

END THE EXPERIMENT, RESTORE THE STANDARD

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Since August, 1971, the best and the brightest economists, politicians and central bankers in the world have run a noble experiment: a world of floating exchange rates and domestic monetary systems ruled by the judgment of men. When President Nixon severed the final link between the dollar and gold 23 years ago and brought the Bretton Woods era to a final end, Americans were promised increased economic security.

Domestically, we were told we could look forward to a more stable economy with higher rates of economic growth. Freed from the strictures of an international gold standard, the members of the Federal Open Market Committee would be able to use their judgment to adjust the money supply in order to insure high employment, sustain economic growth, and avoid costly recessions.

Internationally, we were promised that a floating (i.e. falling) dollar would reduce our trade deficit and assure the international competitiveness of our workers and businesses. Now, with the benefit of 23 years of experience, honest men and women of good will must admit that this experiment, for all of its noble promise and high purpose, has failed. During the 1970s, increased flexibility and free use of judgment delivered a decade of the worst economic performance since the 1930s. Coincident recession and double-digit inflation, banking crises, and record central-bank interventions on foreign-exchange markets were among the most unexpected consequences. By the end of the 1970s, America was suffering from its second oil shock, an international run on the dollar and the highest interest rates in its history. During the 1980s, inflation was brought back below 3 percent, and interest rates were reduced well below 10 percent. But the U.S. also ran the largest trade deficits in its history and the largest debts of any nation, ever. Its banking system was threatened by the Third World debt crisis.¹

The 1990s appear to be no better. This year, the Federal Reserve has once again started down the path of raising interest rates because of fears of too much economic growth and too much employment. To see how far the performance of the current system has fallen short of its promise, consider that between 1947 and 1967, real growth in the United States averaged 3.6 percent a year, with an average unemployment rate of 4.7 percent and a consumer inflation rate of 2.6 percent. Yet, these are exactly the conditions that the Federal Reserve says are not attainable today, when any growth above 3 percent or unemployment below 6 percent is said to be inflationary.

The benefits of floating exchange rates and a weak dollar have yet to produce their promised international benefits. The U.S. trade deficit remains near \$100 billion, and our trade relations with Japan are no better now with the dollar worth 100 yen than they were when the dollar was worth more than 300 yen.

¹Judy Shelton, *Money Meltdown*, New York: The Free Press, 1994.

Political failure

The fact that this failed experiment has not been brought to an end is itself an historic failure in political leadership. Our founders declared that governments are instituted to secure certain unalienable Rights, that among these are Life, Liberty and the pursuit of Happiness. Certainly, a money that can be trusted to maintain its buying power is fundamental to our liberty, to our capacity to take care of ourselves, our families and our communities, and our ability to pursue and realize each of our own dreams and ambitions.

This failure of political leadership can be excused by pointing out that even with all the fits and starts, monetary policy got progressively better during the 1980s. By the end of 1993, interest rates were at their lowest level in more than 20 years.

But this excuse avoids facing the central political issue: the monetary debate is, at its core, about political power. Restoration of a gold standard takes power away from the ruling elite in Washington, who would use monetary policy to manipulate the exchange rate for some short term political advantage, or to favor a politically powerful group. Restoration of a gold standard also increases the power of the people to use money to create and expand new businesses, to purchase homes, cars and other consumer durables, and to shape the economy according to the will of the people expressed in millions of individual, freely selected transactions. The innovations and expansion of the private sector under a monetary standard would do more to shrink the power of government over our lives than any other single action before us today.

The movement toward establishing a gold standard has gone nowhere because we have been content to debate this issue in economic terms, acting as if the political establishment would not resist a diminution of its power. Fifteen years ago, the debate over tax policy was not won by bringing forth a new consensus among economists. If that had been the strategy, the top tax rate in America would probably still be well above 50 percent, and Ronald Reagan might never have been elected President.

Supply-side economics changed public policy because it spoke of tax rates in terms of their impact on individual human beings. Supply-siders recognized that a reduction in tax rates was, at its core, a transfer of power from the politicians in Washington to the people who lived and worked and raised their families outside of the rarefied air of the Beltway. As a result, they popularized tax rate reductions by showing in terms of everyday life why lower tax rates would increase employment, investment and opportunity. The adage: "If you tax something, you will get less of it, and if you subsidize something, you will get more of it. And today we are taxing work, investment and savings, and subsidizing nonwork and leisure," did more than any sophisticated economic argument to bring down tax rates and produce the longest peace-time expansion in the history of the country.

Now we must develop a similar strategy for reforming monetary policy. A gold standard will never be put in place as long as we continue to debate and discuss and speak of the issue within the economics community and with economists' jargon. To change

monetary policy will require a popular uprising no different than the tax revolt that brought Ronald Reagan to office in 1981. And to achieve that, we must show people how restoration of a gold standard will improve their lives. And, we must do this in the language of every day life.

What is money?

Let's begin by re-examining what money is and how it is used. Economists speak of money as if it is a thing: currency, or the M's or the monetary base. And they speak of people as if they are objects: labor, the unemployed, the skilled, the unskilled and the like. "Inflation," we are told, "is too much money chasing too few goods." Yet, what economist or person has ever witnessed money running down the street chasing anything? These commonly used metaphors mislead and conceal the nature of money. And their mechanical nature does not speak to the central concerns of people.

So, let's take a look at money as a phenomenon.

First, money is a human invention. Animals do not use money. Before money, there was barter. The use of salt, copper, iron, silver, gold and finally paper and even cigarettes as money were all human inventions.

Second, money is a phenomenal tool of coordination. It is hard to imagine markets without money. Surely, our modern market economy would not be possible without it. Money provides a universal substitute for providing a good in exchange for a good. Money spans both distance and time, and increases the capacity of people to complete transactions -- buying and selling merchandise today, or lending to finance current spending in exchange for future repayment.

Third, money is based on trust. People accept money in exchange for goods and services because they trust that someone else in turn will accept the money in exchange for an equivalent amount of goods and services. When they lend money, they do so trusting that they will be repaid in money that will be exchangeable into goods and services. Money is useful only because we trust the promise of exchangeability.

What is trust?

Trust is an assessment about a future action. When we say that the stock market will open at 9:30 a.m., we are saying we trust that the promise that the New York Stock Exchange has made to open at 9:30 a.m. will be fulfilled. When we make an appointment for a meeting, we trust that those who promise to attend will be there. When we buy a light bulb, we do so trusting that it has been made to the standards that will permit its use in any standard lamp in the house.

Then our discussion today should be about what policies will increase trust in the stability of the dollar's rate of exchange into goods and services. Let's look for a minute at how trust is produced in every day life.

Trust is built when a promisor recurrently keeps his promise. People build a good credit rating by making and fulfilling explicit promises to pay their bills on time. So, when assessing the trustworthiness of a promisor the questions we need to ask are: Who is the making the promise? What actions are they promising? Are they sincere? And are they competent?

Price level targeting vs. a gold standard

Under current monetary policy, which appears to be some variant of price level targeting, the Federal Reserve is the promisor. The promise, however, is not clear. Various Fed Governors have articulated different promises regarding the intent and direction of monetary policy. In fact, the current tradition of the Fed is for it to avoid any specific promise to which it can be held accountable. The closest the Fed has come to making a promise is to say that it will do its best to bring down the rate of inflation.

In everyday life, we call this a shallow promise. It is like a colleague saying: "I'll try to get back to you as soon as I can," instead of saying: "I will call you back at 10 a.m. ET Monday, September 5." As we all know from experience, shallow promises, even if sincere, are not to be fully trusted.

Price level targeting brought interest rates down because at least the intentions were consistent with maintaining the buying power of the dollar. As such, the longer the Fed was successful in stabilizing commodity prices, including gold, the more we trusted that price level targeting was more than a shallow promise. That is why the gradual but persistent rise in commodity prices during the past year has reduced trust in the dollar. This mistrust, as it always does, has shown up in higher interest rates. In addition, with the appointment of two new Fed Governors, we need to assess whether the Fed will withdraw its weak promise to target the price level.

A monetary policy that will build trust would have a clear promisor, a clear promise for action, and most importantly, a domain or area of observation that would permit all of us to see whether or not the promised action was being fulfilled.

A gold standard satisfies these requirements. The promisor is the U.S. government. Therefore, the promise would not change with changes in the Fed Governors. The action promised is to maintain the dollar's rate of exchange into gold. And the domain of observation is the dollar price of gold.

Why use gold? Because it has a history of having a remarkably stable purchasing power in terms of all other goods and services. Hence, gold acts as the proxy for the price level. By doing so, gold enables the government to, in effect, promise to maintain the dollar's general rate of exchange into goods and services in a way that is observable to all. If the dollar and gold are exchanging at the standard price, the promise is being kept. The keeping of this promise over time builds trust and leads to lower interest rates.

A gold standard also gives the Federal Reserve a rule of action by which it can fulfill the government's promise. Instead of trying to guess what Federal Funds rate is consistent with stable prices, the Fed uses its open market desk to target the price of gold, and hence the price level, directly. A rise in the price of gold signals a surplus of dollars and inflation. The Fed can intervene just as it does today, by selling some of the \$350 billion in U.S. government securities it holds in its portfolio, or by selling gold. Both actions reduce the monetary base. Conversely, a fall in the price of gold signals a shortage of dollars and deflation, prompting the purchase of government securities or gold and thereby expanding the monetary base.

In all these discussions and proposals, it is important to keep in mind what the gold standard will not do. It will not force the U.S. government to balance its budget. Under gold standards, governments, like businesses and individuals, will be able to borrow money at the going market interest rates. In 1947, for example, the Federal debt was equal to 110 percent of GDP, or more than 60 percent larger than today's Federal debt relative to our domestic product. Yet, interest rates on three month Treasury bills were 0.6 percent. Since interest rates will be lower under a gold standard, the cost of financing the deficit to the government will also be lower. Lower interest rates will reduce government spending and thereby reduce the Federal deficit.

Second, a gold standard does not impose a restriction on the quantity of money. In fact, it does just the reverse. To keep its promise, the monetary authority must supply as much or as little money as the public demands at the fixed rate of exchange with gold. In this way, the power over the quantity of money is transferred from the Washington establishment to the people.

More prosperity for all

The only reason the gold standard is important is that it will increase people's trust in the exchangeability of the dollar into goods and services, across town, across the country, around the world, and through time. To see the benefit of a more trustworthy money, imagine what the size of the U.S. economy would be if we had no money, if all our transactions were through barter. Now imagine how much bigger the economy would be if we had a perfect money that was completely trusted. The erratic policies of the last two decades have moved us back and forth along this continuum of barter and perfect money.

The more trustworthy the dollar is, the more useful it is in managing day to day transactions. That means more sales, more jobs, more commerce, and more economic growth. The more we trust the future buying power of the dollar, the lower interest rates will be. Lower interest rates increase our capacity to manage transactions across time. That means more investment, more construction, more opportunity, more jobs and more prosperity.

We can only imagine the gains from creating an international monetary system in which currencies are stable and interest rates are low. For 88 out of the 90 years before 1967, the year the U.S. began to weasel on its promise to maintain dollar-gold convertibility,

interest rates on five year government bonds were below 5 percent. Think of the increases in opportunities for people everywhere to take care of their concerns and realize their dreams if interest rates were once again that low. Think of the homes that would be bought with mortgage rates under 6 percent, the businesses that would be started and expanded with the prime rate at 4 percent, and the jobs that would be created if corporations could once again borrow long term money at rates as low as 5 percent. Think of the resources now devoted to hedging foreign currency exposure and interest rate volatility that would be freed to provide more tangible benefits to our citizens. Think of the billions of dollars in losses in bond derivatives, including \$700 million in one bond portfolio alone, that would be avoided by making unnecessary such esoteric financial instruments. Think how much more secure our futures would be if we knew that the returns to the investment we made today would be repaid in dollars that have the same buying power 10 or 30 years from now when we retire.

Failure to act also has consequences. If interest rates remain high and volatile, think of the loss in jobs, opportunity and investment. Think of the crushed dreams and the permanent reduction in the welfare of our citizens. Think of the intensified bitterness of the underclass, who, without assets and the skills to make assessments about the future value of money, would be left further behind. Think of the threat that some day another nation or bloc of nations might seize leadership of the international monetary system and secure for itself the benefits of providing a monetary standard to the rest of the world by being first to adopt a gold standard. The tremendous American prosperity of the 1950s and 1960s is associated with the world adopting a dollar standard.

The Fed should not wait for a formal and complete monetary standard to increase the trust in its promise to stabilize the price level. The sharp rise in long term interest rates during the past year signals an erosion of trust in the dollar's future buying power. After allowing for a real rate of return of 3 percent, today's 30 year government bond yield of 7.5 percent includes an inflation premium of 4.5 percent. That inflation premium implies the price level will increase 2.75 times over the next 30 years: that is, 30 years from now, the \$20,000 family sedan will sell for \$55,000, and today's \$200,000 house will cost \$550,000.

Such a generalized increase in prices, however, is inconceivable if the dollar can buy as much gold 30 years from now as it can today. Therefore, the Fed can increase trust in the dollar and reduce long term interest rates by promising that, if necessary, it will sell government securities into the open market in order to stop any further increase in the price of gold. As the Fed keeps this promise, trust in the future buying power of the dollar will increase, and interest rates will resume their downward trend.

In 1944, President Truman reinstated dollar-gold convertibility. In 1946 personal and corporate income tax rates were cut. In 1947 the International Monetary Fund (IMF) commenced operations and the benefits of a monetary standard based on gold were extended to the rest of the world through the Bretton Woods Agreement. Between 1945 and 1952:

- ◀ private output (real GNP less defense) expanded at an average annual rate of 5.2 percent,
- ◀ the federal budget was in surplus five out of the seven years,
- ◀ Treasury bill rates ranged between 0.4 percent and 1.8 percent, and
- ◀ the rate of inflation fell from its post-World War II peak of 20 percent to zero.

And the unemployment rate? It never went above 6 percent.²

Such an achievement is surely as possible today, at the end of the Cold War, as it was during those uncertain days surrounding the end of World War II. All that is required is the wisdom to learn from the past and the courage to act to produce a better future. A popular mandate to fix the value of the dollar can be created. Fulfilling this mandate will produce for all Americans, indeed people everywhere, a dollar they can trust and a more secure and prosperous future.

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²Arthur B. Laffer and Charles W. Kadlec, "The Point of Linking the Dollar to Gold," *The Wall Street Journal*, October 13, 1981.