"Gold and Other Bases for Sound Money"

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Thank you Mr. Gilmour. It is a delight to be with you here in Zurich, Switzerland. We Americans have a great appreciation for a beautiful country. We think that we have one, but I must suggest that you have packed into a somewhat more condensed form the most beautiful topography seen in the world.

Since my return from the Soviet Union in September of 1989, I have had many inquiries concerning the possible use of gold in currencies such as that of the United States and other developed countries of the world.[1] Some of you may know that I proposed to the Soviet Union that any economic deregulation — especially deregulation of prices — would not be effective until they first had a sound money system.

And I suggested that there is not such a thing as a sound money that is not both a hard money abroad and also a hard money at home. Hard money for the Soviet Union I believe could first be adopted by a return to a gold-denominated system.

For the Soviet Union that would mean quite a transition cost. They would have to make the transition by first taking the risk of the price-level effect that could be expected from the linking of the ruble to so many grams of gold. And if they chose to establish 40 rubles per gram of gold, versus 20 rubles per gram of gold — or versus 80 rubles per gram of gold — the price-level effect would indeed be quite different. That's a risk that the Soviet Union has no option but to take if they choose to adopt a sound-money program. The only other way for them is to adopt, I suppose, a program such as Poland has adopted, which is to deregulate before you have sound money — and then you have both high inflation and high interest rates.

Indeed, it is the ability to make a transition to a noninflationary economy by tying one's currency to gold that has always been the attraction, an attraction that would be accompanied by relatively low interest rates. But I am sure all of you know here that there is no magic about the link-up between money and any particular metal such as gold. The only magic that there is in sound money is a restraint upon the stock of money, so that the value of money is retained over time and there is just as much tendency to have deflation as there is to have inflation.

Since 1913, when the Federal Reserve was first founded, to 1990, we have experienced an average rate of inflation in the United States of around 4

[1] See the papers in the Appendix for a discussion of Angell's views on the possible role of gold in the Soviet money and credit system.

percent. Unquestionably, that rate of inflation is higher than it would have been if we had continued on a gold standard, a nonmanaged gold standard. Under a gold standard, one does experience inflation during periods of time and one does experience deflation during periods of time. But the fact of the matter is, the rate of inflation seems to be held within somewhat narrow bounds; and the rate of deflation is held within narrow bounds.

The reason for establishing the Federal Reserve System — to bring the United States into a managed gold system — was that it was believed that given the many independent banks then in the United States, pursuing a system that tied the currency literally to gold, invited abrupt monetary shocks that resulted in heavy disruptions and posed threats to economic growth and stability.

So one of the main advantages that goes with gold, *i.e.*, having low short-term rates of inflation and having almost no inflation over time and thereby having very low interest rates, is met by the disadvantage of having a system that is somewhat subject to certain shocks by not having a flexible currency system. Now briefly let me remind you that when the United States decided to use a managed gold standard, that managed gold standard was one in which there were checks upon the management authority to create the monetary base or to create a reserve base. That check was progressively eliminated. Indeed, in the 1930's the gold stock reserves necessary to limit Federal Reserve monetary creation were in fact redefined to permit more monetary expansion.

And in 1970-71, the United States, in the Smithsonian Agreement, agreed to abandon any use of gold whatsoever. Is there a possibility of having sound money under such a regime? Well, of course I believe the answer is yes. Sound money requires in systems like the Swiss National Bank, the Bundesbank, and the Federal Reserve Banks and other central banks simply to have the will to be able to restrain the creation of money — and that means allowing interest rates to rise whenever market forces dictate that they should rise so as to make certain kinds of adjustments.

I believe that when countries in the world that had sound, full-bodied money based upon gold departed from those systems, most of these countries had a lingering beneficial effect. That is, during the 1950's and 1960's, there was not that much expectation for inflation in the United States and to some lesser extent in other countries around the world. Consequently, people behaved in a manner in which they would not take quite as much advantage of somewhat more expansionist or somewhat easier monetary policy. During this period of expansion, individuals and households learned to squirrel their financial assets not in dollars or in other currency denominations, but began to buy real estate. American households particularly began to concentrate in

homeownership. Such arrangements began then to develop a very definite bias, and that bias was followed by monetary policy in which interest rates barely compensated for the rate of inflation. So households and business firms all found it profitable to engage in monetary expansionism.

Now this monetary expansionism in the United States proceeded until (I believe the key date was October 6, 1979) the U.S. dollar felt the full effects of such monetary overexpansionism. So the Federal Reserve at that point in time determined that it would seek to restrain the money stock and to let interest rates go as high as they needed to go.

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

The Federal Reserve has to be mindful today that we have been unsuccessful in further reducing the rate of inflation and that we have gone through an adjustment period in which the rate of inflation has really stabilized at around a 4.5 percent level. That level does not seem to be subject easily to further reductions. And yet the Federal Reserve is determined to pursue restraint in the money stock so as to accomplish some further reductions in that inflation rate.

To give you some notion about the monetary restraint in place, over a 2-year period the growth of the basic M2 money stock in the United States has been about 4 to 4.5 percent. Over a 3-year period the growth of the money stock has been about 4.5 percent. Over a 4-year period, the growth of the money stock has been coming down in recent months until it is now approaching 5 percent. So for a 4-year period, we have had slower money growth than we had in any period in the post-World War II period, and yet we seem not to be getting the kind of effect in terms of reduction of inflation that is being sought or is desired.

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

Now one interesting question for countries such as the United States that own gold stocks is whether or not the gold stock can be used in a way that is

somewhat more profitable than our present facility. Clearly, it would seem to be true that if the United States owns approximately $92 billion worth of gold and the United States in a sense borrows money from its citizens, it in effect has borrowed money to own that gold. And it would appear that owning gold under those circumstances has a fairly high opportunity cost.

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

So then we might ask, how might we use our gold stocks to achieve some of the benefits that might go with the ownership of that gold? Well, one interesting proposition is close to that which I suggested for the Soviet Union. For the Soviet Union, I suggested that making the transition from a system in which you're running 12 to 18 percent of the GDP as a deficit — that making such a transition from a deficit financed by ruble creation to one in which you had a gold-based money system — would mean that you had to make an abrupt transition in regard to balancing their government budget. And that transition would indeed be a rather difficult shock treatment to undergo. I suggested that if they were to make a transition to a gold system, they might be able to use gold-backed bonds in order to have some borrowing during this period of adjustment of their budget deficit.

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

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

Now what would happen if the United States were to issue, let's say, $10 billion worth of gold-indexed bonds? Well, first of all, I think it might provide a great deal of informational content for us to see what might happen with

such a bond issue. That is, we do not know for sure as to what interest rates would prevail at an auction market on gold-indexed bonds. We know that gold mining companies in the United States have made a very heavy investment in gold mining of approximately $8.5 billion in the last 8 years. I think that is probably a fact not fully noted by many. A gold mining investment which this year will bring the United States to the number two among gold producing countries of the world. The United States will undoubtedly surpass the Soviet Union in gold production in 1990.

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

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

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

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

Now if the United States were to issue gold-indexed bonds, such gold-indexed bonds of course would give the United States Treasury an undetermined interest rate. That is, the cost of funding such an issue would

not be apparent up-front. The cost of funding such an issue could vary some depending upon the price of gold. If, for example, the United States had issued gold-indexed bonds in 1970, when the price was $42 per ounce, and if the United States had issued 10-year gold-indexed bonds and if 10 years later in 1980 the price was approximately $650 per ounce, in January of 1980 we would have had something like a 34 percent annual escalation in the price of gold and so the true cost to the Treasury would have been the 3 percent nominal interest rate on the gold-indexed bonds plus the 34 percent increase in the gold price and the Treasury would have had a cost of about 37 percent interest rates during that decade. This, of course, would be the worst decade in the U.S. experience that anyone could possibly look at.

Of course, if the United States had issued gold-indexed bonds in 1980, and they were 10-year gold-indexed bonds maturing in 1990, and if the price of gold was $650 an ounce in January of 1980, and if the price of gold was, let's say, approximately $480 an ounce in January of 1990, then gold would have had a negative appreciation and that would have been subtracted from the 3 percent. So, during that decade, the real cost of funding such a gold-indexed bond issue would have been less than zero.

That is not, I suppose, what interests me. It doesn't interest me so much that gold-indexed bonds would leave certain kinds of uncertainties and certain kinds of risks. The question that interests me most is: would it tend to change the perception of those who believe that it pays to have lower interest rates? Sometimes, I suppose the motivation for lower interest rates could very well come from a Congress that has to face an interest burden on the national debt. So the Congress might suggest, as other debtors would, if interest rates were lower on a $3 trillion debt, then every 1 percent reduction in interest rates would eventually result in $30 billion less of interest. That would be a nice kind of take if the Federal Reserve would just be so kind as to lower interest rates by 1 percent.

I think most of us know that if the Federal Reserve were to lower interest rates by 1 percent, we might get short-term rates down by 1 percent. But I think as we discovered last December, lowering short-term rates does not always cause long-term rates to come down. But if we had gold-indexed bonds, then it would be interesting to have the Congress and maybe the Administration asking the Federal Reserve to please engage in monetary restraint. Because then the Congress and the President might suggest that if the price of gold rises, that increase would increase the burden of taking care of the debt. So you might have a rather reverse arrangement in which the Federal Reserve is being pressured by the Congress and by the Administration to engage in more restrictive monetary policy so as to keep the price of gold down.

Well, I think there is no question that if you entered an era in which you

had more and more gold-indexed bonds, some momentum towards monetary restraint would build. Whether or not that momentum toward monetary restraint is necessary at this time I am not prepared to say. I certainly would believe that the Federal Reserve is capable of monetary restraint without that outside arrangement.

But there might be some merit in exploring such possibilities. I believe that we ought to keep open minds. I am somewhat leery of the notion that going back to another era of a gold standard is apt to be feasible or practical. In the first place, the United States doesn't have to undergo the price-level risk of such a transition. In the second place, the United States has, I think, alternatives that are indeed rather more desirable.

It is my belief that such a transition would involve a price-level risk at the present price of gold. I don't know what the price of gold was today. But I understand that on Friday, it was about $353 an ounce. I'm not of the opinion that if, for example, the United States were to go on a gold-based currency at $350 an ounce, such a price would be desirable. I would have the opinion that such a price would be somewhat inflationary or bring a temporary increase in the price level. My view would be that there would have to be a much lower price of gold than $350 to do that. But we don't need to make that transition cost.

The second reason that I think it would be somewhat undesirable to make that transition would be that gold itself could pose a serious difficulty in relation to transition. There is no necessary reason for undergoing that kind of transition event.

Let me close by suggesting that there is a will within the Federal Reserve today to achieve price-level stability. And I believe that just as in the 1960's and 1970's, the United States did not bear the full effects of a somewhat expansionary monetary policy. There was a somewhat delayed effect. I believe that we will find in the 1990's that we will get some delayed effect in regard to better price-level effects, and I do believe that at the Federal Reserve there is a kind of consensus that says that 4 percent inflation is unsatisfactory.

And I presume that when we get to 3 percent inflation our consensus opinion will be that 3 percent is unsatisfactory. Now I would be interested, as I suggested, in finding out the informational value of using gold-indexed bonds. Thank you.