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The Dollar and Gold: Let's Be Practical

Although gold is now a respectable four letter word and the object of study by the U.S. Gold Commission for its possible use in the U.S. monetary system, the battle to implement a sound monetary system has only begun. Not just any link between the dollar and gold will be helpful. Based on the exchange of views between anti-gold and pro-gold advocates presented in the national news media to date, some essential factors have not been dealt with. Fiat-money proponents seem unaware that "money creation" may be out of official control, notwithstanding the Fed's intention to slowly wind down its inflationary policy. Pro-gold forces have not explained how, after decades of being relieved of the threat of bankruptcy, private bankers will know how to manage their banks soundly if they are required to pay gold against their demand liabilities. The money-credit system is not well understood, and the "experts" should admit it. To gain the benefit of more input into finding a solution to today's monetary mess, Government's monopoly on money should be broken so that an improved monetary unit and system might evolve from decentralized experimentation and voluntary actions in the marketplace.

Anyone following even casually the national newspapers, weekly newsmagazines, or TV network news programs could not have missed the extensive attention given to the issue of restoring some link between gold and the dollar. A number of factors seem to account for this great current interest. Chief among them is the now undeniable fact that the national and international monetary systems are in a state of disarray and are creating enormous general economic problems.

Another factor is that the public has not yet responded to the passage of President Reagan's spending and taxing programs with exhilaration. Some supplysiders attribute this disappointing reaction to continuing high interest rates, reflecting public doubt that inflationary monetary policies are going to be wound down in fact – not only in official rhetoric. Some supplysiders now emphasize that the essential monetary counterpart to President Reagan's fiscal policy is the implementation of some variety of a gold standard. This, they insist, will immediately provide credibility to a professed monetary policy of reduced inflating, will instantaneously lower inflationary expectations, and will quickly reduce nominal interest rates by eliminating their inflation-premium component. Restore a "gold standard" now, they say. They need the stimulative effects of the supply side program soon so that Republicans are not swept out of office come next year's Congressional elections.

At the very time that the above political focus on gold has arisen, developments involving the U.S. Gold Commission also attracted attention to gold. Provided for in a law authorizing funding for the International Monetary Fund signed by then-President Carter on October 7, 1980, this Commission was given 1 year to study and make recommendations concerning the role of gold in the domestic and international monetary systems. The Gold Commission members were not appointed until the spring of this year. (See table on page 150 for a list of its members.) The membership was heavily weighted with persons whose predispositions were against a monetary role for gold.

On July 9th, 7 days before the Commission's first meeting, AIER's Director of Research attended a meeting in Washington, D.C. called by Congressman Ron Paul and Mr. Lewis Lehrman, the only two strongly pro-gold Commission members. They were seeking suggestions for approaching their task from the twenty-odd persons assembled: they had no idea of what they would encounter at the Commission's first meeting; there was no circulated agenda; there was no staff for them; nothing. Some persons in attendance reported they understood that senior administration officials intended merely to go "through the motions" with the Commission in order to appease the hard-money block of conservative Republicans.

As feared, Under Secretary Sprinkel recommended that the meetings be closed to the public, and Congressman Henry Reuss insisted that the October 7, 1981 deadline for the Commission's report be kept.* Mr. Lehrman objected, saying that at least a year would be necessary for the Commission to do its work. Sprinkel supported Reuss. To his credit, Dr. Paul McCracken, no friend of gold, threatened to resign if the Commission were going to issue a sham report. It was generally agreed to seek Congressional extension of the deadline.†

At that point the minutes of the meeting and the meetings themselves were to remain unavailable and closed, as suggested by Beryl Sprinkel without a vote by the Commission members. That was not acceptable to *The Wall Street Journal*, which in an editorial published in April was the first national newspaper to call for serious study of the monetary role of gold.** The *Journal* editors (as did writers for other newspapers) gave national attention to the attempt to hide the Gold Commission's deliberations. More than that, the *Journal* and its parent, Dow Jones and Company, filed suit to get the minutes of the July 16th meeting and to have future meetings open to the public. In early September the Commission, in a telephone poll, voted to open the meetings beginning with

* Send to the Institute on Money and Inflation, Suite B-1, 314 East Capitol Street, Washington, D.C. 20003, for a copy of the July-August 1981 *IMI Bulletin* for detailed notes on the Commission's July 16th meeting.

† We understand that Congressional Commission members will introduce appropriate bills for extending the report date after the Commission agrees on such a date at its September 18th meeting.

** See our *Research Reports*, May 18, 1981, "Warm Welcome to Late Arrival."

that on September 18th. The opening of the Commission meetings should help keep the public's attention on gold.

Just the Beginning

As an organization that has argued the monetary case for gold since our founding in 1934, through the halcyon days of fine-tuning fiscal and monetary policies, one might think we should be overjoyed at the resurrection of the respectability of gold as money. Not so. Perhaps the greatest disservice economists have performed historically is to create unwarranted confidence in their particular theories and thereby to foster unachievable economic expectations by the public. What is the root cause of today's economic plight if it is not the unfounded – indeed, historically refuted – idea that government manipulation of money and other economic activities can assure sustainable prosperity for all?

Around the industrialized free world, two generations have been miseducated to believe that government can cure all economic ills, which makes it virtually impossible for an elected government to retain office through the short-term painful period of withdrawal from the addiction to inflating in order to reap the long-term benefits of a noninflationary situation. The economic argument underpinning this folly, Keynesianism, was embraced by most academics and politicians during the desperate times of the Great Depression. It met the urgent, short-run political needs of the time.

Is somewhat the same thing happening now? Politically connected supplysiders are desperate. If interest rates do not fall soon, their promise of a nearly painless cut in the budget deficit by holding spending more or less constant and gaining revenue from an expanded national income boosted by politically desirable marginal tax rate cuts, will be proven empty. Come November 1982, many of the present Republican "ins" could become the "outs," as disillusioned voters turn back to the promises of the Democratic spenders and central controllers. Hence, some "in" supplysiders now are stressing the need for a dollar tied to gold in order to gain credibility for an anti-inflationary policy. Indeed, it is ironic and perhaps significant that the advocates of an immediate return to some type of gold system as a "quick fix" in order to lower inflationary expectations have much in common with the advocates of wage-price or credit controls: sweeping problems "under the rug" in order to win the next election. That is the pernicious approach President Nixon took in August 1971, when he repudiated the gold dollar and instituted the first peacetime general wage-price controls in the history of this country.

Even some apolitical advocates of gold seem to be acting in desperation. In their view, widespread deep discontent with today's monetary mess offers a rare opportunity to gold's monetary role and if this opportunity is not seized, another chance might not be forthcoming for decades – if ever. Others are desperate for any alternative to the present paper-money system: "Anything has to be better than what we have."

A setting of desperation is not conducive to sound study and deliberation on this topic of greatest import. That the Gold Commission probably will have considerably more time to accomplish its task than first was feared is reason to be somewhat hopeful. But when you consider that the question of a gold monetary unit versus official monetary discretion has been debated for 200 years, a deadline of June 30, 1982 is not sufficient for the magnitude of the job to be done. The level of debate carried on thus far surely does not do justice to the issue. For there to be a reasonable chance that a sound monetary course will be taken in the future, a number of subtle but fundamental aspects of the monetary problem must be investigated. Let us discuss some of these.

U.S. GOLD COMMISSION MEMBERS 17 members
3 - pro-gold
9 anti-gold

Name	*Apparent Predisposition*
Private Individuals	
Arthur J. Costamagna, lawyer	Pro-commodity backing.
Herbert J. Coyne, brokerage firm executive	Pro-gold.
Lewis E. Lehrman, business executive	Strongly pro-gold.
Paul W. McCracken, economics professor	Formerly strongly anti-gold but now less so.
Federal Reserve Board Governors	
Emmett J. Rice	Anti-gold.
J. Charles Partee	Anti-gold.
Henry C. Wallich	Strongly anti-gold.
Administration Officials	
Donald T. Regan, Secretary of Treasury and Chairman of Commission	Relies on Under Secretary Beryl Sprinkel, who is strongly anti-gold.
Jerry L. Jordan, President's Council of Economic Advisers	Anti-gold.
Murray L. Weidenbaum, President's Council of Economic Advisers	Anti-gold.
Congressmen	
Rep. Christopher J. Dodd (D-CT)	Anti-gold.
Sen. Roger W. Jepsen (R-IA)	No predisposition.
Rep. Stephen L. Neal (D-NC)	Anti-gold.
Rep. Ron Paul (R-TX)	Strongly pro-gold.
Rep. Henry S. Reuss (D-WI)	Anti-gold.
Sen. Harrison H. Schmitt (R-NM)	No predisposition.
Rep. Chalmers P. Wylie (R-OH)	Anti-gold.
Nonmember Executive Director	
Anna Schwartz, economist	Strongly anti-gold.

The Goal of Price Stability

Much of the argument about money – gold money or paper money – centers on the goal of price stability. That is not the appropriate ultimate goal of a monetary system. A sound monetary system is one that provides a corrective tendency from inflating and deflating before either becomes so severe that it threatens economic and social chaos.* *One* consequence of such a system will be little change in the purchasing power of the monetary unit in the long run (more or less stability in general prices). Price stability in the short run is not a realistic possibility. Price changes of individual items are essential for the continuous reallocation of a nation's resources to a pattern more nearly consistent with the dynamic conditions of a growing economy – new products, new productive processes, new final demand preferences.

Economic adjustment does not occur instantaneously. In some instances it occurs over many years. As an example, consider the massive adjustments necessitated by the higher energy prices initiated by OPEC in 1973. Time was required for those adjustments: redesign and retooling of motor vehicle manufacturing facilities; retrofitting and redesigning buildings for energy conservation; development, production and installation of new energy controls; design and production of energy-saving electric motors; engineering and construction of increased capacity for and

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* Remember, by inflating/deflating we refer to the creation of excess/insufficient purchasing media to represent the sustainable exchange value (prices) of goods offered in markets.

actual production of more oil drilling rigs, etc. Many price changes had to occur to induce the appropriate supply and demand adjustments. Even in the absence of monetary excesses, price indexes would have had to rise for a time, until prices of the obsolete products and processes would fall after those products gathered dust on the shelves for lack of buyers at the former prices.

Few students of monetary matters would suggest that such price-level changes were the fault of the monetary unit. Yet, some proposals for a new variety of gold standard would change the gold content of the monetary unit when general prices moved by some stated percentage over some specified period. They advocate a variable gold standard, an absurdity and a contradiction even in name.*

That some price-level changes may be necessary for the economy's health undermines the argument of gold opponents who, although they acknowledge that the 19th century gold standard promoted long-term purchasing power stability of the currency, criticize it for its failure to prevent fairly large general price changes over short spans. We shall consider the late 19th century cyclical volatility later, after a point about the comparative importance of long-term currency stability and short-term instability.

In a modern industrial economy, with its extensive volume of highly specialized long-term capital investment, long-term currency reliability is desperately needed. Evaluation of long-term capital projects entails a great deal of uncertainty – business risk – in the best of monetary conditions. But when the high risk of a greatly changing, rapidly depreciating currency unit is added to the situation, sound evaluation of long-term investment opportunities becomes nearly impossible. Every project with a maturity (or payback period) of more than a few years becomes a gamble. Hence, the acceptable time horizon for investments shrinks to the near term. Therefore, although the total rate of saving and investment in an economy might not change, productivity – the source of real income gains – suffers when the otherwise higher yielding long-term project is cancelled in favor of the shorter-term lower-yield project because of the high currency risk.

For this reason, long-term currency reliability – as even critics admit was provided by the gold standard – might foster more rapid average long-term growth in spite of considerable volatility in the short run. Such was the case for industrial output in the final quarter of the 19th century. In spite of substantial cyclical changes and a downward trend of wholesale prices then (see the accompanying chart), U.S. industrial output increased at its most rapid average rate over that long a span in the history of this country. It would seem essential that the Gold Commission gains an understanding of the trade-off consequences between long-term currency reliability and short-term currency volatility before reaching a conclusion about the preferred choice of a monetary unit.

Money and Credit: Use and Abuse

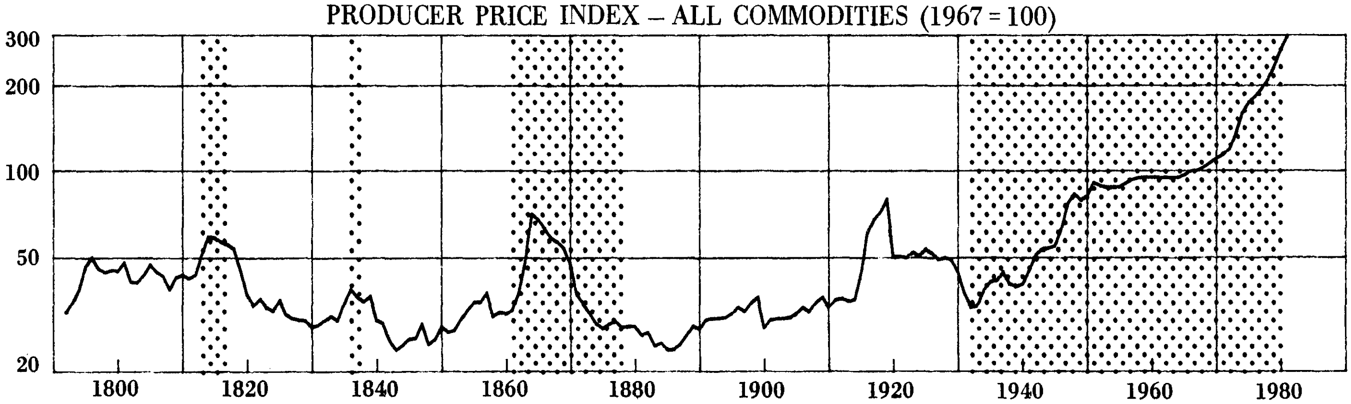
We return to a consideration of the fact that there was indeed substantial short-term price and economic volatility during the best years of the gold standard. The question arises, Was the volatility related to the use or abuse of the monetary unit? Our view is that gold convertibility was not the initiating factor in fostering movement of the economy away from sustainable trends; rather, gold convertibility was a force for correcting inflationary distortions originating elsewhere and constituting an abuse of sound banking practice.

Few students of money, we suspect, would disagree with the propostion that a credit-based economy contains the seeds for cycles regardless of the kind of monetary unit. Let us explain. As soon as someone has available a product to sell, there is the potential for credit. If he exchanges that product for the IOU of the purchaser, credit has been extended, but new purchasing media (money) was not created in the process. If the seller of the product takes the IOU of the purchaser to the seller's supplier and obtains therewith another product, another transaction has occurred without new purchasing media being created. It is probable that, by such practices, optimism about future economic conditions can be generated, with a desire of producers to process more output and sell it.

As a practical matter, such passing on of private IOUs could not go far for lack of knowledge about the quality of the individual debtor's IOU. Here is where banks came in. The seller who received an IOU of a purchaser could take the IOU to a banker and, for a fee (interest charge), the bank would substitute its widely acceptable IOU for the unacceptable IOU of the purchaser. In the process, the bank created money (its demand liabilities were generally used in final payment). Of course, when the monetary unit was gold, the currency-denominated demand liability of the bank could be presented by its holder for gold at any time.

* This applies to, among others, Arthur Laffer's plan, "The Reinstatement of the Dollar: The Blueprint," discussed in our October 1980 *Economic Education Bulletin*, "Plans To Revive The Gold Standard." Available for $1.00.

PRODUCER PRICE INDEX – ALL COMMODITIES (1967 = 100)



Shaded periods indicate times when Americans could not convert U.S. currency into gold.

The bank thus had to keep an adequate stock of gold on hand. Adequacy, however, depended on the quality of the debts held by the bank. If the debts had too long a maturity, such that eventual holders of the bank's demand liabilities (individuals or other banks through whom checks were being cleared) presented them for collection before the bank received payment on the IOUs the bank held, the bank would be unable to meet its obligations. It also would fail if the banker misjudged the ability of the debtor to pay. That often occurred when bankers, caught up in the exuberance of an incipient "boom," overestimated the price that the business borrower would get for the product the banker's loan financed. When the product could be sold only at a "distress" price, the debtor could not pay the bank, and the bank could not pay on its demand obligation. When a number of banks encountered this problem about the same time, banking panics occurred. The earlier misjudgments on credit extensions thus were corrected, as were the allocations of real resources involved.

By early in this century, bankers learned from trial and error that some types of loans provided better assurance of repayment on schedule than other types. They were called "self-liquidating" loans. These were loans to finance the marketing of a product, the near-term expected sale of which would provide the funds for repayment. This practice was also called the "commercial loan theory" of banking, or the "real bills" doctrine.

Three aspects of those practices are especially pertinent to today's new interest in gold as the monetary unit. One, as we said, the banking "panics" of the late 1800's, although they involved harsh adjustment, also provided early adjustment to developing distortions. The cost of trying to eliminate them has been to create the more severe and difficult-to-overcome monetary and economic problems of today. These problems are so severe that most observers admit they have potential for creating an economic collapse and social chaos. The earlier banking panics were early corrections of abuses, something all can wish had occurred earlier in the current episode of excessive money.

The second significant point is that a monetary unit of gold provided the public with a means to protect itself from the effects of developing excesses, and thus to check those excesses. In today's system of fiat dollars, there is the acknowledged problem of the Federal Reserve's finding the fortitude to persue unstintingly its stated objective of slowly reducing the growth of the monetary base. But just at the time that Fed officials are giving a slight indication they will "stay the course" in this instance, the effort may be without significant effect. By means of innovative payments practices, the amount by which purchasing media actually in use can exceed the monetary base may have become virtually limitless. With the developing trend toward huge financial conglomerates, any one of which is too important for monetary officials to let fail, the private financiers (bankers) can aggressively extend paper dollar credits ad infinitem, secure in the knowledge that their credits will be offset by claims on other similar institutions, or if by chance an imbalance develops for one of them, regulatory officials will have to bail them out by providing official paper dollar credit. Without the requirement that issuers of demand obligations pay with something they cannot create (like gold), the potential expansion of purchasing media is limited only by the eventual refusal of the public to accept fiat currency, and that would be termed a flight from currency. It would seem preferable to have a monetary system that checked abuses far before that consequence became a distinct possibility.

This brings us to our third and final point. Simply declaring that the monetary unit is a weight of gold is not sufficient to provide a sound, sustainable monetary system. A constellation of money and banking practices must accompany an attempt to restore gold as the monetary unit. Deposit insurance must be repealed, so that depositors will have to exercise personal responsibility to monitor the practices of their bankers. Banks must not be saved from failing, so that bankers will have to adopt sound lending practices. Bankers will have to re-learn the lost art of sound commercial banking. The American people will have to learn to accept short-term economic hardship to gain long-term economic advancement, protection of personal freedom, and the realistic hope of preserving that for future generations.

What Can Be Done?

The foregoing necessary conditions are impressive in their complexity. And they are depressing in the small chance of their being implemented any time soon. For this reason, we abandoned some time ago the expectation that a sound gold-based monetary system could be reimposed from the top down, that is, by design and adoption by monetary and political officials. By demonopolizing Government's control of the monetary unit and by market experimentation with various monetary units, we should expect that the more useful monetary units and sound banking practices would be adopted.* A bill, "The Free Market Gold Coinage Act" (H.R. 3789), has been introduced into the U.S. House of Representatives by Congressmen Daniel Crane and Ron Paul that provides much of what we believe is necessary for fostering a free-market development of gold money and banking. It would not require that Congress adopt a gold standard or abandon the paper dollar. Its design is to put the issue to the test of the market by providing a fair field on which gold and officially controlled fiat money can compete. (In next week's issue of *Research Reports* we shall publish extracts of the Free Market Gold Coinage Act and comment on specific provisions of it.)

By the end of its tenure, the Gold Commission might best serve the Nation by setting forth a useful description of the enormity and complexity of the problem faced. In a rare attack of humility, the Commission members might unanimously concede that they do not know how to solve it, and consequently they would recommend letting the market decide what monetary system functions best. In our opinion, that action would offer the Nation the best hope of avoiding calamity and setting a course toward sustainable economic progress.

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* See *Research Reports* September 24, 1979, "How To Cope With a Flight from the Currency" and September 1, 1980, "Making Sense Out of the Dollar." Both available for one dollar.

PRICE OF GOLD

	1980	*1981*	
	Sept. 18	*Sept. 10*	*Sept. 17*
Final fixing in London	$672.00	$451.50	$459.00

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