30 million ounces of gold annually. At 350 paper dollars per ounce, redemption of dollars could absorb $8,750,000,000 each year. According to Treasury reports, the United States has enough gold to continue at this rate about 10 years, but if related reforms were accomplished continuation for more than a year or two probably would be unnecessary.

2. Holders of the paper currency or claims on it such as checking accounts would be invited to deposit their paper claims at the Federal Reserve banks in order to establish relative priorities for receiving gold coins in exchange. No interest would be paid on such deposits nor would the depositors be entitled to withdraw their claims; they would be entitled only to gold coins at the London price on the day coins become available for each successive depositor.

3. Paper dollars deposited with Federal Reserve banks for redemption would be in the form of currency or checks drawn on the checking accounts (demand deposits) of various commercial banks, whereupon:

a. In either event, some purchasing media would be removed from circulation.

b. Reserves of the commercial banks would be somewhat reduced.

c. The Federal Reserve banks would buy gold coins from the U.S. Treasury, which would redeem its gold certificates now held by the Federal Reserve banks at the present theoretical gold value of the dollar and use the surplus received for coins in excess of $42.22 dollars per ounce to retire Treasury bills held by the Federal Reserve banks. This would reduce the monetary base of Federal Reserve credit, a procedure that also would remove some inflationary purchasing media from circulation.

4. In the meantime, if all restrictions on gold warehousing were removed, new companies as well as existing banks would become gold merchants who credited customers' accounts with gold deposited, made it available on demand, and loaned gold. Already, some nonbank companies and a few banks accept gold deposits. As the basic principles of sound commercial banking were remembered and applied (or re-evolved much as they did during the 1800's), *commercial* loans denominated in gold could properly be made as they once were.

5. Then origination of Federal Reserve credit could once again be restricted to temporary accommodation of individual banks *only* by rediscounting strictly commercial short-term loans based on shipment of things to the Nation's markets. No longer would the Federal Reserve banks be permitted to buy Government securities and thereby to monetize Government deficits; nor could Government securities be used by individual banks to borrow at the Fed. The check-clearing function of the Federal Reserve banks could be augmented so that checks denominated in gold by specific weights could be cleared much as checks denominated in paper dollars are today. Clearings would be in *both* paper dollars *and* gold by weight (either grams or troy ounces, using decimals as needed of course). Embezzlement via inflating must be abandoned as a way of life.

6. The procedures indicated above might ameliorate but would not solve the problem. Examples of additional appropriate steps might be:

a. Provision for a Federal Budget surplus and regular retirement of the Federal debt every year unless a Budget deficit inadvertently was incurred (borrowing to cover a deficit must be from the public's savings and must not be monetized by the banking system);

b. Establishment of better priorities for Federal expenditures so that essential needs such as adequate provision for National defense would be met; and,

c. Reform of tax programs to foster investment and reduce special privileges.

d. Restudying the Social Security program with a view to eliminating the aspects that Professor Samuelson described as a "Ponzi scheme" several years ago while fulfilling implied promises to all retired or soon-to-be-retired persons; and,

e. Paying all defense expenditures in gold as Napoleon did (he resolutely refused to pay any government expenditures otherwise than in gold). Payment in gold could be required for a portion of taxes.

f. All existing contracts including bond issues, etc. could remain payable in paper-currency dollars, but the Government should experiment with bonds denominated in gold if and when borrowing became necessary. A surprisingly low interest rate probably would be incurred. Eventually all of the U.S. debt could be refunded with gold bonds at a great saving in interest costs.

g. Permitting borrowers to contract for repayment of principal and payment of interest in either gold or so-called "legal tender" paper money as the two parties to the borrowing and lending might agree. When gold was specified in any contract, the present legal tender dollars would be acceptable at the daily rate used by the Government in selling gold coins, that is, in redeeming its paper.

Related Questions and Answers

Q. Why not simply devalue the dollar to some arbitrarily chosen weight not far from the current price such as one-four-hundredth of an ounce of gold?

A. Several other considerations than the current price of gold in paper dollars are involved:

1. A potentially stable exchange relationship between gold and other things generally is not accurately ascertainable at this time. However, judging as best as we have been able to, gold today at $375 may be substantially above such a stable relationship, perhaps by about 50 percent, primarily because inflationary expectations have become so widespread. If the incipient flight from paper currencies into gold and silver continues, the departure from a stable relationship may become much greater, even to infinity and a chaotic collapse of most money-credit systems. Establishing arbitrarily a new gold weight of the dollar could accentuate the rise in prices if the new weight is too small (price too high) thereby further destabilizing the economic situation; or, if too large a new gold weight for the dollar were arbitrarily chosen, distortion in the opposite direction would result in greater distress among debtors than they could be expected to bear. In their desperation, they might stage a revolution and choose a dictator to solve their problems.

2. By making clear the intent to provide honest money for those who preferred it, the United States might be able to establish an area of sanity in a monetary world becoming berserk. Thus the United States might avoid or greatly ameliorate many adverse consequences of past follies.

Q. Would the suggested program solve all serious economic and social problems in the United States?

A. No. Much would remain to be corrected. However, the respite gained from the headlong rush to self-destruction via inflating would provide an oppor-

tunity for reconsideration of the social goals specified and implied by the Constitution of the United States.

Q. What are the alternatives?

A. Obviously, continuing the rash experiment begun nearly a half century ago is one alternative. Almost surely, following that course will destroy the United States and the last, best hope of mankind for centuries ahead. Other alternatives would be various intermediate possibilities in the range from integrity to the dissolute behavior that would end in destroying social order. Perhaps one intermediate possibility would be sufficiently reassuring to make possible continuation of inflating for a few decades. France has depreciated its currency to less than one five-hundredth of its 1914 value in a man's lifetime without experiencing a flight from its currency. Brazil continues with so-called indexing of wages, etc. and may so continue for decades. Perhaps the United States could be equally "successful," but the American people would have to remain asleep for much longer than the Arabs did for that course of action to succeed even temporarily. The Nation may have reached the point where honesty not only is the best policy but also is the only practicable policy for assuring survival of our social order.

PRODUCER PRICES

The rate of price increases for producer crude materials, intermediate products, and finished goods accelerated to double-digit rates during the 3 months ended in August. The acceleration in the rate of increase in producer finished goods prices was attributable to increases in the prices of finished consumer goods; the increase in prices of finished capital equipment decelerated. Smaller increases in producer finished goods prices earlier this year were not reflected in smaller increases in consumer prices. In fact, consumer price increases have accelerated during most of this year. One reason for that divergence was that some of the items accounting for those large increases in consumer prices are not included or have little weight in the producer price index; therefore, producer price changes gave no advance warning. Recent accelerating increases in the prices of producer products, and particularly those destined for the consumer, will augment upward pressure on consumer prices. Thus, even if during the coming months there are smaller increases in the prices of those items that earlier accounted for the rapid increases in the CPI, they probably will be offset at least partly by accelerating price increases in items coming from the producer sector. For this reason, we do not expect that increases in consumer prices will fall below double-digit rates.

According to the U.S. Bureau of Labor Statistics, the unadjusted Producer Price Index for Finished Goods (PPI) during August was 217.3 (1967=100), which was 11.1 percent above the level of a year earlier. During August the seasonally adjusted PPI rose 1.2 percent, which is a 15.4 percent compound annual rate. The PPI measures changes in the prices received in the primary domestic markets by producers of commodities that will not undergo further processing.

Although changes in producer prices for finished goods usually lead changes in the Consumer Price Index (CPI), they do not always do so. One reason for divergencies is that the PPI includes products that are not purchased by consumers and the CPI includes services that are not reflected in the PPI. Earlier this year is one period when changes in the CPI did not follow a deceleration of increases in producer prices. As the accompanying chart shows, from February through July the rate of increase in the PPI slowed, but the rate of increase in the CPI rose sharply.

ANNUAL RATES OF CHANGE
IN PRODUCER PRICE INDEXES

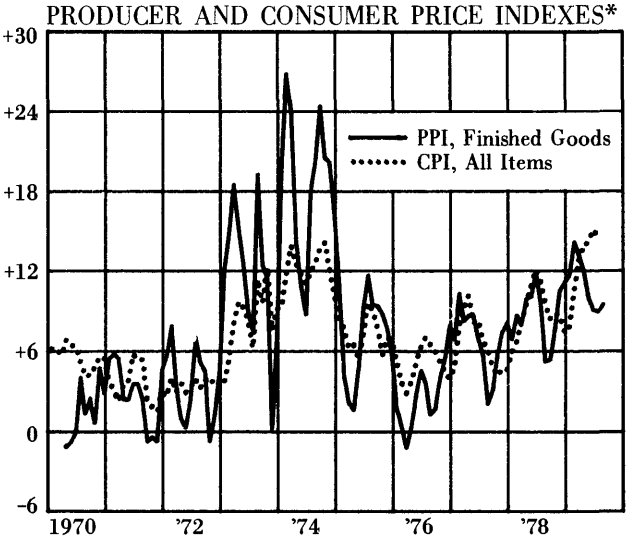
Relative Importance	*Index*	*Over Span of 3 Months Ended in:* *Aug. 1979*	*May 1979*	*Feb. 1979*	*Nov. 1978*
100.0	Finished goods	11.7	9.1	14.3	9.5
70.6	Consumer goods	13.9	8.7	16.1	9.5
17.1	Durable goods	7.8	8.2	14.3	–
25.4	Foods	–	2.4	20.6	16.5
28.1	Other nondurable	30.6	19.7	13.0	10.4
29.4	Capital equipment	5.7	9.5	10.4	7.8
100.0	Intermediate goods	17.0	14.3	12.1	10.8
5.4	Foods & feeds	14.8	.4	20.6	14.8
94.6	Other	17.0	14.8	12.1	10.8
100.0	Crude goods	10.8	5.7	27.7	24.4
58.6	Foods & feedstuffs	2.8	–1.2	30.6	28.2
41.4	Other	22.5	17.0	23.9	21.6

Note: All rates are compound annual rates based on seasonally adjusted data.

The recent rapid increases in the CPI reflected, among other things, large increases in the housing component, which accounts for 44.3 percent of the total CPI. The cost of housing, in turn, has reflected large increases in the costs of new homes, rapidly rising residential mortgage rates (a financial service), and substantial increases in the prices of home heating fuels and other utilities. Costs related to homeownership are not heavily weighted in the PPI (5.8 percent); therefore, the PPI has not been affected by such rapidly rising prices to the same extent as the CPI.

The accompanying table shows the percent change from 3 months earlier in the three producer price indexes and their major components. For the 3 months ended August 1979, the rate of increase in the finished goods index accelerated from the 3 months ended in May. This was attributable to the acceleration in the rate of price increases for finished consumer goods, specifically such nondurable goods. The acceleration in the rate of price increases in the nondurable goods

PRODUCER AND CONSUMER PRICE INDEXES*



* Compound annual rates of change from 3 months earlier, unadjusted data.

(except food) component was attributable in part to the increases in gasoline prices (6.1 percent during August), and number 2 fuel oil prices (6.0 percent during August). The price of gasoline and number 2 fuel oil increased, respectively, at 70.7 and 146.5 percent annual rates during the 3 months ended in August. Increases in capital equipment prices, which do not directly affect the CPI, have trended downward since February. During the most recent 3-month period, they rose at the rate of "only" 5.7 percent.

Among the other stages of processing, prices of producer intermediate goods (materials, supplies, and components) increased more than most producer prices during the 3 months ended in August. The 17.0 percent annual rate of increase then for this grouping was slightly higher than the 14.3 percent rate of increase during the preceding 3-month period. Substantial 3-month price increases occurred in the energy-related subcomponents and in the residential and nonresidential building materials subcomponents of the Intermediate Goods Index.

As is shown in the table, the Crude Goods Index rose 10.8 percent on an annual basis during the 3 months ended in August. This index is dominated by crude foodstuffs and feedstuffs (weighted 58.6 percent), and, within that category, by the livestock component (24.8 percent). The foodstuffs and feedstuffs component increased at a rate of only 2.8 percent during the past 3 months, little changed from the rate during the preceding 3 months. The prices of livestock, the largest single subcomponent in the Crude Goods Index, fell at a rate of 60.2 percent during the latest 3-month period. We reported in *Research Reports* for August 20, 1979 that "the beef cattle supply now reportedly is small, which will put further upward pressure on beef prices, but pig and poultry (not included in the livestock subcategory) supplies reportedly are adequate to restrain pork and poultry price increases over the next few months." Obviously, the recent rate of decrease in crude livestock prices will not continue for long, and when those prices turn, they will tend to offset possible smaller increases in other components.

The "other" crude materials category, which is dominated by energy-related products, increased at a 22.5 percent rate during the most recent 3-month period. Within this category, the prices of natural gas and of crude petroleum (domestic production only) rose at rates of 31.8 percent and 74.3 percent, respectively, during the 3 months ended in August.

In general, changes in prices flow from the crude (unprocessed) stage, to the manufacturing processes, to the producer finished goods stage, and finally, for some items, to the retail, or consumer, level. Thus, when the price of a crude commodity increases, that increase is passed on eventually to the manufacturer, who in turn passes it on to the wholesaler, then to the retailing level, and ultimately to the consumer. Price increases need not originate at the crude goods stage, however; additional price increases can be imposed at any stage, say to reflect higher labor costs, or financing costs, or larger mark-ups, etcetera. Also, the speed at which price increases are passed on varies. For example, price changes for livestock or other perishable food items are passed along more quickly to the consumer level, but price changes in scrap metals usually take months to reach users because of the processing time at the various stages. Thus, the small increases in prices for crude foodstuffs and feedstuffs probably will affect the food component of the CPI in coming weeks, but the effect might be largely offset by price increases for other activities involved in getting the food to the consumer. The large increases in the prices of energy-related crude products, however, surely will be passed through the various processing stages and exert upward pressure on consumer durable and nondurable (except food) prices for several months.

BOOK REVIEW

Energy – The Created Crisis by Antony C. Sutton, published by Books in Focus, 160 East 38th Street, New York City, 1979. 160 pages, $10.95.

No one knows how much energy this planet contains nor if this energy ever will be extracted. Divers experts have made many predictions about the ultimate quantity of energy, but few evidently realized that advancing technology would expose the limits of their knowledge. Also undermining some such predictions were the personal philosophies that often clouded the thinking of the pseudo-scientists and commentators who made the predictions.

But the world is not about to run out of energy. According to Mr. Sutton: "our mythical energy shortage can be dismissed . . . . There is available now in the United States, excluding solar sources and without oil and gas imports, . . . sufficient energy resources . . . at our present rate of consumption for about 2,000 to 3,000 years – without discovering new reserves." If his reporting of published government and private figures is off by 90 percent, at a minimum there is still enough energy to last 200 to 300 years. And if there is no immediate energy crisis, as many now proclaim, then there is much to question.

Mr. Sutton does that job well. After documenting his figures, he demonstrates that government is unable to remain free of self-interest partly because, "Unfortunately, we now have a gigantic, expensive bureaucracy dependent on a crisis. By arguing that shortages will return . . . the multi-billion dollar, 20,000 employee Department of Energy political machine [is kept] in business." Moreover, businessmen increasingly solicit favor from a powerful and spendthrift government capable of bestowing preferential competitive advantages and of lavishing taxpayers' money. Businessmen have not been slow to realize that, when government controls prices, their futures lie with the will of politicians and not with the results of the free market: ". . . the political tail wags the technio-economic dog," says the author.

Mr. Sutton's book makes clear that ". . . we have reason indeed to wonder . . . and perhaps be more than a little suspicious" about the intentions of those who create an energy crisis.

PRICE OF GOLD

	1978	*1979*	
	Sept. 21	*Sept. 13*	*Sept. 20*
Final fixing in London	$215.65	$332.95	$380.00

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