

Gold-Indexed U.S. Bonds?

The comments below are excerpted from remarks made by Federal Reserve Board Governor Wayne D. Angell at Progress Foundation's 3rd International Monetary Conference in Zurich, Switzerland, on June 11, 1990. Governor Angell gained prominence most recently with his advice in September to the Soviet Union to restore the ruble to gold convertibility. Although he remains committed to a central banking regime for the United States, his (qualified) favorable assessment of the historical monetary role of gold and especially his proposal to test gold-indexed U.S. bonds as a means of financing Government expenditures and promoting monetary restraint, would seem to contrast sharply with the official view of 15 years or so ago that gold was a "barbaric relic" to be purged entirely from the Nation's money system. Rather, an inescapable inference to be drawn from Governor Angell's proposal would seem to be the enduring quality of gold as money.*

"Since 1914, when the Federal Reserve was first founded, to 1990, we have experienced an average rate of inflation in the United States of around 4 percent. There is no question that rate of inflation is higher than it would have been if we had continued on a gold standard, a non-managed gold standard.

Under a gold standard, one does experience inflation during some periods of time; and one does experience deflation during other periods of time. But the fact of the matter is, the rate of inflation seems to be held within somewhat narrow bounds; and the rate of deflation is held within narrow bounds.

The reason for establishing the Federal Reserve System was to bring the United States into a managed gold system. It was believed, given the many independent banks we had in the United States — a system in which we had abrupt monetary shocks — tying the currency literally to gold resulted in such heavy disruptions as to pose threats to economic growth and stability. In short, one of the main advantages that goes with gold — that is, having low rates of inflation and having almost no inflation over time and thereby having very low interest rates — is met by the disadvantage of having a system that is somewhat subject to certain shocks by not having a flexible currency system.

Inflationary Bias

Let me remind you briefly that when the United States decided to use a managed gold standard, that managed gold standard was one in which there were checks upon the [power of the] management authority to create the monetary base or to create a reserve base. That check was progressively eliminated. Indeed, in the 1930's the gold stock reserve necessary to limit Federal Reserve monetary creation was in fact redefined so as to permit more monetary expansion. And in 1970-71, the

* Minor editorial changes have been made for clarity of presentation. The complete text, including Governor Angell's response to questions about his proposal, will be included in the *Proceedings of the conference*, forthcoming in AIER's *Economic Education Bulletin* series.

United States in the Smithsonian Agreement agreed to abandon any use of gold whatsoever.

Is there a possibility of having sound money under such a regime? Well, of course I believe the answer is yes. Sound money requires in systems like the Swiss National Bank, the Bundesbank, and the Federal Reserve Banks, and other central banks simply to have the will to be able to restrain the creation of money — and that means allowing interest rates to rise whenever market forces dictate that they should rise so as to make certain kinds of adjustments.

I believe that when countries that had sound, full-bodied money based upon gold departed from that system, most of them experienced a lingering beneficial effect. That is, during the 1950's and 1960's, there was not that much expectation for inflation in the United States — and to some lesser extent in other countries around the world. Consequently, people behaved in a manner in which they would not take quite as much advantage of somewhat more expansionist or somewhat easier monetary policy.

During this period of expansion, individuals and households had learned to squirrel their financial assets not in dollars or in other currency denominations but began to buy real estate. American households particularly began to concentrate in home ownership, and such arrangements then began to develop a very definite bias. That bias was followed by monetary policy in which interest rates barely compensated for the rate of inflation, so that households and business firms alike found it profitable [for the Government] to engage in monetary expansionism.

And Bust

This monetary expansionism in the United States proceeded until — I believe the key date was October 6, 1979 — the U.S. dollar was feeling the full effects of such over-monetary expansionism as had occurred during the previous decade and a half. And so at that point the Federal Reserve determined that it would seek to restrain the money stock and to let interest rates go as high as they needed to go.

As you may all know, we had a short and very sharp recession in 1980, followed by a much longer and sustained recession in 1981 and 1982. As a result of that, the rate of inflation was reduced from close to 12 percent to a rate closer to 4 percent. That adjustment did not come without costs.

Now the Federal Reserve has to be mindful today that we have been unsuccessful in further reducing the rate of inflation and that we have gone through an adjustment period in which the rate of inflation has really stabilized at around a four and a half percent level. That level does not seem to be subject easily to improvement. And yet the Federal Reserve is determined to pursue restraint in the money stock so as to accomplish some further reductions in that inflation rate.

To give you some notion about the monetary restraint in place, over a 2-year period the growth of the basic M2 money stock in the United States has been about 4 to 4.5 percent. Over a 3-year period the growth of the money stock has been about 4.5 percent. Over a 4-year period, the growth of the money

stock has been coming down in recent months until it is now approaching 5 percent. So for a 4-year period, we have had slower money growth than we had in any period in the post-World War II period, and yet we seem not to be getting the kind of effect in terms of reduced inflation that is being sought or is desired.

So some people are tempted to ask, is there any approach that might bring more success? Well, I am somewhat content in my belief that continued restraint with patience will produce the kind of slowdown in inflation that is desired. There are those that say that zero inflation or price level stability is not feasible. I would suggest that if zero inflation is not feasible, then there *will* be a continued erosion in the purchasing power of the dollar over time. I think one lesson from the gold standard is that periods in which inflation has some slight increase are followed by some periods in which inflation is on the other side, a deflationary phenomenon so the price level returns to its previously determined level.

A New Role for Gold?

One interesting question that applies to countries that own gold stocks, such as the United States, is whether or not the gold stock can be used in a way that is somewhat more profitable than our present facility. Clearly, it would seem to be true that if the United States owns approximately \$92 billion worth of gold and also borrows money from its citizens, it in effect has borrowed money to own that gold. It would appear that owning gold under those circumstances has a fairly high opportunity cost.

So one might ask: why not sell the gold and have that much less debt and end up then with a lower interest burden than you would have otherwise? I can see some merits in such an argument. But I am quite certain politically that such a move would not be favored by many groups in the United States and would not be apt to occur. So then we might ask: how might we use our gold stocks to achieve some of the benefits that might go with the ownership of that gold?

Well, one interesting proposition is close to that which I suggested for the Soviet Union. I suggested to the Soviets that in a system running 12 to 18 percent of the Gross Domestic Product as a deficit, making the transition from a deficit financed by ruble creation to one in which you had a gold-based money system would mean, of course, that you had to make an abrupt transition in regard to balancing the government budget. That transition would indeed be a rather difficult shock treatment to undergo. I suggested to them that if they were to make a transition to a gold system, they might be able to use gold-backed bonds in order to have some borrowing during this period of adjustment of their budget deficit.

The question might arise for the United States: could we use gold in a way that is more profitable than it was under a pre-Smithsonian gold system? Under the pre-Smithsonian gold system, the United States said that internationally gold could be traded for dollars around \$42 per ounce. But, of course, this was a kind of friendly arrangement with central banks. Every central bank was, in effect, asked not to call upon the United States to do so, because everybody began to recognize that gold in the free market would be more than \$42 if that gold dollar restraint was abandoned.

The interesting question could be: what might happen if we had no gold dollar price level target, but instead we used gold as a means of alternatively issuing different kinds of bonds? U.S. law would not permit the Treasury at the present time to issue gold-backed bonds, because such gold-backed bonds would not qualify as being payable in lawful money of the United States. But there are many who believe that it would be legal for the U.S. Secretary of the Treasury to issue dollar-denominated bonds that are indexed to gold prices.

Now what would happen if the United States were to issue, let's say, \$10 billion worth of gold-indexed bonds? First, I think it might provide a great deal of informational content for us to see what might happen with such a bond issue. That is, we do not know with any certainty what interest rates would prevail at an auction market on gold-indexed bonds.

We know that gold mining companies in the United States have made a very heavy investment in gold mining of approximately \$8.5 billion in the last 8 years. I think it is probably a fact not fully noted by many that this represents a gold mining investment which this year will bring the United States to number two among the gold producing countries of the world. The United States will undoubtedly surpass the Soviet Union in gold production in 1990.

"Gold Standard" Real Interest Rates

New methods for gold production, called heap leaching, have been found in which there has been extensive investment. And it may very well be that the price of gold under these methods with substantial amounts of low-grade ores in Nevada and other states might be as low as \$220 to \$230 an ounce. Now those gold mining investments were largely paid for during the 1980's by issuing gold bonds, and those gold bonds generally went for 2 to 3 percent interest rates, which I think is understandable. Individuals who find it rather expensive to own gold would much prefer to own [shares] in a reputable gold mining company in which they could receive some positive interest rates and would not have to have storage costs and other insurance costs as a transaction cost.

But that doesn't mean that if there were large quantities of gold-indexed bonds — for example, if some country issued a \$100 billion worth of gold-indexed bonds a year — they would still have a rate of interest as low as 2 to 3 percent. I would suggest that there would be an informational value for an issue of around \$10 billion. That would provide us with a key to knowing something more about 'gold standard' real interest rates, and that would in a sense give us a chance to make some comparison with certain nominal interest rates.

But let us suppose that we took it one step further and asked: what would happen if the United States were to, say, decide to cover the thrift crisis by issuing gold indexed bonds? Let us suppose that we decide to take care of the thrift crisis more up-front and that we decide to issue \$100 billion worth of gold-indexed bonds.

Well, if that were to take place, then it would seem to me quite likely that the interest rate would tend to move up beyond the 2 to 3 percent level, because I would think that you would be putting into gold-bond ownership more individuals and more corporations than you would have under the present environment. So I would expect the interest rate might get somewhat higher as you increase the stock of bonds.

And New Uncertainties

Now if the United States were to issue gold-indexed bonds, such gold-indexed bonds of course would give the United States Treasury an undetermined interest rate. That is, the cost of funding such an issue would not be apparent up-front. The cost of funding such an issue could vary depending upon the price of gold.

If, for example, the United States had issued gold-indexed bonds in 1970, when the price was \$42 per ounce, and if it had issued 10-year gold-indexed bonds, and if 10 years later in 1980 the price was approximately \$650 per ounce, in January of 1980, then we would have had something like a 34 percent annual escalation in the price of gold. So the actual cost to the Treasury would have been the nominal interest rate on the gold-indexed bonds, 3 percent, which you could add to the 34 percent gold-price appreciation, and the Treasury would have

had a cost of about 37 percent interest rates during that decade, which of course would be the worst decade that anyone could possibly look at.

Of course, if the United States had issued gold-indexed bonds in 1980, and they were 10-year gold-indexed bonds maturing in 1990, and if the price of gold was \$650 an ounce in January of 1980 and if the price of gold was let's say approximately \$400 an ounce in January of 1990, then of course there would have been a negative appreciation and that would have been subtracted from the 3 percent, so during that decade the real cost of funding it would have been less than zero.

Creating Incentives for Monetary Restraint

Now that is not, I suppose, what interests me. It doesn't interest me so much that gold-indexed bonds would leave you with certain kinds of uncertainties and certain kinds of risks. The question that interests me most would be: would it tend to change the perception of those who believe that it pays to have lower interest rates? Sometimes I suppose the motivation for lower interest rates could very well come from a Congress that has to face an interest burden on the national debt. So the Congress might suggest, as other debtors would, if interest rates were lower on a \$3 trillion debt, then every one percent reduction in interest rates would eventually result in \$30 billion less of interest and that would be a nice kind of take if the Federal Reserve would just be so kind as to lower interest rates by one percent.

I think most of us know that if the Federal Reserve were to lower interest rates by one percent, that we might get short-term rates down by one percent. But as we discovered last December, lowering short-term rates does not always cause long-term rates to come down.

But if we had gold-indexed bonds, the interesting possibility is that we would have the Congress and maybe the Administration asking the Federal Reserve to please engage in monetary restraint. Because then the Congress and the President might suggest that if the price of gold rises, then that increase in the price of gold would increase the burden of taking care of the debt. Indeed, you might have a rather reverse arrangement in which the Federal Reserve is being pressured by the Congress and by the Administration to engage in more restrictive monetary policy so as to keep the price of gold down."

WHY DO COLLEGES COST SO MUCH?*

Today's students and their parents probably are painfully aware of the high price of a college or university education. Indeed, numerous newspaper and magazine articles, television broadcasts, Congressional hearings, state-sponsored college-tuition bond issues, and private financing plans, have publicized the growing distance between the "list price" of an undergraduate degree and the consumers' and taxpayers' ability to pay it. Most approaches to this problem have focused on the supposed need for greater Government aid to students and their families. Robert W. McGee, drawing on his experience as an Accounting Professor, suggests that a more useful approach to college costs might begin with the colleges themselves. About two-thirds of college and university expenditures are relatively fixed costs associated with overhead and support facilities. However, costs related to instruction itself, which today are roughly equivalent to combined revenues from tuition and fees, gifts, grants, and endowment earnings, are — or ought to be — highly flexible. The greatest savings could

be achieved if the instructional "labor force" were introduced to the market discipline that creates greater efficiencies in the nonacademic world.

College costs are escalating faster than the general cost of living. One reason often given for this rapid increase is that providing education to college students is a labor intensive activity, and such costs are not easily automated (*i.e.*, increases in "productivity" are not easily achieved). However, the factors underlying the college cost spiral involve other structural impediments that need to be eradicated before expenses can be contained.

A major source of rising college costs would seem to be that colleges are organized bureaucratically rather than for profit. Consumers (students) often seem to be the furthest things from the minds of college bureaucrats when they ponder a change in an educational policy. The popular quip that "college would be a good place to work if it weren't for the students" only begins to capture the extent to which professional academic activity may be divorced from instruction *per se*.

Minimal Classroom Time

Since providing a college education is labor intensive, one obvious way to keep costs down would seem to be through more-efficient utilization of labor — *i.e.*, the time college professors spend instructing students. Professors actually spend very little time in the classroom and the trend is to spend even less. A few years ago, most colleges required their full-time professors to teach 12 hours a semester or 24 semester hours a year. That means spending 12 hours a week in the classroom for 30 weeks a year — or 360 hours a year (about 9 regular work weeks), some of which time is consumed by exams. And even that figure is somewhat inflated. A college hour is actually 50 minutes, so contact time actually is about 300 hours a year.

Compare that with the requirements of the average high school teacher, who must spend about 5 hours a day, 5 days a week, 180 days a year in class — 900 contact hours — or with someone who has a factory or office job that requires 1,700 to 2,000 hours a year.

Furthermore, the trend is toward even fewer college classroom hours. Many colleges have reduced the teaching load for a full-time professor to 9 hours a semester. Faculty members who engage in research often spend only 3 or 6 hours in class.

A *Chronicle of Higher Education* study of professors' compensation shows a wide range of salaries, from \$20,000 to more than \$70,000 (excluding fringe benefits), depending on the school and the subject taught. The professors who engage in research tend to get paid more and teach less. A professor who earns \$70,000 a year and spends 6 hours a week in class (5 actual clock hours) earns about \$467 an hour. Even a professor who earns "only" \$40,000 and teaches 12 hours a week (10 actual contact hours) earns \$133 an hour.

In fairness, it should be said that professorial duties involve more than teaching. Professors must prepare their lectures and serve on committees. They also must grade examinations and term papers and advise their students. For faculty members who teach graduate students, the latter task *can* be time consuming. But preparation time often is minimal (or zero) for courses that are taught every semester, year after year. Each time the same course is taught, less preparation is required.

Professors often occupy their "spare time" by serving on committees. Anyone who has ever served on a college committee knows how unproductive that time can be. There are committees for every purpose under the sun, including a committee to determine who shall serve on which committee. One college in New Jersey even has a committee to determine whether the lines on the parking lot should be painted at a 45-degree or 90-degree angle (it could not agree after several

* This article was prepared by Robert W. McGee, an Associate Professor of Accounting and Taxation at Seton Hall University who is Adjunct Research Fellow at American Institute for Economic Research.

meetings). Much college committee work is either irrelevant or consists of work that could better be performed by a single individual who would be held accountable for any decisions made. Individual committee members are not responsible for committee decisions, which is seen as an advantage by those who serve on committees. Where there is no responsibility, the decisions made tend to be of lower quality than where some individual can be held accountable for a mistake.

The Accreditation Monopoly Creates Inefficiencies

In practice, such inefficient labor practices have been encouraged by what might be called the "accreditation monopoly" of regional accreditation agencies. The U.S. Department of Education has divided the country into 6 geographical regions, each of which has only one official accreditation agency. These agencies have the authority to approve or disapprove the general programs of colleges and universities within its jurisdiction. They also grant monopolies to a number of special accreditation agencies charged with reviewing particular programs, such as business and nursing. Without this approval, the schools would not qualify for numerous types of Government aid and they would be at a distinct competitive disadvantage in competing for students.

In order to meet accreditation "standards," colleges and universities must adopt a number of policies that have very little to do with instructional quality, yet increase costs. If a college tried to make its professors spend as much time in class as a high school teacher, they would lose their accreditation.

To maintain their accreditation, schools must maintain a specified percentage of PhDs on their faculties. Yet, in many fields, the PhD degree is largely unrelated to any increase either in subject-matter knowledge or teaching ability. Although some coursework is involved, the PhD degree is primarily a research degree. Even required coursework may have very little to do with the subject in which the degree is earned, especially in business concentrations. For example, the average PhD program in accounting requires only a few accounting courses. The dissertation required to complete the degree consists of research on a topic that often has very little pertinence in the "real" world of accounting. Completing the dissertation often may not make the student either a better practitioner or a better classroom performer.

An Untapped Labor Pool

Even though they finish the coursework portion of the program, most students who begin a PhD program do not complete the degree. Thus, a large number of potential faculty never get the credentials they need to gain entrance into college teaching. With the vast majority of potential teachers arbitrarily precluded from competing for teaching positions, it is no wonder that colleges have to pay their professors so much.

Again, the situation in accounting provides a good example. Accountants who spend the first 5 years after earning the bachelors degree working for a public accounting firm or corporation accumulate a tremendous amount of experience. They often earn a CPA and/or MBA in that time as well. If they decide to enroll in a PhD program instead, they will spend 5 years reading about accounting rather than practicing it, and writing a dissertation probably about some esoteric topic that has little to do with the "real" world. If, at the end of 5 years, the practitioner applies for a college teaching position, he or she will be regarded as less-qualified than someone who completed the PhD program but who has no experience in the subject to be taught. Of every 20 potential accounting faculty members, perhaps 19 have pertinent experience but no PhD. Thus, perhaps 95 percent of the potential pool of college accounting professors is arbitrarily precluded from entry into the field. When such a large percentage of potential supply is cut off, the price has to go up.

Under present accreditation standards, many colleges would not consider hiring a Thomas Edison, Henry Ford, Abraham Lincoln, or Aristotle on account of their spotty educational credentials. Colleges that do hire such "unqualified" individuals risk losing their accreditation.

It does not take a PhD to teach remedial math, freshman English, or elementary accounting. In fact, PhDs may be less qualified to teach some such courses than others who have spent their time learning the subject by practicing it rather than by reading about it.

The Costs of "Publish or Perish" ...

The publish or perish syndrome also increases college costs. Many colleges are under intense pressure to have their faculties publish, and they give them reduced course loads to do so. If the faculty does not produce a sufficient number of publications each year, the school risks losing its accreditation. For example, the pressure for business school professors to publish is so intense that some colleges have started a movement to replace the American Assembly of Collegiate Schools of Business (AACSB), the agency that accredits business schools, with one that does not require as much publication. But this movement faces a major obstacle because the U.S. Department of Education will recognize only one accrediting agency for each specialty — and the AACSB has already been designated as the sole agency qualified to accredit business programs. Why should the AACSB change its rules if the business schools it accredits have no place else to go for accreditation?

... And Tenure

Beyond these concerns, the institution of tenure (*i.e.*, the granting of a guaranteed job for life to professors after 6 years or so, whether they can teach or not) may add incalculably to college costs. It is almost impossible to fire a professor who has tenure. In practice, virtually all colleges have to keep a number of unqualified professors on the payroll. Their costs must go up as a result, and these costs are passed along to the consumer. If a private business were unable to get rid of its deadwood, it probably would be faced with bankruptcy. But colleges, especially state-supported institutions, rely on taxpayers to shoulder this cost.

In short, a main reason college costs are so high is that, in these and other ways, colleges are sheltered from competition. The regional accreditation associations' monopoly grip on accreditation ought to be broken. There is no need that accreditation be a function of government any more than there is a need for government to be involved in many other spheres of economic activity. Consumers Union, Standard & Poor's, Underwriters Laboratories and other private agencies do a commendable job of informing consumers. There is no reason to expect that private accreditation agencies could not do the same with colleges, if given the chance. At the very least colleges that must now maintain irrelevant accreditation standards, small course loads, and the publish or perish syndrome, then would be able to use their faculties more effectively for their primary purpose — namely, the education of their students.

PRICE OF GOLD

	1989	1990	
	Jun. 29	Jun. 21	Jun. 28
Final fixing in London	\$376.30	\$349.75	\$352.30

Research Reports (ISSN 0034-5407) (USPS 311-190) is published twice a month at Great Barrington, Massachusetts 01230 by American Institute for Economic Research, a nonprofit, scientific, educational, and charitable organization. Second class postage paid at Great Barrington, Massachusetts 01230. Sustaining memberships: \$14 per quarter or \$48 per year. POSTMASTER: Send address changes to *Research Reports*, American Institute for Economic Research, Great Barrington, Massachusetts 01230.