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Warm Welcome to Late Arrival

The editors of The Wall Street Journal *have finally said a few words about the role of gold in the monetary system; they are that gold deserves to be seriously studied for that purpose. If the editors undertake such a study, and can keep an open mind about the issue, it probably will be only a matter of time before they endorse the gold standard – so convincing is the evidence in our opinion. William Rees-Mogg, former editor of* The Times *of London, reached that conclusion in the early 1970's and succinctly described why: The gold standard is required for its market-imposed discipline on the proclivities of politicians and their central banking allies to inflate, and such discipline is necessary for economic and social order with a high degree of individual freedom.*

For their courage in supporting unpopular ideas (such as, let New York City fail), for their clarity in describing basic economic relationships, and for their perceptiveness in recognizing the solutions to pressing economic problems implied by these basics, the editors of *The Wall Street Journal* long have had our high respect. They have published editorials fiercely attacking wage-price controls in any form, protectionist programs of all types, Government subsidies (Chrysler), high Government spending and large budget deficits, legal barriers to the free flow of capital – domestic or international, the notion of fine-tuning the economy, demand-management policies, wasteful social-welfare spending programs, and excessive monetary expansion, to name a few. In taking these positions and clearly describing the basis for them, the editors surely have performed a valuable service to the Nation.

Distressingly missing from *The Journal's* editorial stance, however, was any mention of the monetary role of gold, either the connection between its abandonment and the subsequent marked depreciation of the dollar or of its possible usefulness for curing the Nation's severe monetary ills. At least that was the situation until April 27. On that date *The Journal* carried an editorial called "The Four-Letter Word." That word was "gold." As the extracts below reveal, the editors stopped far short of endorsing the re-adoption of gold as the standard of value and the monetary unit of the United States, but they now recommend it as a possibility at least. Here are the most pertinent parts of that editorial:

"We recount these developments to suggest that gold is worth a truly serious study, not to suggest it is a panacea. Historically a gold standard has not always provided perfect price stability, though it did prevent continued inflationary bias. If we did decide to go back to gold, there would remain an enormous array of difficult technical questions, not least at what gold price.

"More broadly no monetary target can provide a substitute for political will. If politicians want to inflate, they can nick the price of gold as easily as they can overshoot the Ms. And a potent argument can be made that if the political will exists, nearly any monetary target will do. In our inflationary age, it seems to us, the important thing is not how to measure the rate of money creation but how to slow it down.

"Given these conflicting sentiments, a serious study of gold probably would not come to a unanimous conclusion. But somehow the economic world worked better under Bretton Woods with its gold link than it has since, and our recent experience scarcely gives us reason to write off as taboo any idea that historically seemed to work. There is plenty of reason to follow President Reagan's lead, stop treating gold as a four-letter word and get on with serious study."

The Reigning Error

We wonder what took *The Journal's* editors so long to come even to this point. Mr. William Rees-Mogg, formerly editor of *The Times* of London, discussed and advocated a return to gold as the monetary unit as early as 1974. *The Journal's* editors might read Mr. Rees-Mogg's *The Reigning Error, The Crisis of World Inflation* to learn what convinced their fellow newspaperman of the need for returning to a gold standard. They would find there these trenchant observations:

"Sanity consists in limitation; the inordinate is always insane and always ends in destruction. Because inflation is indeed inordinate, it too has a certain insanity about it and it naturally tends to end in an explosion of destruction, a nihilist act with money. The insanity of inflation leaves a mark of insanity on society; it changes a good society into one which, so long as inflation lasts, is wholly and fraudulently unjust. All evil is a breach of order, but only some evil is a breach of order with unlimited effect; inflation is an unlimited monetary and economic evil. . . .

"Inflation has always had the same monetary causes and the same social consequences. There is no inflation which has not started with an increase in the money supply; there is no inflation which has not ended with a corruption of society, proportionate only to the degree of the inflation itself. It corrupts and weakens every social institution; it makes every member of society feel himself to be the victim of every other member of society; it sets class against class. It makes governments weak and unsure of themselves; it has in recent history destroyed more lawfully constituted governments than any other force except war itself. . . .

"The natural tendency of gold is to prevent rapid alteration of the money stock, and therefore to inhibit inflation and deflation alike. . . .

"If we successfully restore a gold standard we shall destroy inflation, probably in the only way it can be destroyed. We shall restore price stability and remove a serious threat to democracy.

"This comes back to the starting point. Inordinacy always ends in ruin, and inordinacy can only be controlled by systems that are objective and external, rather than by purely subjective restraints. The reigning error of the twentieth century is just this, the rejection of the idea of external discipline. The damage that Dr. Spock did was that he destroyed confidence in discipline for children; the damage that Freud did was that he destroyed belief in the necessity of discipline in sexual conduct; the damage of the explosion of science was that it destroyed discipline in man's dealings with nature. Keynes made an equally profound attack on the idea of discipline in money.

"All these things were done with good intentions; they rejected discipline because they wanted a world in which no children cried, no one was sexually distressed, no one was deprived of any natural resource, a world in which the sun would shine every day of the week. Keynes in particular wanted to destroy the limits on economic progress, and particularly the limit of unemployment.

"Who can quarrel with such kindly intentions? Who would not like an earthly paradise, or sympathise with those who worked to bring one about? Yet the enterprise of removing suffering from the world is a dangerous one. Suppose that the suffering turns out to be necessary to avert greater sufferings, suppose that suffering is necessary to successful adjustment to the real conditions of life, how is one to deal with that?"

The foregoing remarks were made in 1974. A few of us held these views throughout the halcyon days of Keynesian demand-management policies, that is, since the mid-1930's, when Franklin D. Roosevelt took the United States off the domestic gold standard and adopted inflating as a technique for stimulating the economy. The evidence supporting the gold standard is not emerging only now; it simply has been disregarded for the most part.

Some Glaring Misconceptions

Here is not the place to discuss fully the operation and advantages of the gold standard, but a portion of *The Journal's* editorial deserves comment. The editors display a surprising misunderstanding about the role of gold when they assert: "More broadly no monetary target can provide a substitute for political will. If politicians want to inflate, they can nick the price of gold as easily as they can overshoot the Ms. And a potent argument can be made that if the political will exists, nearly any monetary target will do. In our inflationary age, it seems to us, the important thing is not how to measure the rate of money creation but how to slow it down."

Let us consider the first idea expressed in the quotation, namely, "[N]o monetary target can provide a substitute for political will." In making that statement, perhaps the editors were attempting to give due regard to clear historical evidence that throughout history governments eventually have been able to circumvent the limitations of the gold standard. That the gold standard once was widely applied but now is nowhere in effect is irrefutable evidence that the gold standard does not ensure the preservation of sound monetary conditions (including its own preservation) simply by its adoption. That evidence does not necessarily imply, however, that *political will* is the necessary ingredient for the continuing implementation of the gold standard.

The historical evidence suggests that governments never have taken the lead in adopting the gold standard; rather, the public, acting through voluntary exchanges in the markets, insisted on the use of gold as the monetary unit. Only subsequently did governments give legal recognition to the fact that gold was the preferred standard of value and medium of exchange. Governments were able to subvert the gold standard only after the public carelessly disregarded the distinction between gold as the monetary unit and the legal representations (gold coins or redeemable currency claims to gold) of that unit. Often such disregard was encouraged by governments that wanted to fund wars by the hidden tax of inflating rather than explicit taxes. In other instances, as in our own country, the very success of the gold standard fostered the misapprehension that the currency claim under any circumstance was as good as the monetary unit itself (the dollar was "as good as gold") and governments took advantage of the situation. In summary, we doubt that "political will" ever was responsible for sound money. What was responsible was an educated public, a public "educated" by the demands of the marketplace. We describe some of these demands later in this discussion.

At this point, we focus on the second sentence of the subject quotation, namely, "If politicians want to inflate they can nick the price of gold as easily as they can overshoot the Ms." We simply doubt that inflating can be hidden easily by "nicking" the price of gold. Devaluations require legislative action, and they attract worldwide public attention to what is happening to a nation's currency. Overshooting M targets has been rationalized regularly by monetary and government officials as temporary aberrations. Moreover, the overshooting has been quietly cumulated. For example, this year's targets for the Ms are based not on growth rates applied to the midpoints of last year's targeted Ms, but on last year's (and the previous years') *already excessive* Ms. Yet the monetary authorities trumpet their intent to achieve somewhat lower, "less inflationary," Ms. Under the gold standard, the authorities would be forced to "nick" the price of gold annually to accomplish the same end. The successive devaluations would be readily apparent, as would the cumulative debasement of the currency unit. We should think that anyone who believes that a properly informed public is necessary for effective functioning of democratic governments and market-based economies would want this clear signal of monetary abuse in operation.

Of the questionable assertions made in the editorial, the most serious is, "And a potent argument can be made that if the political will exists, nearly any monetary target will do." We discussed above the issue of political will; if sound money must wait on political will, it probably will wait forever. *Public will* expressed in the marketplace (including a free market for banking) seems to us the best hope for developing an early solution (by which we mean avoidance of a stagnating economy and a monetary collapse) to the Nation's monetary problems.

Once the role of the free market in the monetary sphere is recognized, it becomes clear that monetary expansion cannot be viewed usefully only in terms of money supply or of money supply growth ("nearly any monetary target will do"). Money demand is as significant as money supply. Once the demand for money is acknowledged to be significant, attention must be given to the *type* of demand for money that can be met with new money creation without inflating occurring. When Federal Reserve Board Chairman Paul Volcker was trying to "jawbone" banks into more monetary restraint in early 1980, he tacitly admitted that some types of demand for money (reflected in the demand for bank loans) are inflationary and others not. He urged bankers to place *qualitative* conditions on their lending practices: "Banks should take care to avoid financing essentially speculative

activity in commodity, gold and foreign exchange markets" and should restrict loans for corporate takeovers to those that "clearly promise improvement in economic performance." This hardly is consistent with the notion that "any monetary target will do."

A coherent explanation has not been given by the Fed as to why some types of money demand are more suitable for monetization than others. That explanation is contained in the "old" idea of the "commercial loan theory" or the "real-bills doctrine." Indeed, it was incorporated in the original Federal Reserve Act. Unfortunately, like the lessons of the gold standard, it has been disregarded for many years.

Gold, the Quantity and Quality of Money, and a Sound Economy

Perhaps the clearest explanation of the connections among the gold standard, the quantity of money, the quality of money, and the functioning of a market economy was given by William E. Dunkman in *Qualitative Credit Control* published in 1933. These few extracts convey his chief arguments: [Italics indicate our emphasis.]

"When a debt structure has been built up, reserves become important as the ultimate means of settling balances of debts. Since gold is the means of making these settlements between countries, deposits on the books of the central bank the means of settling debts between banks in the same banking system, and deposits on the books of the commercial banks the means of settling debts between individuals, the ability of central banks to maintain gold reserves, of commercial banks to maintain central bank deposits, and of individuals to maintain bank deposits have a similar significance, namely, the ability to keep debts and credits equal. Credit control should aim at limiting debts between individuals, between banks, and between banking systems to those which can be cleared against credits. Regulation of the reserve base will not do this. The most that can be hoped for from this type of control is the regulation of the total quantity of commercial bank deposits. But it will not prevent the development of a debt-credit structure on the reserve base which may, *due to its distribution*, make the reserve base inadequate to settle the unmatched debts. Thus no matter what control is exerted over the reserve base and no matter what the nature of this base, whether gold, inconvertible paper, or central bank deposits, the problem of controlling the superstructure of credit remains. Lack of control leads to a condition in which the reserve base appears inadequate. . . .

"Expansion of the credit analysis approach suggests possible methods of attacking the general aspects of the problem of credit control. . . . In order to indicate briefly the main outlines of the problem of credit control, . . . attention must be directed to the fundamental requisite that a borrower be able and willing to repay his loan at maturity. . . . The banker must, therefore, come to view each industry as a whole, rather than confining his analysis to individual concerns. He must include, as a part of his analysis, a study of the production of the industry as a whole, the sales, the inventories, the debts which these goods are to liquidate, price movements, etc. He must learn to think in terms of the credit standing not only of individuals and corporations but of industries as well. Thus instead of an attempt to adjust the total quantity of credit to the volume of production or to an average of prices by alterations in the reserve base, the problem of credit control becomes an attempt to build up a superstructure of credit which will not place too great a strain on the reserve base, because the debts upon which the credit structure is built will be liquidated by goods rather than settled by payments out of the reserve base. . . .

"The approach to credit [money] control by this route emphasizes the importance of the exchangeability of goods, and relates the study of credit closely to the study of economic value; *for the sound expansion of credit [money] is seen to be limited by the increase in exchange values.* A *general index of prices* or a study of the relationship of the total quantity of bank credit to the total quantity of goods produced, *is seen to be inadequate,* for it gives no consideration to the exchange problems of an economy based on specialized production. An *adequate study* of credit *requires that emphasis be given* to the kinds of production, and to the conditions under which exchange is to take place, or *to relative prices.* Thus changes in the level of prices would seem to indicate changes in the degree of exchangeability of goods rather than changes in the value of money. Furthermore, in the study of bank credit the assets (debts) upon which such credit is based and the goods which are to liquidate them are of more significance than is the total quantity as compared with other total quantities. . . .

"Since the extension of credit always involves the estimate of values in anticipation of the sale of goods, the real problem is that of estimating these values as nearly correctly as possible. *Only in this way can the currency (bank credit) be kept in proper relation to the value of goods.* Therefore, a banking system which extends credit only on goods which are in the process of marketing or as near final sale as possible, thus limiting the degree of anticipation, will not make as many errors in judgment as one which extends credit for the purpose of providing the capital equipment to be used in the production of other goods. Thus clearance will be improved and the necessity of resorting to reserves in order to pay for goods which have not been exchanged against other goods will be reduced. When a banking system ceases to base the medium of exchange on exchangeable goods and becomes more deeply involved in production, it is treading on dangerous ground. For by making the bonds of industry or loans on stocks the basis of its deposits [money creation], the bank incurs a larger measure of liability for the risks of industry. Even though its debtors fail to repay their loans, it must meet its obligations on demand. Therefore, not only will industrial mistakes affect the bank's net worth, but losses will have to be made up by payments out of its reserves. The danger is particularly acute when the banking system is composed of a large number of banks, for each bank must bear its own losses and the result is likely to be a large number of bank failures. While this may seem to be justified in an individualistic philosophy, it is disastrous for the community. If the situation is serious enough it will lead to a demand that bank deposits be guaranteed, either by the government or by the banks as whole. This is tantamount to a demand for the unification or socialization of the banking system. If values are to be thus guaranteed, it is but natural to expect that a more centralized control of production by one or the other of these agencies will follow. This may not be wholly undesirable, but it should be recognized as an aspect of the banking problem."

Squeezing a Balloon

Of course, what Dunkman predicted in 1933 has occurred in that bank deposits were and are guaranteed by quasi-government agencies. This has removed from the

individual depositor the responsibility to choose wisely the bank where he maintains his deposit claims. It has both enabled and compelled the managers of the major banks to make riskier loans; the more aggressive managers take the risks secure in the knowledge that the monetary authority would not allow their banks to fail, and the more cautiously inclined bankers must follow suit in order to earn a comparable rate of return and not be ousted from their positions. In turn, the monetary authorities cannot allow recessions (which correct prior excesses) to run their course, out of a fear that the financial system will collapse. Thus, they have reinflated soon into each recession, creating further distortions each time, eventually having to adopt a fiat paper monetary unit because holders of their inflated currencies exercised their right to claim gold. But still the problems of the distorted economy plague them. How do they limit creation of "nothing" fiat money? From time to time they entreat bankers to lend only for "productive purposes," which the authorities must specify. Mandatory credit controls, whereby the authorities direct the flow of new money to specific productive endeavors, is the next step. Thus it might develop that control of production becomes centralized through the banking system, as Dunkman warned. This is evident in countries that have had prolonged double-digit and triple-digit rates of currency depreciation. It is not "theoretical."

We extend a hearty welcome to *The Wall Street Journal's* editors as they seriously inquire into the potential role of gold in a monetary system. As they say, gold is not a panacea, but it is one apparently essential aspect of a sound monetary system, which in turn is essential for a sound, private-capital, free-market economy and a cohesive society offering freedom, liberty, and justice. If *The Wall Street Journal's* editors follow their own advice and studiously inquire into the question, we are confident that in time they will vigorously endorse the usefulness of the gold standard and sound commercial banking.

MORE REVELATIONS THAT THE FED DOES NOT KNOW WHAT'S HAPPENING

More evidence recently came to light of the extent to which U.S. monetary authorities are groping to achieve more useful estimates of purchasing media, or the money stock. On May 1st, the Federal Reserve Board of Governors published revised seasonally adjusted figures for M-1B, the official measure of money supply that most closely approximates purchasing media in use. The new M-1B figures reflect seasonal adjustment factors applied for the first time to "other checkable deposits" (OCD), which include primarily NOW accounts but other similar accounts also. Until this revision, seasonally adjusted M-1B incorporated a seasonal adjustment only for the currency and demand deposit components of M-1B, not for the OCD component. A succinct description of the effects of the changes was given in a table (and its accompanying footnotes) that was included in the Board release discussing the new seasonally adjusted data. Portions of that table are reproduced nearby.

Plainly, the Board of Governors recognizes that not all of M-1B represents transactions balances. The shift-adjusted M-1B figures in column (3) more closely approximate the transactions (purchasing media) portion of M-1B. Yet, in its regular reports of the monetary aggregates, the Fed gives only the standard M-1B data, not the shift-adjusted figures. The difference obviously is substantial.

M-1B SEASONALLY ADJUSTED AND ADJUSTED FOR NOW ACCOUNT SHIFTS SINCE YEAR-END

1981	*M-1B (SA)* (1)*	*Shifts to NOWs from sources other than demand deposits (SA)† (2)*	*M-1B Shift Adjusted (SA) (1) less (2) (3)*
		Levels (in billions of dollars)	
January	416.0	3.6	412.4
February	419.0	6.1	412.9
March	422.9	7.5	415.4
April (3 wks. ending Apr. 22)	429.6	9.4	420.2
		Growth Rates (percent change at annual rates)	
Dec. 1980 to Apr. 1981 (3 wks. ending Apr. 22)	13.9		6.8
Dec. 1980 to Mar. 1981	11.3		4.0

* Seasonally adjusted M-1B in 1981 is constructed by adding the following seasonally adjusted components: currency; the sum of demand deposits and other checkable deposits (apart from this year's accumulated trend growth) coming from demand deposits; other checkable deposits (apart from this year's accumulated trend growth) coming from savings deposits; and a relatively small accumulated trend growth, amounting to $200 million per month in the first several months of the year. This trend growth represents the expansion in OCD balances only for accounts already in existence at the end of 1980. Based on information currently available from a number of sources, such as samples of depository institutions and households and econometric cross-section analysis of deposit behavior at commercial banks, the share of OCD growth apart from trend since the beginning of 1981 attributable to demand deposits is estimated to be: about 75 to 80 percent in January and 70 to 75 percent in February and March. No additional information bearing on this proportion for April is yet available; the calculations shown above assume that the share of OCD growth apart from trend in April was 70 percent. Thus, the share coming from savings accounts and other non-demand deposit sources is estimated to be: about 20 to 25 percent in January, 25 to 30 percent in February and March, and 30 percent in April.

† In order to derive a seasonally adjusted M-1B measure that abstracts from shifts in 1981 into OCD from non-demand deposit sources, an estimate of seasonally adjusted inflows to OCD from these sources must be subtracted from M-1B. Such amounts are derived by multiplying the increase in OCD (not seasonally adjusted) in excess of trend in end-of-year OCD balances (not seasonally adjusted) by the mid-points of the ranges given in footnote 1 for the share coming from non-demand deposit sources; cumulative amounts are then seasonally adjusted by applying the seasonal factor for commercial bank savings deposits.

Perhaps the Fed is not publishing the shift-adjusted data because of its own doubt about the accuracy of its estimates. When we earlier spoke with a Board economist about their estimating procedures, he said they involved a great deal of "arbitrary judgment" and "eyeballing." Withholding dubious estimates is commendable, but the published M-1B data also are dubious and inadequate for what they purportedly measure. In view of this situation, one should not be surprised that the money and credit markets, the international monetary systems, and the economy as a whole are highly volatile.

PRICE OF GOLD

	1980	*1981*	
	May 15	*May 7*	*May 14*
Final fixing in London	$517.00	$477.75	$476.50

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