HEARING OF THE SUBCOMMITTEE ON DOMESTIC MONETARY POLICY & TECHNOLOGY

Statement and Testimony of Lewis E. Lehrman

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I. Monetary policy, the Federal Reserve, the Budget Deficit, and Inflation

Since the expansive Federal Reserve program of Quantitative Easing began in late 2008, oil prices have almost tripled, gasoline prices have almost doubled. Basic world food prices, such as sugar, corn, soybean, and wheat, have almost doubled. Commodity and equity inflation, financed in part by the Fed's flood of excess dollars going abroad, has profound effects on the emerging markets. But in many emerging countries, food and fuel make up 25-50% of disposable income. Families in these countries can go from subsistence to starvation during such a Fed-fueled commodity boom.

The Fed credit expansion, from late 2008 through March 2011 -- creating almost two trillion new dollars on the Fed balance sheet -- triggered the commodity and stock boom, because the new credit could not at first be fully absorbed by the U.S. economy in recession. Indeed, Chairman Bernanke recently wrote that Quantitative Easing aimed to inflate U.S. equities and bonds directly, thus commodities indirectly. But some of the excess dollars sought foreign markets, causing a fall in the dollar on foreign exchanges. With Quantitative Easing the Fed seems to aim at depreciating the dollar. In foreign countries, such as China, financial authorities frantically purchase the depreciating dollars, adding to their official reserves, issuing in exchange their undervalued currencies. The new money is promptly put to work creating speculative bull markets and booming economies.

The emerging market equity and economic boom of 2009 and 2010 was the counterpart of sluggish growth in the U.S. economy during the same period. But the years 2011 and 2012 will witness a Fed- fueled economic expansion in the United States. Growth for 2011, in the United States, will, I believe, be above the new consensus of 3.5% -- unless there is an oil spike, combined with even greater catastrophe in Japan. The Consumer Price Index (CPI) will be suppressed because unemployment keeps wage rates from rising rapidly; the underutilization of industrial capacity keeps finished prices from rising rapidly. Inflation has shown up first in commodity and stock rises.

For Congress the irony could be that euphoria -- always caused by renewed, gradual inflation -- may set in once again, disarming potential budget and monetary reforms.

But commodity and stock inflation inevitably engenders social effects, not only financial effects. Inflationary monetary and fiscal policies have been a primary cause of the increasing inequality of wealth in American society. Bankers and speculators have been, and still are, the first in line, along with the Treasury, to get the zero interest credit of the Fed. They were also the first to get bailed out. Then, with new money, the banks financed stocks, bonds, and commodities, anticipating, as in the past, a Fed-created boom. The near zero interest rates of the Fed continue to subsidize the large banks and their speculator clients. A nimble financial class, in possession of cheap credit is able, at the same time, to enrich themselves, and to protect their wealth against inflation.

But middle income professionals and workers, on salaries and wages, and those on fixed income and pensions, are impoverished by the very same inflation that subsidizes speculators and bankers. Those on fixed incomes earn little, or negative returns, on their savings. Thus, they save less. New investment then depends increasingly on bank debt, leverage, and speculation. Unequal access to Fed credit was everywhere apparent during the government bailout of favored brokers and bankers in 2008 and 2009, while millions of not so nimble citizens were forced to the wall, and then into bankruptcy. This ugly chapter is only the most recent chapter in the book of sixty years of financial disorder.

Inequality of wealth and privilege in American society is intensified by the Fed-induced inflationary process. The subsidized banking and financial community, combined with an overvalued dollar -- underwritten by China -- have also submerged the manufacturing sector, dependent as it is on goods traded in a competitive world market. In a word, the government deficit and the Federal Reserve work hand in hand, perhaps unintentionally, to undermine the essential equity and comity necessary in a constitutional republic. Equal opportunity and the harmony of the American community cannot survive perennial inflation.

If the defect is inflation and an unstable dollar, what is the remedy?

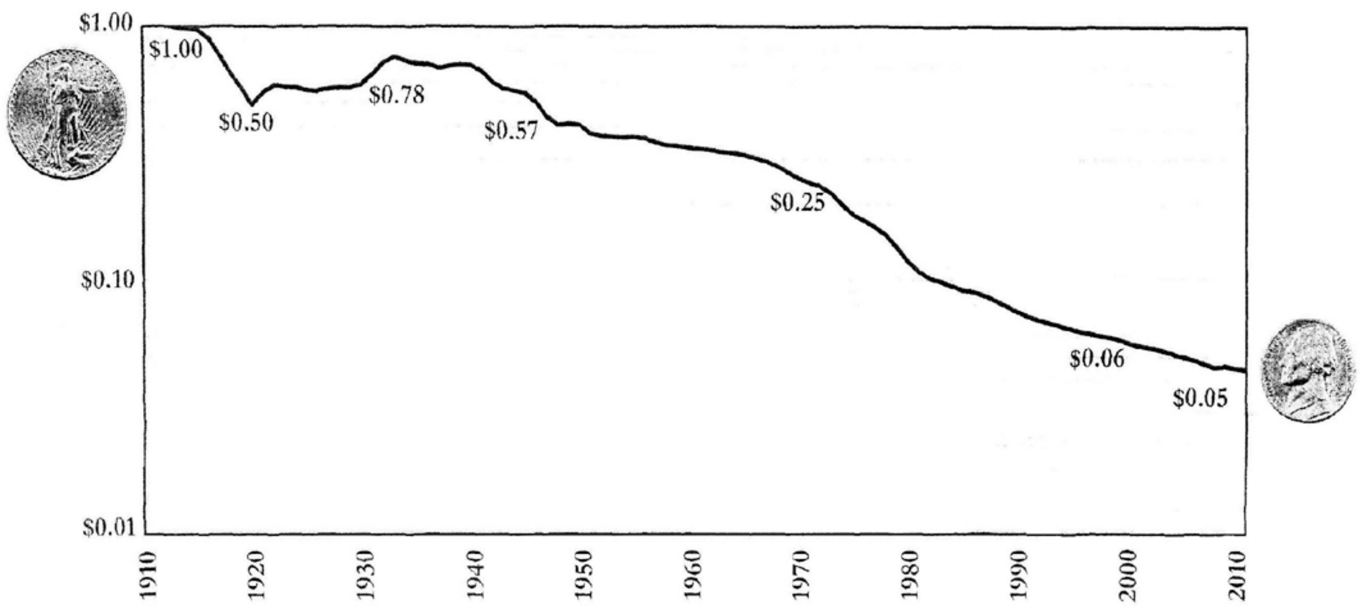
A dollar convertible to gold would provide the necessary Federal Reserve discipline to secure the long term value of middle income savings, to backstop the drive for a balanced budget. The gold standard would terminate the world dollar standard, by prohibiting official dollar reserves, and the special access of the government and the financial class to limitless cheap Fed and foreign credit.

The world trading community would benefit from such a common currency -- a non-national, neutral, monetary standard -- that cannot be manipulated and created at will by the government of any one country. Thus, dollar convertibility to gold must be restored. But dollar convertibility to gold must also become a cooperative project of the major powers. Gold, the historic common currency of civilization, was during the Industrial Revolution and until recent times, the indispensable guarantor of stable purchasing power, necessary for both long-term savings and long-term investment, not to mention its utility for preserving the long-term purchasing power of working people and pensioners. The gold standard puts control of the supply of money into the hands of the American people, as it should in a constitutional republic. Because excess creation of credit and paper money can be redeemed by the people for gold at the fixed statutory price, the monetary authorities are thus required to limit the creation of new credit in order to preserve the legally guaranteed value of the currency. As President Reagan said: “Trust the people.”

To accomplish this monetary reform, the U.S. can lead, <u>first</u>, by announcing future convertibility, on a date certain, of the U.S. dollar, the dollar itself to be defined in statute as a weight unit of gold, as the Constitution suggests; <u>second</u>, by convening a new Bretton Woods conference to establish mutual gold convertibility of the currencies of the major powers -- at a level which would not pressure nominal wages; <u>third</u> to prohibit by treaty the use of any currency but gold as official reserves.

A dollar as good as gold is the way out. It is the way to restore American savings and competitiveness. It is the way to restore economic growth and full employment without inflation. Gold convertibility is the way to restore America’s financial self-respect, and to regain its needful role as the equitable leader of the world.

A Century of Decline in the Dollar's Value



March 15, 1910
One ounce gold = $20.00

March 15, 2011
One ounce gold = $1,396.60

II: The Monetary Problem and its Solution in Historical Perspective

As a soldier of France, no one knew better than Professor Jacques Rueff, the famous French central banker and economist, that World War I had brought to an end the preeminence of the classical European states system; that it had decimated the flower of European youth; that it had destroyed the European continent's industrial primacy. No less ominously, on the eve of the Great War, the gold standard -- the gyroscope of the Industrial Revolution, the proven guarantor of one hundred years of price stability, the common currency of the world trading system -- the monetary standard of commercial civilization -- was suspended by the belligerents.

The Age of Inflation was upon us.

The overthrow of the historic gold standard, led, during the next decade, to the great inflations in France, Germany, and Russia. The ensuing inflationary convulsions of the social order, the rise of the speculator class, the obliteration of the savings of the laboring and middle classes led directly to the rise of Bolshevism, Fascism, and Nazism -- linked, as they were, to floating European currencies, perennial budgetary and balance of payments deficits, central bank money printing, currency wars and the neo-mercantilism they engendered.

Today, one observes -- at home and abroad -- the fluctuations of the floating dollar, the unpredictable effects of its variations, the new mercantilism it has engendered, and the abject failure to rehabilitate the dollar's declining reputation. Strange it is that an unhinged token, the paper dollar, is now the monetary standard of the most scientifically advanced global economy the world has ever known.

The insidious destruction of the historic gold dollar -- born with the American republic -- got underway gradually, in the 1920s, during the inter-war experiment with the gold-exchange standard and the dollar's new official reserve currency role. It must be remembered that World War I had caused the price level almost to double. But after the war, Britain and America tried to maintain the pre-war dollar-gold, sterling-gold parities. Designed at the Genoa Convention of 1922, the official reserve currency roles of the convertible pound and dollar collapsed after 1929 in the Great Depression -- a collapse which helped to cause and to intensify the worldwide deflation and depression. Then, Franklin Roosevelt in 1934 reduced the value of the dollar by raising the price of gold from $20 to $35 per ounce.

But it must be emphasized that it was in 1922, at the little known but pivotal Monetary Conference of Genoa, that the unstable gold-exchange standard had been officially embraced by the academic and political elites of Europe. It was here that the dollar and the pound were confirmed as official reserve currencies to supplement what was said to be a scarcity of gold. But there was no true scarcity, only overvalued currencies after World War I. Professor Rueff warned in the 1920s of the dangers of this flawed gold-exchange system designed "to economize gold." He predicted again in 1960-61 that the Bretton Woods system, a post-World War II gold-exchange standard, flawed as it was by the same official reserve currency contagion of the 1920s, would soon groan under the flood weight of excess American dollars going abroad. Rueff in the 1950s and 1960s forecast permanent U.S. balance of payments deficits and the tendency to constant budget deficits, and ultimately the suspension of dollar convertibility to gold. His prescience was borne out by the facts.

After World War II, Professor Rueff saw that because the United States was the undisputed hegemonic military and economic power of the free world, foreign governments and central banks, in exchange for these military services and other subsidies rendered, would for a while continue to purchase, (sometimes to protect their export industries,) excess dollars on the foreign exchanges against the creation of their own monies. But these foreign official dollars, originating in the U.S. balance of payments and budget deficits, were then redeposited by foreign governments in the New York dollar market which led to inflation and excess consumption in the United States. This same process engendered inflation in its European and Asian protectorates which purchased excess dollars against the issuance of their own currencies. In a word, official reserve currencies jam the indispensable, international settlements and adjustment mechanism. Moreover, these purchases of dollars by foreign central banks have the simultaneous effect of creating inflation in these foreign countries and undervaluing their currencies relative to the dollar. Incipient mercantilism was only one pernicious result of the dollar's overvalued, official reserve currency status. The decline of the great U.S. manufacturing center was another.

Incredibly, during this same period of the 1960s, the International Monetary Fund authorities had the audacity to advocate the creation of Special Drawing Rights (SDRs), so-called "paper gold," invented, as International Monetary Fund officials said, to avoid a "potential liquidity shortage." At that very moment, the world was awash in dollars, in the midst of perennial dollar and exchange rate crises. Professor Rueff remarked that the fabrication of these SDRs by the International Monetary Fund would be "irrigation plans implemented during the flood."

The post-World War II gold-exchange standard (Bretton Woods) came to an end on the Ides of March, in 1968, when President Johnson suspended the London Gold Pool. After a few more crippled years, Bretton Woods expired on August 15, 1971. The truth is that Monetarists and Keynesians sought not to reform Bretton Woods, as the true gold standard reform of Jacques Rueff intended, but rather to demolish it. The true gold standard had become passé among the intellectual, economic, and political elites because of their confusion over the difference between the gold standard and the gold-exchange standard -- the collapse of the latter, <u>not</u> the former -- having intensified the depression. I shall give you just one example of the obtuseness of the political class of the 1960s and 1970s, which happened at the height of one major dollar crisis. A friend of Professor Rueff, the American banker and policy intellectual, Henry Reuss, Chairman of the Banking and Currency Committee of the United States House of Representatives, went so far as to predict, with great confidence and even greater fanfare, that when gold was demonetized, it would fall from $35 to $6 per ounce. (I am not sure whether Congressman Reuss ever covered his short at $800 per ounce in 1980.)

President Nixon, a self-described conservative, succeeded President Johnson and was gradually converted to Keynesian economics by so-called conservative academic advisers, led by Professor Herbert Stein. Mr. Nixon had also absorbed some of the teachings of the Monetarist School from his friend Milton Friedman -- who embraced the expediency of floating exchange rates and central bank manipulation and the targeting of the money stock to create a stable inflation rate. Thus, it was no accident that the exchange rate crises continued because the underlying cause, inflation, continued. On August 15, 1971, after one more violent dollar crisis, Nixon defaulted at the gold window of the western world, declaring that "we are all Keynesians now." In 1972, Nixon, a Republican, a so-called free market President, imposed the first peacetime wage and price controls in American history -- encouraged by some of the famous "conservative" advisers of the era.

In President Nixon's decision of August 1971, the last vestige of dollar convertibility to gold, the final trace of an international common currency, binding together the civilized trading nations of the West, had been unilaterally abrogated by the military leader of the free world.

Ten years later at the peak of a double digit inflation crisis, the gold price touched $850. At the time, Paul Volcker, Chairman of the Federal Reserve declared that the gold market was going its own way and had little to do with the Fed's monetary policies. Volcker then engineered a draconian credit contraction leading to near 11% unemployment and a decline in inflation. At that time, Professor Wallich declared that the gold market is but "a side show." Secretary of the Treasury William Miller, and a short-lived Fed Chairman, who had been selling United States gold at about $200 in 1978, announced solemnly that the Treasury would now no longer sell American gold. Presumably Secretary Miller, an aerospace executive, meant that whereas, more than one-half the vast American gold stock had been a clever sale, liquidated at prices ranging between $35 and $250 per ounce -- now, in the manner of the trend follower, Secretary of the Treasury Miller earnestly suggested that gold was a "strong hold" at $800 per ounce.

On January 18, 1980, Fed Governor Henry Wallich, a former Yale Economics professor, explained Federal Reserve monetarist policies in an article appearing in the Journal of Commerce:

> "The core of Federal Reserve…measures," basing "control upon the supply of bank reserves," he said, "gives the Federal Reserve a firmer grip on the growth of monetary aggregates…"

As subsequent events showed, the Federal Reserve promptly lost control of the monetary aggregates. The bank prime rate rose to 21%, inflation to double digits.

Professor Rueff's experience as a central banker had taught him from hard experience what his five volumes of monetary theory and econometrics demonstrated. That is, no central bank, not even the mighty Federal Reserve, can determine the quantity of bank reserves or the quantity of money in circulation -- all conceits to the contrary notwithstanding. The central bank may influence indirectly the money stock; but the central bank cannot determine its amount. In a free society, only the money users -- consumers and producers in the market -- will determine the money they desire to hold. In a reasonably free society, it is consumers and producers in the market who desire and decide to hold cash balances, and also to change the currency and bank deposits they wish to keep; it is central banks and commercial banks which can supply them.

During the past forty years, the important links between central bank policies, the rate of inflation, and the variations in the money stock have caused much debate among the experts. It is still generally thought by neo-Keynesian, and some monetarist economists and central bankers, that the quantity of money in circulation, and economic growth, and the rate of inflation can be directly coordinated by central bank credit policy. May I now firmly say that, to the best of my knowledge, no one who believes this hypothesis, and, as an investor, has systemically acted on it in the market, is any longer solvent. But I do confess, that the neo-Keynesian and monetarist quantity theories of money still hang on -- even if its practitioners in the market cannot. In the end neo-Keynesian and monetarist economists at the Federal Reserve were ultimately required to accommodate to a reality in which, for example, during 1978, the quantity of money in Switzerland grew approximately 30% while the price level rose only 1%. The quantity of money, M-1, grew in 1979 about 5% in the

United States while the inflation rate rose 13%. The Fed learned that the CPI inflation rate cannot be precisely associated with the quantity of money in circulation.

If then, a central bank cannot determine the quantity of money in circulation, what, in Rueffian monetary policy, can a central bank realistically do? To conduct operations of the central bank, there must be a target. If the target is both price stability and the quantity of money in circulation, one must know, among other things, not only the magnitude of the desired supply of money, but also the precise volume of the future demand for money in the market -- such that the twain shall meet. It is true that commercial banks supply cash balances, but individuals and businesses -- the users of money -- generate the decisions to hold and spend these cash balances. Thus, the Federal Reserve must have providential omniscience to calculate correctly, on a daily or weekly basis, the total demand for money -- assuming the Fed could gather totally reliable statistical information -- which it cannot; and even if the Fed's definitions of the monetary aggregates were constant -- which they are not.

Jacques Rueff, himself the Deputy Governor of the Bank of France, clarified this fundamental problem in the form of an axiom: Because the money stock cannot be determined by the Federal Reserve Bank, nor can it determine a constant rate of inflation, the monetary policy of the central bank must not be to target the money supply or the rate of inflation. The Federal Reserve Bank simply cannot determine accurately the manifold decisions of the public to hold money, for individual and corporate purposes, in order to make necessary payments and to carry precautionary balances. Therefore, the leaders of the European central bank and the Federal Reserve System, all central banks cannot and should not try to determine the quantity of money in circulation.

But, if the true goal of the central bank were long run stability of the general price level, the operating target of monetary policy at the central bank must be simply to influence the supply of cash balances in the market, such that they tend to equal the level of desired cash balances in the market. To attain this goal, the central bank must abandon open market operations and simply hold the discount rate, or the rediscount rate, above the market rate -- when, for example, the price level is rising -- providing money and credit only at an interest rate which is not an incentive to create new credit and money. Indeed, if the target of monetary policy is long run price stability, the central bank must supply bank reserves and currency only in the amount which is approximately equal to the desire to hold them in the market. For if the supply of cash balances is approximately equal to the desire to hold them, the price level must tend toward stability. If there are no excess cash balances, there can be no excess demand, and, thus, there can be no sustained inflation. There also can be no sustained deflation, caused by scarcity of cash balances, because the target of monetary policy is a stable price level and, in these circumstances, the central bank supplies the desired cash balances.

An effective central bank policy, therefore, must reject open market operations. Professor Rueff shows further that, in order to rule out inflation, and unlimited government spending, the government treasury must be required by law to finance its cash needs in the market for savings, away from the banks. That is, a government treasury, in deficit, must be denied the privilege of access to new money and credit at the central bank and commercial banks, in order also to deny the government the pernicious privilege of making a demand in the market without making a supply -- the ultimate cause of inflation. That is, since the Federal Reserve creates new money and credit to finance the Treasury deficit, but the Treasury creates no new goods and services, total money demand will exceed supply at prevailing prices. Prices must rise. At first, commodity and equity prices advance. Then the general price level rises gradually. This exorbitant U.S. government financing privilege, a function of total Fed discretion and of the dollar's reserve currency status, is a necessary cause of the balance of payments deficit and persistent inflation. It is also a fundamental cause of unlimited budget deficits and bloated big government. So long as new bank credit is available to the government, so long will the budget deficit persist and grow.

One can see that the monetary theory and policy of Jacques Rueff finally does come to grips with, indeed it modifies, the famous Law of Markets of Jean Baptiste Say, building of course on Say's insights, but perfecting the flawed Quantity Theory of Money. Jacques Rueff reformulated the quantity theory of money, definitively, in the following proposition: aggregate demand is equal to the value of aggregate supply, augmented (+/-) by the difference between the variations, during the same market period, in the quantity of money in circulation and the aggregate cash balances desired. This is a central theorem of Rueffian monetary economics. Rueff demonstrated that Say's law does work, namely, that supply tends to equal demand, provided, however, that the market for cash balances must tend toward equilibrium. Any monetary system, any central bank, which does not reinforce this tendency toward equilibrium in the market for cash balances destroys the first law of stable markets, namely, overall balance between supply and demand -- a necessary condition for limiting inflation and deflation.

It is conventional wisdom that Milton Friedman and the Monetarists try to regulate the growth of the total quantity of money and inflation through a so-called money stock rule designed to constrain the central bank monopoly over the currency issue. In practice, the Federal Reserve has failed, and will fail, to succeed with such a flawed, academic, and impractical rule. Professor Friedman, himself, humbly admitted failure in a remarkable 2003 interview. The much simpler, more reliable, market-biased technique -- proven in the laboratory of history -- as Professor Rueff demonstrated, would be to make the value of a unit of money equal to a weight unit of gold, in order to regulate, according to market rules, the same central bank monopoly. But academics have argued for a century that a monetary "regulator," such as gold money, absorbs too much real resources -- by virtue of the process of gold production -- and is therefore, in economic terms, too costly.

Whatever the minor incremental mining cost of a gold-convertible currency, it is a superior currency stabilizer, as history shows. The empirical data also show that it is a more efficient regulator of price stability in the long run. The gold standard was no mere symbol. It was an elegantly designed monetary mechanism -- carefully orchestrated over centuries by wise men of great purpose -- who developed convertibility into a supple and subtle set of integrated financial and credit institutions organized to facilitate rapid growth, quality job creation, a stable price level, above all, social stability amidst free economic institutions. Thus did the free price mechanism and the international gold standard become the balance wheel of rapid economic growth during the long-lasting Industrial Revolution. Who can deny that two generations of floating exchange rates, pegged undervalued currencies like the Chinese Yuan, and discretionary central banking, have burdened the world with booms, panics, and busts, producing immense inflation and uncertainty costs, much greater than the comparatively modest cost of mining gold?

Therefore, in order to bring about international price stability and long run stability in the global market for cash balances, the dollar and other key currencies must be defined in law as equal to a weight unit of gold -- at a statutory convertibility rate which insures that nominal wage rates do not fall. Indeed, nothing but gold convertibility, without official reserve currencies, will yield a real fiduciary monetary standard for the integrated world economy.

At the end of the first decade of the new millennium, the world requires, a real monetary standard, a common non-national monetary standard, to deal with the monetary disorder of undervalued, pegged, currencies and manipulated floating exchange rates -- the diabolical agents of an invisible, predatory mercantilism. Despite all denials, the currency depreciations of today are, without a doubt, designed to transfer unemployment to one's neighbor and, by means of an undervalued currency, to gain share of market in manufactured, labor intensive, value-added, world traded goods. If these depreciations and undervaluations are sustained, floating exchange rates combined with the twin budget and trade deficits will, at regular intervals, blow up the world trading system. Great booms and busts, inflation and deflation, social instability must ensue.

To head off the mercantilism of present floating exchange rates, and the consequences of exchange rate disorders caused by official dollar reserves, an international monetary conference is indispensable. The present high rates of unemployment and perverse trade effects, associated with floating exchange rates, require an efficient and stable international monetary reform. Not least because floating exchange rates re-price entire national production systems at unpredictable intervals. Such monetary perversity cannot be sustained. A European Monetary Union may be necessary; but it is not sufficient.

Now we see clearly, what before we saw in a glass darkly -- the dollar's official reserve-currency status still gives an exorbitant credit privilege to the United States. Professor Rueff spoke of American "deficits without tears," because the American budget deficit and balance-of-payments deficits were -- they still are -- almost automatically financed by the Federal Reserve and the world-dollar reserve-currency system -- through the voluntary (or coerced) buildup of dollar balances in the official reserves of foreign governments. These official dollar reserves were, and still are, immediately invested by foreign authorities, directly or indirectly, in the dollar market for United States securities, thus giving back to the United States, at subsidized rates, the dollars previously sent abroad as a result of the persistent United States balance-of-payments deficit and budget deficits. This is the subtle mechanism by which excess American domestic consumption and budget deficits are financed. To describe this awesome absurdity, Professor Rueff invoked the metaphor of the King's overworked tailor, yoked permanently to fictitious credit payments by His Majesty's unrequited promissory notes. Despite his purchases, His Majesty's cash balances and euphoria kept rising, blinded as he was to his ultimate, debt-induced insolvency.

There is not sufficient time to dwell on all the intricacies of the superior efficacy of the balance-of-payments adjustment mechanism grounded in domestic and international convertibility to gold. But it can, I think, be shown that, in all cases, currency convertibility to gold, without official reserve currencies, is <u>the least imperfect monetary mechanism</u>, both in theory and in practice, by which to rule out currency wars, to maintain global trade and financial balance, a reasonably stable price level, and economic growth -- while ensuring budgetary equilibrium. This proposition has been proven in the only laboratory by which to test monetary theory -- namely, the general history of monetary policy under paper and metallic regimes, and, in particular, the history of the international gold standard. (See chart in appendix.)

Whereas, by contrast, when one country's currency -- the dollar reserve currency of today -- is used to settle international payments, the international settlement and adjustment mechanism is jammed -- for that country -- and for the world. This is no abstract notion. An example from the past: during the twelve months of 1995, one hundred billion dollars of foreign exchange reserves were accumulated by foreign governments which were directly invested in U.S. Treasury securities held in custody at the New York Federal Reserve Bank -- thus financing the more modest U.S. current account and U.S. budget deficits of the time. Between March 10, 2010 and March 9, 2011, foreign governments monetized $415 billion dollars in the form of U.S. securities held in custody at the Fed. This is only a fraction of the $3.5 trillion of official dollar reserves, held in custody at the Fed, accumulated by March, 2011, over two generations. This accumulation of foreign dollar reserves is a gigantic mortgage on America. It is the infernal mechanism by which the government budget deficit and balance of payments deficits are financed. Along with the Fed, foreign dollar reserves are sufficient today to finance domestic over-consumption in the United States at below market interest rates.

It is essential to understand the nature of this ongoing process of currency degradation -- because the dollar's reserve-currency role in financing the U.S budget and balance of payments deficits certainly did not end with the breakdown of Bretton Woods in 1971. The perennial and extraordinary U.S. budget and balance of payments deficits still persist because there is, today, no efficient international monetary mechanism to forestall the American deficits. Indeed, Professor Rueff argued that if the official reserve role of the dollar -- i.e., the world dollar standard -- were abolished, and convertibility restored, the immense U.S. budget and current account deficits must end -- a blessing not only for the United States, but for the whole world. This is so because the Fed and the Treasury would be bound by statute and treaty to maintain the gold convertibility of the dollar. It is true that both law and international treaty may be violated, but they do create the only barriers to the license of rogues.

The reality behind the "twin deficits" is simply this: the greater and more permanent the Federal Reserve and foreign reserve facilities for financing the United States budget and trade deficits, the greater will be the twin deficits and the growth of the U.S. Federal government. All congressional, administrative, and statutory attempts to end the United States deficits have proved futile, and will prove futile, until the crucial underlying flaw -- namely the absence of an efficient international settlements and adjustment mechanism -- is remedied by international monetary reform inaugurating a new international gold standard and the prohibition of official reserve currencies.

Broadly speaking, at least three essential steps toward convertibility could be taken by America and other great powers.

(1) The U.S. president should request the Federal Reserve System to cooperate with, say, a Group of Ten to stabilize the value of key currencies at levels consistent with balanced international trade among national currency areas. That is to say, exchange rates should be stabilized at approximately their purchasing power parities, based largely upon comparative unit labor costs of standardized world traded goods. To do this, indexes of purchasing power can be agreed upon within the Group of Ten and, thus, an optimum and fair value determined for mutual convertibility of national currencies. But how should the value of the gold monetary standard be determined? The optimum value of the gold parity should reflect a gold price correctly positioned within the hierarchy of all prices; that is, a price proportional to its underlying cost of production. This dollar price of gold, or more properly, the defined gold weight of the monetary standard, must be set above the average of the marginal costs of production of gold mines operating throughout the world. This price would provide for steady output of the gold monetary base (about an average of 1.5% to 2% increase per year over a long run, as centuries of available monetary statistics show). Such a

gold price would also prevent any decline in the average level of nominal wages -- avoiding, for example, the British problem of underemployment in the 1920's caused by an overvalued pound. Under existing conditions, during the present market period, I have estimated, based on empirical data, that the optimum convertibility price of gold is not less than $2,000 per ounce. (March, 2011)

(2) The President should recommend to the Group of Ten, that convertibility regimes take effect at a fixed date in the future, subsequent to the international monetary conferences and agreements made there, perhaps an interval of three to four years. Gold-convertible currencies should become the monetary standards of Europe, of the United States, of the world, just as the gold standard should become the common money of world trade and finance in Asia and elsewhere.

To simplify, if the United States government, or any other key country, then creates excess money and credit, under conditions of gold convertibility, it will be forced in a relatively short period to change, because market participants will exchange paper currencies for gold, or gold for paper, to bring the quantity of money in circulation into balance with the desire of the public to hold these cash balances.

In a constitutional republic such as the United States the sovereign people should control the supply of money through the limiting mechanism of gold convertibility of the dollar. As President Reagan said, “Trust the people.” Moreover, domestic monetary reform in the United States, and elsewhere, would also mean that only gold and domestic, non-government, secured, self-liquidating securities, convertible at maturity to gold, could serve as collateral, or backing for new currency issues such as, for example, Federal Reserve Notes. Standard gold coins, minted according to the statutory standard, should be generally circulated in the market to be held by all working people, so as to guarantee that neither the monetary standard, nor the wages and savings of working people, will be arbitrarily abridged by inflationary governments. Such a regime, among other purposes, eliminates the advantage of nimble speculators over middle income people and those on fixed incomes.

(3) The new international monetary system would rule out, by enforceable treaty obligations, official reserve currencies which so plagued the entire financial history of the twentieth century and the first decade of the twenty-first. Existing official dollar-reserves could be consolidated and refunded and then gradually amortized over the long term (even to a certain extent refunded through the rise of the official value of gold above the last official revaluation ($42.22 per ounce). This is not unlike the consolidation plan deployed by the first United States Secretary of the Treasury, Alexander Hamilton, to refund the national and state debts after the revolutionary war.

This was and is the Rueff plan, brought up to date to deal with the exigencies of the present facts and circumstances. May I say, it is an intellectual scandal that such a solution is today regarded as impractical. For if we and our former adversary, Russia, can share capsules in space, why can the United States and its trading partners not agree to restore monetary convertibility, the indispensable condition for stable currencies, world economic growth, and free trade?

By pinning down the future price level by gold convertibility, the immediate effect of international monetary reform will be to end currency speculation in floating currencies, and terminate the immense costs of inflation hedging. Gold convertibility eliminates the very costly exchange of currencies at the profit-seeking banks. Thus, new savings will be channeled out of financial arbitrage and speculation, into long-term financial markets.

Increased long-term investment and improvements in world productivity will surely follow, as investment capital moves out of unproductive hedges and speculation -- made necessary by floating exchange rates -- seeking new and productive investments, leading to more quality jobs. Naturally, the investment capital available at long term will mushroom, inspired by restored confidence in convertibility, because the long run stability of the price level will be pinned down by gold convertibility -- as history shows to be the case in previous, well-executed monetary reforms of the past two hundred years. Along with increased capital investment will come sustained demand for unemployed labor, at quality wages, to work the new plant and equipment.

The world now awaits a far-seeing leader to carry out the international monetary reform proposed by the great monetary statesman of the twentieth century, Professor Jacques Rueff.

Lewis E. Lehrman
March 15, 2011

America needs: *A dollar that is, once again, an honest dollar, a dollar as good as gold*.[1]

Both American and world history show that only proper monetary reform -- specifically, restoring the international gold standard without official reserve currencies -- will end chronic episodes of inflation (or deflation), U.S. international payments deficits, and endless Federal deficit spending.

A brief monetary history of the United States. The stability of the U.S. dollar has varied widely in its history. This variation is explained by two factors: the monetary standard chosen for the dollar, and whether other countries have simultaneously used securities payable in dollars as their own monetary standard.

The United States has alternated between two kinds of standard money: inconvertible paper money and some precious metal (first silver, then gold). The dollar was an inconvertible paper money during and after the Revolutionary War (1776–92), the War of 1812 (1812–17), the Civil War (1862–79), and again from 1971 to the present. The dollar was effectively defined as a weight of silver in 1792–1812 and 1817–34, and as a weight of gold in 1834–61 and 1879–1971. The dollar was not used by foreign monetary authorities as a monetary reserve asset before 1913, but has been an official "reserve currency" for many since 1913, and for most since 1944.

Applying these two criteria divides the monetary history of the United States into distinct phases. We can compare the stability of these monetary regimes by examining the variation in the Consumer Price Index (as reconstructed back to 1800) by two simple measures: long-term CPI stability (measured by the annual average change from beginning to end of each monetary standard) and short-term CPI volatility (measured by the standard deviation of annual CPI changes during the period). Weighting these criteria equally, the classical gold standard from 1879-1914 was the most stable of all U.S. monetary regimes (as the table below shows).

The first chart shows why ending the dollar's official reserve currency role would end chronic U.S. payments deficits. In 1980 U.S. residents owned net investments in the rest of the world equal to about 10 percent, but by 2009 had become net debtors equal to about 20 per cent, of U.S. GDP. Meanwhile U.S. net official monetary assets -- official monetary assets minus foreign liabilities -- declined by almost exactly the same amount, while the books of the rest of American residents remained in balance or slight surplus.
This comparison proves that the entire decline in the U.S. net investment position has been due to Federal borrowing from foreign monetary authorities.

As the second chart shows, the same process caused the commodity-led inflations that triggered each of the recessions of 1974-75, 1979-80, 1990-91, and 2007-9. The chart compares the annual rate of inflation of CPI nondurable goods -- mostly food and energy prices -- with a ratio of the main factors affecting them: the lagged "World Dollar Base," or total supply of "high-powered" dollars, divided by a proxy for the current demand for high-powered dollars: U.S. currency and commercial bank reserves times current world oil production.

In each case, voters blamed the President: Richard Nixon, Gerald Ford, Jimmy Carter, George H.W. Bush, George W. Bush, or Barack Obama. Thus, any presidential candidate who does not wish to become a by-word must restore the first principle of successful presidential economic policy, by defining the dollar again as a weight of gold and ending by treaty the dollar's role as chief official reserve currency.

U.S. Consumer Price Index, Long-term stability and short-term volatility, By period and monetary system: 1800–2009	Long-run stability (average annual change)	Short-run volatility (standard deviation annual change)	Memo: Maximum price change (High vs. low)	Stability rank (weighing both criteria equally)
1800–1834: Domestic silver standard (interrupted 1812–17 by domestic paper standard)	-1.5%	5.2%	76%	4
1834–1861: Domestic gold standard	-0.4%	3.5%	36%	2
1862–1879: Domestic paper standard	+0.1%	8.8%	74%	3
1879–1914: International gold standard	+0.2%	2.2%	20%	1
1914–1944: Interwar international gold-dollar-sterling standard	+1.9%	7.2%	99%	5
1944–1971: Bretton Woods international gold-dollar standard	+3.1%	3.1%	130%	4
1971–2009: International paper dollar standard (1971–1981 1981–2009)	+4.5% (+8.5%) (+3.1%)	2.8% (+2.7%) (+1.2%)	432% (125%) (137%)	4

[1] John D. Mueller, *Redeeming Economics: Rediscovering the Missing Element* (ISI Books, 2010) Table 16-1

United States House of Representatives
Committee on Financial Services

"TRUTH IN TESTIMONY" DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name:	2. Organization or organizations you are representing:
Lewis E. Lehrman	The Lehrman Institute

3. Business Address and telephone number:

[redacted]

4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?
☐ Yes ☑ No	☐ Yes ☑ No

6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.

7. Signature:

Please attach a copy of this form to your written testimony.