

Cato Institute Policy Analysis No. 16: The Gold Standard: An Analysis of Some Recent Proposals

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Joseph T. Salerno

Joseph T. Salerno is an assistant professor of economics at Rutgers University.

Executive Summary

The case for a free-market commodity money as provided by a genuine gold standard is simple yet decisive. It is based on the insight that the root cause of inflation in the modern world is the almost absolute monopoly over the supply of money which all national governments possess within their respective political jurisdictions. That such an arrangement necessarily produces inflation is not difficult to explain.

To begin with, almost all governments obtain the bulk of their revenues through taxation which, regardless of its particular form, ultimately involves -- indeed, is definable as -- a coerced levy upon the monetary incomes or assets of its citizens, i.e., the net taxpayers. However, whatever ethical or practical considerations may be brought forward to justify taxation, since it is essentially coercive, tax increases have always found little favor among the citizenry. So, ever fearful of arousing popular unrest, governments naturally sought alternative means for augmenting their revenues from taxation. It was for this purpose that all national governments eventually secured for themselves a legal monopoly of issuing money, empowering them to inflate, i.e., to create new money, virtually at will.

Especially under today's various national fiat-money standards, inflation provides a relatively simple, costless, and secure means for amassing money assets. In substance, all a government needs to do to increase its real income is slap some ink on paper and spend the proceeds on commodities and services produced by the private market. In this way, the national government is able to divert scarce resources from private uses and utilize them for its own purposes, while circumventing the popular discontent which invariably accompanies an overt imposition of higher taxes. Actually, in the world of modern monetary and financial institutions and practices, inflation entails a much more arcane process than the mere printing and spending of new units of currency. This fact obscures the true cause of inflation from the public and permits the government to shift the blame for the monetary unit's shrinking purchasing power and other undesirable consequences of inflation from itself to other groups or to circumstances beyond its control. These include OPEC, monopolistic corporations, powerful labor unions, spendthrift consumers, unfavorable weather conditions, etc.

It should be no surprise, then, that all government-monopolized fiat moneys exhibit symptoms of inflationary disorder -- just as it is no surprise when other groups in the economy exploit the monopoly privileges granted them by law to increase their money incomes, e.g., via tariffs, occupational licensure, exclusive public franchises, etc. Indeed, it is a general lesson of history as well as a rule of common sense that an individual or group endowed with a legal monopoly over any area of the economy will use it to its own pecuniary advantage. To put it rather bluntly, government is an inherently inflationary institution and will ever remain so until it is dispossessed of its monopoly of the supply of money.

Indeed, lately an increasing number of economists have come to regard inflation as a necessary consequence of the political control of money. Most prominent among them is F. A. Hayek, Nobel laureate in economics, who has forcefully argued that the recurring bouts of macroeconomic instability which have always afflicted market economies are "a consequence of the age-old government monopoly of the issue of money." [1] According to Hayek, furthermore:

... there is no justification in history for the existing position of a government monopoly of issuing money. It has never been proposed on the ground that government will give us better money than anybody else could. It has always, since the privilege of issuing money was first explicitly represented as a Royal prerogative, been advocated because the power to issue money was essential for the finance of government -- not in order to give us good money, but in order to give to government access to the tap where it can draw money it needs by manufacturing it. That, ladies and gentlemen, is not a method by which we can hope ever to get good money. To put it into the hands of an institution which is protected against competition, which can force us to accept the money, which is subject to incessant political pressure, such an authority will not ever again give us good money. [2]

Even "mainstream" economists have begun to express similar views. For example, respected monetary theorist Robert J. Barro concludes in a recent study:

In relation to a fiat currency regime, the key element of a commodity standard is its potential for automaticity and consequent absence of political control over the quantity of money and the absolute price level... The choice among different monetary constitutions -- such as the gold standard, a commodity-reserve standard, or a fiat standard with fixed rules for setting the quantity of money... may be less important than the decision to adopt some monetary constitution. On the other hand, the gold standard actually prevailed for a substantial period (even if from an "historical accident," rather than a constitutional choice process), whereas the world has yet to see a fiat currency system that has obvious "stability" properties. [3]

And William Fellner of the American Enterprise Institute reluctantly admitted recently that there is a "substantial element of truth involved in the assertion that fiat money has been misused in all history -- has always led to the corruption of the currency." [4]

At this point, it should be noted that the fatal flaw in the monetarist program for monetary stability lies in the fact that its policy prescriptions completely fail to address the fundamental cause of inflation, namely, the governmental monopoly over money. The monetarist "quantity rule," according to which a governmental agency such as the Fed is to maintain a stable rate of growth in the quantity of money, is not an anti-inflation policy at all. It is merely the enunciation of a request that the political authorities exercise restraint in exploiting their monopoly of issuing money, which, under the monetarist program, would remain virtually intact. Such a request, I might add, is incredibly naive in the light of theory and history.

The virtue of a genuine, 100-percent gold standard, in contrast, is precisely that it establishes a free market in the supply of money and, in doing so, brings about a complete abolition of the governmental monopoly in this most sensitive and vital area of the market economy. Under a pure commodity money, the money-supply process is totally privatized: The mining, minting, certification, and storage of the money commodity as well as the issuance of fully covered, i.e., 100-percent gold-backed, bank notes and deposits are carried out by private firms operating in a free market.

The complete "denationalization" of money which thus occurs under a genuine gold standard yields a money whose value is fully secured against arbitrary political manipulations of its supply. Under the gold standard, the quantity of money and hence its value is determined solely by market forces, such as the demands of the public for money and the costs associated with digging up gold. While the purchasing power of a pure commodity money such as gold, like the price of any commodity on the free market, therefore tends to fluctuate according to changes in its supply and demand, there exists an inherent long-run tendency to stability in the value of such a money. [5] This contrasts sharply with a government-monopolized fiat money which, as noted above, is inherently inflationary and subject to large, unpredictable fluctuations in value over both the short- and long-terms.

It is noteworthy that, although he regards a pure commodity standard as ultimately undesirable because of its high resource cost, Milton Friedman recognizes its unique potential as a guarantee of monetary stability. Writes Friedman:

If money consisted wholly of a physical commodity...in principle there would be no need for control by the government at all...

If an automatic commodity standard were feasible, it would provide an excellent solution to the liberal dilemma of how to get a stable monetary framework without the danger of irresponsible exercise of monetary powers. A full commodity standard, for example, an honest-to-goodness gold standard in which 100 percent of the money consisted literally of gold, widely supported by a public imbued with the mythology of a gold standard and the belief that it is immoral and improper for government to interfere with its operation, would provide an effective control against government tinkering with the currency and against irresponsible monetary action. Under such a standard, any monetary powers of government would be very minor in scope.[6]

To briefly sum up, advocacy of the gold standard is based on the view that governments are inherently inflationary institutions; therefore, the only realistic and lasting solution to the problem of inflation is to completely separate the government from money and return the latter institution to the free market whence it originally emerged.

Proposals for a Gold Standard

We now turn to a critical examination of a number of recent proposals which aim at once again giving gold a role in the U.S. monetary system. Although these plans vary significantly in basic conception as well as institutional details, all but one suffer, to a greater or lesser degree, from the same fundamental flaw: they leave intact the current government monopoly of money. For purposes of discussion, these monetary reform proposals may be grouped under four headings: the gold-certificate reserve, the gold "price rule," the classical gold standard, and the parallel private gold standard.

The Gold-Certificate Reserve

Robert E. Weintraub, senior economist for the Joint Economic Committee, has proposed the reinstatement of the gold-certificate reserve requirement for Federal Reserve notes.[7] Under Weintraub's plan, the Fed would be legally required, as it was prior to 1968, to maintain a reserve of gold certificates whose value, at a stipulated legal price of gold, would be a fixed proportion of its outstanding note liabilities. Before 1968, when the legal or "par" value of gold was \$35 per ounce, the reserve requirement was 25 percent, and so, in effect, each dollar of currency in circulation was "backed" by 25 cents in gold. Weintraub's plan "would require that the Federal Reserve banks hold at least 9 cents in gold certificates at their legal value [\$42.22 per ounce since 1973] behind each dollar of note liabilities in perpetuity." [8] The nine percent reserve requirement reflects the ratio of par value gold certificates held by the Fed to its note liabilities prevailing at the end of 1980.

According to Weintraub:

Legislation to keep the percent of legal value gold certificates behind Federal Reserve notes what it was at the end of 1980 in perpetuity would prevent any future currency growth. And, unless the public wanted to hold an increasing part of its total transactions balances (currency plus checking deposits in depository institutions) in the form of checking deposits, preventing currency growth would prevent any future growth in the transactions or exchange media measure of money.[9]

However, Weintraub finds such a result undesirable because he believes that some growth in the money supply is necessary "to accommodate our economy's long-term growth potential." [10] His proposal, therefore, includes a provision for increasing the legal value of gold, which would initially be set at the current \$42.22 per ounce, at a stipulated monthly rate. This would bring about an effective expansion in the Fed's reserve of gold certificates and permit a corresponding increase in the currency in circulation and, hence, in the overall money supply. Weintraub favors an annual rate of increase in the par value of gold which would ultimately facilitate a three percent per annum

rate of growth in the supply of money.

Weintraub expresses the belief, moreover, that "the plan should prove attractive to both monetarists and gold standard advocates." [11] In fact, it should appeal to neither group and for good reason.

To begin with, Weintraub's plan is essentially an attempt to realize through legislation the monetarist goal of a steady and predictable rate of growth of the money supply within the existing fiat-money framework. Its main drawback, from the monetarist perspective, is that it involves a needlessly complicated and cumbersome technique to achieve the desired goal. Why not simply legally mandate the Fed to pursue a straightforward "quantity rule," as the monetarists have always argued? Weintraub does not provide an answer to this question.

Advocates of a gold standard, on the other hand, also should find little to be pleased about in this proposal because a gold-certificate reserve requirement is not a genuine gold standard at all. Under the gold standard, the monetary unit is a weight unit of gold; under Weintraub's plan, gold is not money but a reserve commodity which is supposed to restrain the creation of government fiat money. Furthermore, since Weintraub's proposal leaves untouched the government monopoly of the money supply, it is unreasonable to expect that the gold-certificate reserve requirement, even if enacted, would long serve as a bulwark against inflation. The most likely prospect is that it would be gradually reduced and finally eliminated altogether, no doubt in the wake of a series of "emergencies." Indeed, Weintraub fully recognizes and is prepared for such a prospect, arguing that his plan "could be amended if the constraint proved to be harmful, and probably it could be changed or repealed in a day or two in such unlikely case." [12] Needless to say, this hardly recommends it as a durable barrier against inflation.

Moreover, past experience with the gold-certificate reserve also leads to the expectation that it would provide a weak and easily manipulated restraint on inflation. Thus, up until World War II, the Fed was legally required to hold a 35 percent gold-certificate reserve for its deposit liabilities and a 40 percent reserve for its note liabilities. To facilitate the wartime inflation, the reserve requirement was reduced to 25 percent for both the Fed's note and deposit liabilities. As a result of persistent, inflation-induced balance-of-payments deficits, the gold-certificate reserve requirement for the Fed's deposit liabilities was abolished in 1965, while the reserve requirement for its note liabilities was finally eliminated in 1968.

In conclusion, what Weintraub proposes is not a gold standard but an unwieldy and historically ineffective expedient designed to mitigate the inflationary tendencies of a government fiat money.

The Gold "Price Rule"

The gold "price rule" denotes the monetary reform proposal put forth in various forms by a number of supply-siders including Arthur Laffer, [13] Robert Mundell, [14] and Jude Wanniski. [15] Laffer's detailed formulation of the proposal has also served as the basis of the Gold Reserve Act of 1980, a bill introduced in Congress by Sen. Jesse Helms. [16]

According to Laffer's blueprint, at the end of a previously announced transition period of three months, the Federal Reserve would establish an official dollar price of gold "at that day's average transaction price in the London gold market." [17] From that date onward, the Fed would stand ready to freely convert dollars into gold and gold into dollars at the official price. In addition, "when valued at the official price, the Federal Reserve will attempt over time to establish an average dollar value of gold reserves equal to 40 percent of the dollar value of its liabilities." [18] This level of gold reserves Laffer designates the "Target Reserve Quantity."

Once Laffer's plan was fully operational, the Fed would have full discretion in conducting monetary policy through discounting, open market operations, etc., provided that: the dollar remains fully convertible into gold at the official price; and the quantity of actual gold reserves does not deviate from the Target Reserve Quantity by more than 25 percent in either direction, i.e., actual gold reserves do not fall below 30 percent or rise above 50 percent of the Fed's liabilities, which are also known as the "monetary base." However, should gold reserves decline to a level between 20 percent and 30 percent of its liabilities, the Fed would lose all discretion in determining the monetary base which, as a result, would be completely frozen at the existing level. If, in spite of this, gold reserves continued to decline to between 10 percent and 20 percent of the Fed's liabilities, the Fed would be legally constrained to reduce the monetary base at the rate of one percent per month.

Should these measures prove incapable of arresting the decline in the dollar value of gold reserves before it reaches less than 10 percent of Fed liabilities, then:

The dollar's convertibility will be temporarily suspended and the dollar price of gold will be set free for a three month adjustment period.

During this temporary period of inconvertibility, the monetary authorities will be required to suspend all actions that would affect the monetary base. Again, the price of gold would be reset as before and convertibility would be reinstated.[19]

Laffer's plan also includes "a symmetric set of policy dicta" which are to be implemented in the case in which actual gold reserves exceed the Target Reserve Quantity.

It must first be pointed out that Laffer's monetary reform proposal, whatever its merits or drawbacks, is not a blueprint for the gold standard. Rather, it is an outline of an elaborate scheme for legally constraining the monetary authority to adhere to a "price rule" in determining the supply of fiat money in the economy. In fact, as Laffer himself has made clear recently, gold has no necessary role in the implementation of such a price rule. According to Laffer and Miles:

... the Fed would institute its dollar "price rule" by stabilizing the value of the dollar in terms of an external standard. This standard would be a single commodity or a basket of commodities (a price index)...

Regardless of precisely which external standard is chosen, there are two basic rules of Fed behavior under the price rule. First, if the dollar price of the standard starts to rise (the dollar starts to fall in value), the Fed must reduce the quantity of dollars through open market sales of bonds, foreign exchange, gold, or other commodities. Second, if the dollar price starts to fall (the dollar rises in value), the Fed must increase the quantity of dollars through open market purchases of bonds, foreign exchange, gold or other commodities. The Fed is charged with keeping the value or price of the dollar stable in terms of the external standard.[20]

Even if gold is chosen as the "external standard" in the price-rule regime, it is not itself money, as in the case of a genuine gold standard, but merely "the intervention asset" or "the item for which dollars are exchanged." [21]

Thus stripped of its gold-standard terminology, Laffer's price rule appears as a technique designed to control inflation under the current fiat-money standard. It is thus very similar in nature, if not in technical detail, to the quantity rule advocated by the monetarists. This is clearly evident in Laffer and Miles' admission that "in an unchanging world where all information is freely available, there of course would be a 'quantity rule' which would correspond to a given 'price rule.'" [22] In fact, Miles and Laffer prefer a price rule to a quantity rule because they believe that, under the current monetary system, the former is technically superior to the latter. In "restraining the supply of dollars." [23]

Thus, under close examination, Laffer's plan turns out to be, in essence, a kind of price-rule monetarism, the references to gold notwithstanding. As such, it is vulnerable to criticism on precisely the same grounds as the more conventional quantity-rule monetarism. The most serious criticism of both varieties of monetarism is that they fail to come to grips with the root cause of inflation, namely, the government monopoly of the supply of money. This is true of Laffer's plan despite the elaborate set of legal sanctions which would be invoked against the monetary authorities for their violations of the price rule. For, in the end, such sanctions, even if rigorously applied, do not prevent inflation but merely respond to a fait accompli. This point is implicitly recognized by Laffer who includes in his plan a provision for "temporary periods" of dollar inconvertibility. These would readjust the official gold price following sustained bouts of monetary inflation which cause gold reserves to fall below the legally permissible lower limit.

Furthermore, as in the case of the gold-certificate reserve, we may appeal to history for evidence regarding the success of the gold price rule in stanching the flow of government fiat currency. We need look no further than the late, unlamented Bretton Woods System (1946-1971). Under this "fixed-exchange-rate" system, the U.S. monetary authority followed a gold price rule, buying and selling gold at an officially fixed price of \$35 per ounce. Foreign monetary authorities, on the other hand, pursued a dollar price rule, maintaining their respective national currencies convertible into dollars at a fixed price. According to Laffer and Miles, "as long as the rules of the system were being

followed, the supplies of all currencies were constricted to a strict price relationship among one another and to gold." [24]

Unfortunately, "the rules of the system" were subjected to numerous and repeated government violations and evasions, including frequent outright "readjustment" of the price rules, i.e., exchange-rate devaluations, when they became inconvenient restraints on the inflationary policies pursued by particular governments. [25] Needless to say, the Bretton Woods System did not prevent the development of a worldwide inflation which brought the system to its knees in 1968 and led to its final collapse in 1971.

After duly noting the political manipulations involved in the destruction of the Bretton Woods System, [26] Laffer and Miles clearly delineate the reasons why governments prefer and benefit from the removal of any and all checks on their power to inflate the money supply:

Why should governments be biased toward increasing the money supply at a faster rate? There are essentially two incentives -- a political incentive and a financial one. The political incentive is political survival. Many politicians, especially those up for reelection, are familiar with the theory that increases in the money supply promote expenditure, increase GNP, and reduce unemployment. These changes in turn are assumed to make the citizens of the country look more kindly upon the incumbent government. While there may be some validity in this theory, unfortunately it is often implemented under the notion that if a little money creation is good, a lot must be even better.

The financial motive for printing money is the fact that while money is practically costless to produce, it can be used for purchasing goods and services. The resulting seignorage represents revenue to the government. Revenue gathered in this way means less revenue must be gathered in another way, say, through direct taxation.

Given these incentives to print money, it can be seen why removal of the monetary constraints on governments tends to create inflation rather than deflation. [27]

Given his recognition of the powerful inflationary bias built into the political process and of the historical failure of monetary price rules to hold such a bias in check, Laffer's advocacy of a renewed gold price rule is something of a mystery.

The Classical Gold Standard

Over the past few years, the case for reinstating the "classical" gold standard has been propounded with great vigor and insight by Lewis Lehrman, a businessman and scholar whose views were influential in formulating the economic policy agenda of the Reagan administration and who is now a candidate for governor of New York. [28] Lehrman's writings are heavily influenced by the ideas of his former teacher, the late French economist and longtime gold-standard advocate, Jacques Rueff. [29]

Like his mentor, Lehrman advocates a genuine gold standard which "would establish the dollar as a weight unit of gold." [30] As Lehrman explains:

Under the gold standard there is no price for gold. The dollar is the monetary standard, set by law equal to a weight of gold. The price of gold does not exist.... Under the gold standard, the paper dollar is a promissory note. It is a claim to a real article of wealth defined by law as the standard. [31]

In Lehrman's proposal, Federal Reserve notes as well as dollar-denominated demand deposits at commercial banks and other depository institutions would once more become (as they were prior to 1933) warehouse receipts for gold, instantly redeemable for gold dollars at face value upon the demand of the bearer or depositor. Legal reserve requirements for bank deposits would be superfluous since "the failure to redeem... excess dollars for gold would, under convertibility rules, threaten the bankruptcy and dissolution of a commercial bank." [32] The monetary authority, for its part, would be "constrained... by law to redeem excess dollars with specified weight units of gold..." [33] Or, in other words, it must stand ready "...to buy and sell at the official rate all the gold offered or all the gold demanded." [34] The Fed would furthermore be restrained from carrying out any open-market operations, although it would be permitted to lend reserves to commercial banks at an "unsubsidized" discount rate, i.e., a rate at or slightly above the market rate.

Without going into further detail, it is clear that Lehrman proposes a monetary system which very closely approximates the classical gold standard with all its strengths and weaknesses. The most serious weakness of the classical gold standard, and of Lehrman's proposal, is the predominant role played by, what Lehrman himself calls, "a monopoly central bank." [35] Yet, Lehrman is willing to countenance the existence of such an institution and, indeed, to cede significant powers to it so long as it adopts "reasonable self-denying ordinances." [36] Thus, for example, the Fed would be expected to abstain from manipulating the gold content of the dollar or from directly purchasing assets on the open market. On the other hand, under Lehrman's plan, it would still retain its monopoly of the note issue and its position as the central warehouse and clearinghouse for commercial bank reserves. Moreover, its discretion with regard to discount-rate policy would still permit it to function as a "lender of last resort."

With so much power over the monetary system thus concentrated in the hands of a government institution, it is no wonder that Lehrman refers to the gold standard repeatedly as a "political institution" [37] and not once as a "free-market institution." In fact, at one point Lehrman comes perilously close to conceiving the gold standard as price-rule monetarism, that is, as merely an efficient political technique for controlling the government monopoly of the money supply. Thus, he writes:

To be sure, Monetarists would claim to fix the total quantity of money, through a specified money stock rule, in order to regulate the government monopoly (the Federal Reserve Board) which supplies cash balances to the market. Yet the simpler, market-related technique would be to make the value of a unit of money equal to a weight unit of gold, in order to regulate the same monopoly. [38]

In any case, since government is an inherently inflationary institution, it can be expected to be an implacable enemy of the gold standard. Under these circumstances, to grant to a government institution, such as a central bank, a powerful influence over the operation of the gold standard is not unlike proffering the fox an invitation to guard the chicken coop. This is surely the lesson taught by the broad sweep of monetary history, especially in more recent times as we witness Western governments employing every means at their disposal to progressively transmogrify the classical gold standard into our current, highly inflationary system of fluctuating national fiat currencies. Von Mises does not exaggerate when he states:

...the gold standard did not collapse. Governments abolished it in order to pave the way for inflation. The whole grim apparatus of oppression and coercion -- policemen, customs guards, penal courts, prisons, in some countries even executioners -- had to be put into action in order to destroy the gold standard. Solemn pledges were broken, retroactive laws were promulgated, provisions of constitutions and bills of rights were openly defied. [39]

Von Mises proceeds to demolish the deeply entrenched myth, that Lehrman appears to accept, which likens the gold standard to a political "game" wherein the government players must adhere to some vaguely specified "rules of the game." Writes von Mises:

But the gold standard is not a game; it is a market phenomenon, and as such a social institution. Its preservation does not depend on the observation of some specific rules. It requires nothing else than that the government abstain from deliberately sabotaging it. To refer to this condition as a rule of an alleged game is no more reasonable than to declare that the preservation of Paul's life depends on compliance with the rules of Paul's-life game because Paul must die if somebody stabs him to death. [40]

In summary, there is no compelling reason to believe -- and one searches Lehrman's writings in vain to find any argument to the contrary -- that the classical gold standard will prove to be a more durable barrier to political manipulation of the money supply the second time around than it was the first time.

Aside from its overriding political flaw, Lehrman's proposal is characterized by serious economic shortcomings. These are ultimately related to the fact that the type of gold standard that Lehrman proposes is what Hayek has termed a "national reserve system." [41] The essential feature of such a system is fractional-reserve banking, combined with the concentration of the ultimate cash reserves of all the nation's banks in the nation's financial center or, more likely, in the government central bank.

An historical example of the operation of the national reserve system is provided by the classical gold standard. Under this system, the central bank generally holds the ultimate cash reserve -- in this case, gold -- for the entire national banking system. The gold reserve serves as immediate backing for the central bank's note and deposit liabilities which, in turn, constitute the reserve base for the notes and deposits of commercial banks. The latter are held, along with central bank notes and gold itself, in the money balances of the public. Since both the central bank and the commercial banks hold fractional reserves against their liabilities, the money and credit structure of the economy resembles an inverted pyramid, with a relatively narrow base of gold reserves supporting a much larger superstructure of bank notes and deposits ultimately convertible into gold.

As a result, the classical gold standard was and is extremely vulnerable to monetary deflations and inflations, due to balance-of-payments disequilibria, changes in the public's preferences for holding gold vis-a-vis bank notes and deposits, financial crises, etc. The reason for this is that any loss or gain of gold reserves by the banking system causes a multiple expansion or contraction of bank notes and deposits, which constitute a large proportion of the money supply. These frequent bouts of monetary inflation and deflation, moreover, are likely to be aggravated by the fact that the very mechanism by which the banking system adjusts to changes in the gold reserve base involves an artificial alteration in the entire structure of interest rates in the economy. This leads to a distortion in productive activity.

A brief example will suffice to illustrate this point. Suppose that the central bank is faced with an influx of gold reverses due to a balance-of-payments surplus. In order to arrest and reverse this inflow, it will lower the discount rate and thus expand its loans to commercial banks. Commercial bank reserves will, as a result, increase, and, while maintaining their accustomed or legally required ratio between reserves and liabilities, the banks will be able to profitably increase their loans by lowering the interest rate they charge. Since the bulk of these loans are taken up for investment purposes, investment spending in the economy will rise relative to consumption spending. This will naturally induce a shift of productive resources and monetary investment out of consumer goods industries and into capital goods industries.

Unfortunately, this outcome, the fall of interest rates and the decline of consumption relative to investment, does not reflect a genuine and voluntary shift in the time preferences of the public, i.e., deliberate choices to save more of their income and spend less on consumption. Consequently, the expansion of capital goods industries at the expense of consumer goods industries will eventually prove to be unsustainable, resulting in widespread unemployment and business failures when economic activity is finally readjusted to more faithfully reflect the time preferences of consumer-savers in the economy. As a matter of fact, the day of reckoning will come when the monetary inflation engineered by the central bank has raised prices and incomes in the country sufficiently so that the balance-of-payments surplus is transformed into a deficit and gold begins to flow out of the country. In order to staunch the outflow of gold reserves, the central bank is constrained to raise its discount rate which, in turn, drains reserves out of the banking system and causes a rise in bank loan rates and a corresponding contraction in bank loans and, ultimately, in the money supply. As the structure of interest rates in the economy begins to readjust to reflect the voluntary social allocation of income between consumption and saving, the numerous malinvestments and resource misallocation engendered by the previous inflationary boom are revealed and corrected amidst conditions of economic depression.

In light of the foregoing analysis, it is my belief that Lehrman's plan for restoring the classical gold standard, while it will undeniably provide greater long-run stability in the value of money than the present fiat-money regime, will not rid us of the recurring fluctuations in macroeconomic activity which have plagued the market economy for the past two centuries. I hasten to stress that this is not a defect of the gold standard itself but of its organization along the lines of the national reserve system described above. In fact, most of the oft-noted defects in the classical gold standard lie in precisely those areas where its operation diverges from that of a fully free-market, 100 percent gold standard. This point has been cogently argued by Leland Yeager:

National fractional reserve systems are the real source of most of the difficulties blamed on the gold standard....The difficulties arise because the mixed national currencies -- currencies which are largely paper only partly gold -- are insufficiently international. The main defect of the historical gold standard is a necessity of "protecting" national gold reserves.... In short, whether a Central Bank amplifies the effects of gold flows, remains passive in the face of gold flows, or "offsets" gold flows, its behavior is incompatible with the principles of the full-fledged gold standard....Indeed, any kind of monetary management runs counter to the principles of the pure gold standard.[42]

On the other hand, notes Yeager:

Under a 100 percent hard-money international gold standard, the currency of each country would consist exclusively of gold (or of gold plus fully-backed warehouse receipts for gold in the form of paper money and token coins). The government and its agencies would not have to worry about any drain on their reserves. The gold warehouses would never be embarrassed by requests to redeem paper money in gold, since each dollar of paper money in circulation would represent a dollar of gold actually in a warehouse. There would be no such thing as independent national monetary policies; the volume of money in each country would be determined by market forces. The world's gold supply would be distributed among the various countries according to the demands for cash balances of the individuals in the various countries. There would be no danger of gold deserting some countries and piling up excessively in others, for each individual would take care not to let his cash balance shrink or expand to a size which he considered inappropriate in view of his income and wealth.

Under a 100 percent gold standard...the various countries would have a common monetary system, just as the various states of the United States now have a common monetary system. There would be no more reason to worry about disequilibrium in the balance of payments in New York City. If each individual (and institution) took care to avoid persistent disequilibrium in his personal balance of payments, that would be enough....The actions of individuals in maintaining their cash balances at appropriate levels would "automatically" take care of the adequacy of each country's money supply.[43]

The Parallel Private Gold Standard

The most innovative scheme for establishing a gold money involves a wholly private, "parallel" gold standard which would exist side by side with the already established government fiat-money standard. Variations on this plan have been proposed by Henry Hazlitt[44] and Professor R. H. Timberlake.[45] Although I shall focus primarily on Timberlake's proposal because it is worked out in greater detail, reference will be made to Hazlitt's proposal to highlight several substantive differences between the two.

Timberlake's plan holds forth great initial promise because, unlike the preceding three plans that have been examined, it is predicated on the recognition that inflation "will be stopped only by fundamental changes in the Fed." [46] Thus, Timberlake's plan "would begin with the abolition of the Federal Reserve System as a policy-making central bank." [47]

Timberlake foresees no technically insurmountable barriers to such a course of action. He argues that the regulatory functions of the Fed can easily be dispensed with since "banks have no more reason to be regulated than grocery stores" and "should be left alone to justify their existence in a free-market system." [48] Regarding the check-clearing services provided by the Fed to its member banks, Timberlake points to privatization as the simple and sensible solution. Writes Timberlake:

The technical check-clearing operations of the Federal Reserve Bank could still be handled by the existing physical facilities. Federal Reserve Banks could be reorganized as regional bank clearing houses. Since the Fed banks are already legally owned by commercial banks that exercise no control or ownership, the solution is simple: Turn the Federal Reserve Banks over to the legitimate owners and let the member banks operate them. This change would probably result in many interesting innovations and economies in bank management and checking facilities.[49]

This leaves the Fed's functions relating to the execution of monetary policy. According to Timberlake, they are at best superfluous and at worst highly inflationary. In the case of reserve requirements, Timberlake contends that "banks can manage their own reserve necessities," noting that "no other system in the world employs reserve requirement laws to regulate commercial banks." [50] The discounting function, Timberlake holds to be "both unnecessary and undesirable." Not only does it play a minor role in the Fed's execution of monetary policy, but commercial banks are able to fulfill their needs for reserves by borrowing from one another on the well organized and private Federal Funds market. "Ending Federal Reserve discounting," writes Timberlake, "therefore, would simply be ending something that is largely an advertising gimmick for promoting the image of the Fed as a banker's welfare agency." [51]

But what of open market operations, "the process that keeps the money stock growing at inflationary rates"? It is in answering this question that Timberlake introduces his proposal for a parallel gold standard. First, the U.S. Treasury would sell its entire gold stock (260 million ounces) or distribute a pro rata share to every U.S. citizen either in coin or in redeemable certificates. Second, the "policymaking structure of the Federal Reserve System" would be abolished. Finally, the outstanding note liabilities of the Fed, the currency in circulation, would be frozen and the member-bank reserve accounts converted into Federal Reserve notes. The commercial banks would have the option of holding the latter in their own vaults or leaving them on deposit in the "new" regional clearinghouses.

Timberlake expects that the gold, once in private hands, would soon find its way into private depository institutions, thus giving rise to gold-based demand deposits and notes redeemable upon demand in gold or Federal Reserve notes, at the option of the depositor. According to Timberlake:

This new system would not be a gold standard because the government would not declare gold or anything else legal tender....

Gold-based deposits and currency would circulate side by side with the frozen stock of existing federal reserve notes. Prices of gold in terms of other moneys would be quickly determined by market factors.[52]

Timberlake's proposal includes two elements that are absolutely essential to the establishment of a stable commodity money: the complete liquidation of the government central bank; and the return of the gold stock to private hands. In this respect, it is far superior to the first three proposals which I have analyzed because all of them leave the existing structure of the Federal Reserve system, for the most part, untouched. Moreover, under the plans of Laffer and Lehrman, even though the public can convert dollars into gold, the Fed still retains strategic control over the nation's gold stock by virtue of its position as a monopoly "banker's bank."

Unfortunately, Timberlake's proposal involves two drawbacks. First, by stipulating only that depository institutions are legally required to redeem their notes and demand deposits for gold upon demand, Timberlake is opening the door to a system of "free banking" based on fractional reserves. Although this system would, in fact, produce a much sounder and "harder" money than even the classical gold standard, there would still be potential, albeit severely limited, for inflation. More important than the direct economic effects of such inflation, however, there looms the distinct possibility that the political authority may use the occasional, but highly visible, financial crises and bank failures which follow the inflationary boom as a pretext for regulation of the banks "in the public interest." Having thus regained its first crucial foothold, the government would be well on its way to reimposing its monopoly over money.

There is a much more serious shortcoming in this plan, however. It is obscured by Timberlake's overly optimistic assumption that once the gold stock has been retrieved from government control, gold will be automatically and as a matter of course remonetized by the market, thus serving as the basis for a parallel private currency. But the sad fact is that the public, who ultimately determines what is and what is not money, has grown accustomed to governmental fiat money and, as a result, is unlikely to undertake spontaneously the pattern of actions necessary to create de novo a parallel commodity money. This is so despite the fact that the existing fiat money, e.g., the dollar, was at one time merely a name for a specific weight of gold, and despite the more general fact that money always initially emerges as a useful commodity produced on the free market. For once the government succeeds in severing the name of the monetary unit, which the public has grown accustomed to over the years, from the free-market money-commodity, a government-monopolized fiat money becomes entrenched among the public and the money-commodity is effectively demonetized. This is certainly borne out, for example, by the history of the dollar. Originally the name for approximately one-twentieth of an ounce of gold money (from 1834 to 1933), the dollar is today a purely nominal entity and, consequently, whatever is legally designated as a "dollar" is accepted by the public as money. Gold is now one among many nonmonetary commodities for which the fiat dollars are exchanged.

It follows from what has been said that, once a fiat money has gained currency in the economy, the only sure method for restoring a free-market commodity money necessarily involves once again legally defining the monetary name already in use as some definite unit of weight of the former money-commodity. Of course, considerations of the prevailing economic reality -- namely, the enormous inflation of the supply of fiat dollars that has occurred since the severing of the gold-dollar link -- would determine the exact ratio at which the redemption of dollars for gold could be

initiated and maintained without precipitating severe economic dislocations. But this is a complex issue which cannot be addressed here

In light of the foregoing discussion, the most that could reasonably be expected from Timberlake's proposal is not the spontaneous emergence of a parallel gold standard at all, but the existing unitary fiat-dollar standard in which the monetary base, as embodied in the frozen stock of Federal Reserve notes, remains constant. Two important points can be made regarding the inflationary potential of the reformed fiat-money regime which is actually likely to emerge under Timberlake's proposal.

First, even if we assume that the monetary base (equal to the total quantity of Federal Reserve notes held in the money balances of the public and in private bank reserves) remains rigidly fixed, there is still room for monetary inflation and deflation so long as fractional reserve banking exists (as it apparently would under Timberlake's proposal). Thus, for example, increased public preference for holding money balances in the form of demand deposits or private bank notes, as opposed to Federal Reserve notes, would result in an influx of Fed notes into private bank reserves, leading to the familiar process of a multiple expansion of bank credit for the system as a whole. The final result of this process would be an inflationary expansion of private bank notes and demand deposits. On the other hand, a contraction of the money supply would occur due to the public shifting some of its money holdings from, e.g., checking accounts to Fed notes in hand.

Second, and more important in the long run, although Timberlake's program laudably envisions the dismantling of the Federal Reserve system and the complete privatization of banking, the dollar, which constitutes the "high-powered" money or the ultimate reserves of the banking system, still remains an essentially nominal entity subject to inflationary creation by government fiat. Given its inflationary proclivity, it is highly improbable that the government will forever resist the opportunity to increase its revenues by expanding the supply of dollars.

In sum, Timberlake's proposal does not live up to its initial promise, either as a viable blueprint for achieving a free-market gold money or as a long-run cure for inflation. The reason underlying both shortcomings is that the proposal does not even address the most crucial issue of meaningful monetary reform: the denationalization of the existing fiat money.

Henry Hazlitt's proposal for a private parallel gold standard is much more modest in conception than Timberlake's, although he too wishes "to get government, as far as possible, out of the monetary sphere. [53] The first and most crucial step in Hazlitt's plan "is to get our government and the courts not only to permit, but to enforce, voluntary private contracts providing for payment in gold or in terms of gold value." [54]

The full plan would be implemented as follows:

Governments should be deprived of their monopoly of the currency-issuing power. The private citizens of every country should be allowed, by mutual agreement, to do business with each other in the currency of any country. In addition, they should be allowed to mint privately gold or silver coins and to do business with each other in such coins... Still further, private institutions should be allowed to issue notes payable in such metals. But these should be only gold or silver certificates, redeemable on demand in the respective quantities of the metals specified. The issuers should be required to hold at all times the full amount in metal of the notes they have issued, as a warehouse owner is required to hold at all times everything against which he has issued an outstanding warehouse receipt, on penalty of being prosecuted for fraud. And the courts should enforce all contracts made in good faith in such private currencies. [55]

Hazlitt's proposal is at once less ambitious in its aims but more realistic in its likely results than the proposal put forth by Timberlake. Thus, Hazlitt does not propose the immediate abolition of the Federal Reserve system or the return of the government gold hoard to private hands. Instead, recognizing that a private gold standard would not emerge immediately and automatically alongside the well entrenched fiat-dollar standard, Hazlitt believes that, given the legal framework he has set out, a private, 100 percent gold standard would slowly but surely evolve in step with the inevitable inflationary destruction of the fiat dollar. According to Hazlitt:

As the rate of inflation increased, or became more uncertain, Americans would tend increasingly to make long-term

contracts payable in gold. This is because sellers and lenders would become increasingly reluctant to make long-term contracts payable in paper dollars or in irredeemable money-units of any other kind.

This preference for making long-term contracts in gold would apply particularly to international contracts. The buyer or debtor would then either have to keep a certain amount of gold in reserve, or make a forward contract to buy gold, or depend on buying gold in the open spot market with his paper money on the date that his contract fell due. In time, if inflation continued, even current transactions would increasingly be made in gold.

Thus, there would grow up, side by side with fiat paper money, a private domestic and international gold standard. Each country that permitted this would then be on a dual monetary system, with a daily changing market relation between the two monies. And there would be a private gold system ready to take over completely on the very day that the government's paper money became absolutely worthless -- as it did in Germany in November, 1923, and in scores of other countries at various times.[56]

As described by Hazlitt, the process of transition to a private gold standard amidst the hyperinflationary breakdown of the fiat currency is certainly realistic enough. Moreover, it must be admitted that the economy would suffer much less devastation from the consequences of hyperinflation if, upon the demise of the primary fiat-money standard, people did not have to resort to barter but were able to take advantage of an already developing commodity-money standard. Still, Hazlitt's plan leaves one naturally wondering why meaningful monetary reform must await the catastrophe of a hyperinflation, while the economy continues in the throes of an ever worsening stagflation.

In fact, Hazlitt himself expects that the implementation of his proposal will serve to avert a hyperinflationary Armageddon by constraining the government to surrender its fiatmoney monopoly and restore a genuine gold standard. Unfortunately, Hazlitt is not very clear on exactly how this would come to pass. He writes:

I should perhaps make one point clear. I do not expect that allowing citizens to do business in the currencies of foreign nations or in private gold coins will in the long run in most countries mean that these citizens will do most of their business in these foreign or private currencies. I am assuming that practically all governments will continue to issue an official currency and that, when they have ceased inflating, they will issue their own gold coins and certificates. And I assume that most of their citizens will then use their own governments' money and coins. But this is because I expect that once freedom of choice in currencies is permitted, each government will begin to reform its own monetary practices. What will count is not only the actual competition of foreign money or private coins, but the ever-present possibility of the competition of foreign or private money.[57]

In this passage, Hazlitt alludes to the potential competition from a private gold standard as the key factor which will induce government to abandon its inflationary ways and embrace the gold standard. However, this contradicts his earlier analysis of the transition from a hyperinflated fiat money to a free-market gold money. As Hazlitt points out, it is only after hyperinflation is well under way that the public will even contemplate incurring the substantial costs of completely abandoning the existing medium of exchange in current transactions as well as credit transactions. In short, inflation will have to progress a long way before the parallel gold standard, as conceived in Hazlitt's plan, presents serious competition to the government fiat money. In the meanwhile, the economy will still be left to suffer the ravages of a hyperinflation.

Conclusion

The road to long-term monetary stability leads ultimately to the complete abolition of the government monopoly of issuing money and, concomitantly, to the return of the function of supplying money to the free market. The most crucial and difficult step along this road -- though certainly neither the first nor the last -- involves reconstituting the dollar, the existing fiat money, as a commodity money. This would be done by restoring it to its original status as a legally redeemable claim to a fixed weight of the former money-commodity, gold. Only if and when this step is taken is there hope of ever achieving the ultimate aim of a wholly "denationalized" money whose supply and value are at long last free from the arbitrary manipulations of a nonmarket monopolist.

FOOTNOTES

- [1] F. A. Hayek, *Denationalisation of Money -- The Argument Refined: An Analysis of the Theory and Practice of Concurrent Currencies*, 2nd enl. ed. (London: The Institute of Economic Affairs, 1978), p. 14.
- [2] F. A. Hayek, "Toward a Free Market Monetary System," *Journal of Libertarian Studies* 3, no. 1 (1979): 7.
- [3] Robert J. Barro, "Money and the Price Level under the Gold Standard," *Economic Journal* 89 (March 1979): 31.
- [4] William Fellner, "Gold and the Uneasy Case for Responsibly Managed Fiat Money," Washington, D.C. American Enterprise Institute, p. 99.
- [5] For works detailing the nature and operation of a pure commodity money, see: Murray N. Rothbard, *The Case for a 100 Per Cent Gold Dollar* (Washington, D.C.: Libertarian Review Press, 1974), reprinted from Rothbard, "The Case for a 100 Per Cent Gold Dollar," in Leland Yeager, ed., *In Search of a Monetary Constitution* (Cambridge, Mass.: Harvard University Press, 1962), pp. 94-136; Rothbard, *What Has Government Done to Our Money?* (Novato, Cal.: Libertarian Publishers, 1978); Milton Friedman, *Essays in Positive Economics* (Chicago: The University of Chicago Press, 1970), pp. 206-10; Friedman, *A Program for Monetary Stability* (New York: Fordham University Press, 1959), pp. 4-8; Friedman, "Should There Be an Independent Monetary Authority," in Yeager, ed., *In Search of a Monetary Constitution*, pp. 220-24; Jacques Rueff, "The Fallacies of Lord Keynes' General Theory," in Henry Hazlitt, ed., *The Critics of Keynesian Economics* (Princeton, N.J.: D. Van Nostrand Co., Inc., 1960), pp. 242-46; Mark Skousen, *The 100 Percent Gold Standard: Economics of a Pure Money Commodity* (Lanham, Md.: University Press of America, Inc., 1980).
- [6] Friedman, "Should There Be an Independent Monetary Authority," pp. 220-22.
- [7] U.S. Congress, Joint Economic Committee, *The Gold Standard: Its History and Record Against Inflation*, by Roy W. Jastram, with an Appendix on Restoring the Gold Certificate Reserve," by Robert E. Weintraub (Washington, D.C.: Government Printing Office, 1981), pp. 21-24. Weintraub's plan is also described in Lindley H. Clark, Jr., "What Kind of a Gold Standard Is Needed?" *Wall Street Journal* August 18, 1981, p. 33.
- [8] Weintraub, "Restoring the Gold Certificate Reserve," p. 21.
- [9] *Ibid.*, p. 22.
- [10] *Ibid.*
- [11] *Ibid.*, p. 24.
- [12] Quoted in Clark.
- [13] Arthur Laffer, *Reinstatement of the Dollar: The Blueprint* (Rolling Hill Estates, Cal.: A. B. Laffer Associates, 1980). Also see Arthur B. Laffer and Charles W. Kadlec, "The Point of Linking the Dollar to Gold," *Wall Street Journal*, October 13, 1982, p. 32.
- [14] Robert A. Mundell, "Gold Would Serve into the 21st Century," *Wall Street Journal*, September 30, 1981, p. 33.
- [15] Jude Wanniski, *The Way the World Works* (New York: Simon and Schuster, 1978), especially pp. 161-67. See Wanniski, "A Job Only Gold Can Do," *New York Times*, August 27, 1981, p. A31.
- [16] The text of Helms' bill is reproduced in Ernest P. Welker, *Plans to Revive the Gold Standard*, *Economic Education Bulletin*, vol. 20, no. 10 (Great Barrington, Mass.: American Institute for Economic Research, 1980), pp. 7-9.
- [17] Laffer, *Reinstatement of the Dollar*, p. 4.
- [18] *Ibid.*
- [19] *Ibid.*, p. 5.

- [20] Arthur B. Laffer and Marc A. Miles, *International Economics in an Integrated World* (Glenview, Ill.: Scott Foresman and Co., 1982), pp. 399-400.
- [21] *Ibid.*, p. 400.
- [22] *Ibid.*, p. 401.
- [23] *Ibid.*
- [24] *Ibid.*, p. 260.
- [25] For accounts of the breakdown of the Bretton Woods System see Jacques Rueff, *The Monetary Sin of the West*, trans. Roger Glemet (New York: Macmillan Co., 1972); and Guillaume Guindeg, *The International Monetary Tangle: Myths and Realities*, trans. Michael L. Hoffman (White Plains, N.Y.: M.E. Sharpe, Inc., 1977).
- [26] Laffer and Miles, *International Economics*, pp. 259-62.
- [27] *Ibid.*, pp. 397-98.
- [28] Lehrman has stated his view on the gold standard in a number of publications, including: Lewis E. Lehrman, *The Case for the Gold Standard: Reflections on the Struggle for Financial Order* (New York: Morgan Stanley & Co., Inc., 1981); Lehrman, *Monetary Policy~ the Federal Reserve, and Gold* (New York: Morgan Stanley & Co., Inc., 1980); Lehrman, "The Case for the Gold Standard," *Wall Street Journal*, July 30, 1981, p. 33; Lehrman, "Should We (and Could We) Return to the Gold Standard?" *New York Times*, September 6, 1981, p. 4E.
- [29] For Rueff's views on the gold standard, see Jacques Rueff, *The Age of Inflation*, trans. A. H. Meeus and F. G. Clarke (Chicago: Henry Regnery Co., 1964); and Rueff, *Balance of Payments: Proposals for the Resolution of the Most Pressing World Economic Problem of Our Time*, trans. Jean Clement (New York: Macmillan Co., 1967).
- [30] Lehrman, *The Case for the Gold Standard*, p. 21.
- [31] Lehrman, "Should We (and Could We) Return to the Gold Standard?"
- [32] Lehrman, *Monetary Policy, the Federal Reserve System, and Gold*, p. 41.
- [33] *Ibid.*
- [34] Lehrman, *The Case for the Gold Standard*, p. 20.
- [35] *Ibid.*, p. 6.
- [36] *Ibid.*
- [37] *Ibid.*, pp. 8,10,17,18.
- [38] Lehrman, *Monetary Policy, the Federal Reserve System, and Gold*, p. 40.
- [39] Ludwig von Mises, *The Theory of Money and Credit*, trans. H. E. Batson, new enl. ed. (Irvington-on-Hudson, N.Y.: The Foundation for Economic Education, Inc., 1971), p. 420.
- [40] *Ibid.*
- [41] For a discussion of the nature and operation of the national reserve system, see F. A. Hayek, *Monetary Nationalism and International Stability* (New York- Augustus M. Kelley Pub., 1971), pp. 1-34 passim.

[42] Leland B. Yeager, "An Evaluation of Freely-Fluctuating Exchange Rates" (Ph.D. dissertation, Columbia University, 1952), pp. 11-17.

[43] Ibid., pp. 9-10.

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[45] R. H. Timberlake, Jr., "Solving the Monetary Crisis, Policy Report 3 (October 1981): 9. See also Timberlake, "Monetization Practices and the Political Structure of the Federal Reserve System," *Policy Analysis* (Washington, D.C.: Cato Institute, August 12, 1981).

[46] Ibid.

[47] Ibid.

[48] Ibid.

[49] Ibid., p. 10.

[50] Ibid.

[51] Ibid.

[52] Ibid.

[53] Hazlitt, *The Inflation Crisis*, p. 176.

[54] Ibid.

[55] Ibid., pp. 187-88.

[56] Ibid., p. 177.

[57] Ibid., pp. 189-90.