

Go Forward to Gold

How to lift the reserve-currency curse

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The most disturbing aspect of the current financial crisis is that no U.S. official has correctly identified its primary cause. Experts variously attribute the economic reverses to subprime lending, derivative trading, excessive leverage, and regulation that was either too lax or too strict (take your pick), but these are symptoms rather than causes. Ignored is the main culprit: the dollar's role as the world's main official reserve currency. Though he almost certainly doesn't realize it yet, President-elect Barack Obama will either set the dollar's reserve-currency status on the path to extinction or risk becoming the next victim of what we call "the reserve-currency curse."

Official reserves are money held by governments and central banks for the settlement of international payments. A Spanish bank may not want to accept Indian rupees, and it might be inconvenient for Qatar Petroleum to accept Mexican pesos for a million barrels of oil. An official reserve *currency* is one everybody agrees to accept, and right now that currency is the dollar. But foreign-exchange reserves are commonly held in the form of government debts of the nation that issued the currency. In the case of the United States, that includes all those government bonds piling up in China and elsewhere. The problem is that, unlike gold, official dollar reserves increase the money supply in one country without decreasing it in another. When reserves are being increased, the effect is inflation. When reserves are liquidated, the effect is deflation — potentially dangerous deflation.

To understand how the dollar's reserve-currency role helped cause the recent bubbles, and the ensuing crisis in the world financial system, we must apply the analysis of the great French economist and central banker Jacques Rueff, who was the first to explain the process. As a financial attaché in London in the early 1930s, Rueff witnessed the collapse of the post-World War I monetary system. He correctly diagnosed the stock-market boom of the 1920s, and the subsequent crash and price deflation, as the result of massive official accumulation — and subsequent liquidation — of foreign-exchange reserves. Foreign countries' dollar reserves were certainly not the only factor involved, but before and during the Depression they were large enough to play a decisive role.

Many years later, in the 1960s, Rueff correctly predicted (and tried to prevent) the breakdown of the dollar-based Bretton Woods system. This 1944 agreement made the gold-convertible U.S. dollar the official reserve currency of the world monetary regime; it also fixed exchange rates within narrow limits. When the U.S. abandoned gold convertibility in 1971, thereby eliminating fixed exchange rates, the dollar's reserve-currency role expanded sharply; without gold backing the system, it became a question of confidence, and the world had confidence in the dollar. Rueff died in 1978, but today's

international monetary system — based on the paper dollar, which is backed by nothing but faith in the American economy — has the same potentially fatal flaw that he pointed out in two earlier gold-exchange standards. As was true in the 1920s and the 1960s, the dollar's reserve-currency role has led to the main pathologies that now plague the world economy: the speculative “hot money” flows that first inflated and then deflated stock, bond, and real-estate prices; the sharp rise and fall of commodity prices, especially of oil and other energy commodities; Congress's apparently incorrigible fiscal irresponsibility; and the mushrooming U.S. deficit in international trade and payments.

The key difference between a reserve-currency system and the gold standard is that foreign-exchange reserves, in the form of government bonds, are not only *assets* of the national authority that holds them, as gold was; they are also (unlike gold) *debts* of the country that issues them. Thus, when foreign monetary authorities acquire U.S. debt securities as reserves, U.S. monetary authorities are, in effect, borrowing the same amount.

We all hold our wealth in one of three forms: money, goods (including services), or securities (which are in effect claims on future goods). It is therefore a fundamental truth of accounting that the net international payments for official reserves (money), current account (trade in goods and services), and private-capital account (securities) must equal zero: That is, a surplus or deficit in one account requires an offsetting surplus or deficit in the other two combined. Simply put, if you trade \$100 in currency for \$50 in goods and \$50 in securities, somebody else has traded \$50 in goods and \$50 in securities for \$100 in currency. Payments have to balance out. When foreign countries increase their dollar reserves, it means that U.S. residents have bought that much more foreign wealth than they have sold. The result is a net outflow of capital known as “hot money” because it is highly mobile, speculative, and very sensitive to fluctuations in interest and exchange rates.

The overall U.S. balance-of-payments deficit has persisted almost continuously since 1960, and within the last few years has reached its highest levels ever. This growth in U.S. demand for goods and securities, stoked by central-bank financing, has taken place without a matching growth in supply of goods and services to soak it up. The result is inflation: more money chasing the same amount of goods. And it works both ways: When official reserves are sold, the process is thrown into reverse and deflation can result, as in the Depression.

It now typically takes about two and a half years for these effects to work their way through the economy, as one sector responds to another and the hierarchy of prices adjusts to (positive or negative) excess monetary demand. As happened in 1973–74, 1979–80, and 1990–91, the massive 2002–08 commodity-price surge was set in motion by the previous massive expansion of what we defined in the 1980s as the “world dollar base”: the sum of U.S. currency, commercial-bank dollar reserves, and foreign official dollar reserves. These reserves are sometimes called “high powered” dollars because they permit private banks to expand their lending by a multiple of their reserves. When reserves disappear, lending has to contract by a similar multiple.

By observing the growth of the world dollar base and tracking its impact on the markets, our firm was able to predict correctly in 2005 that crude oil would hit \$100 a barrel by the end of 2007 — and then, as rising production costs squeezed profit margins, to warn investors to shift from equities to Treasury bills. Retail gasoline prices ultimately more than quadrupled — not because energy supplies fell, but because the world supply of “high-powered dollars” (money available to be multiplied through bank lending) had expanded much faster than world energy supplies.

MONEY PLUS CONGRESS EQUALS DANGER

Congress has become increasingly addicted to reserve-currency finance by a kind of fiscal version of Parkinson’s Law: Public spending expands to absorb all available tax revenues. Working in tandem with this is Parkinson’s Debt Corollary: Public borrowing expands to absorb all available means of finance. In other words, the government will borrow as much as it can from whoever will lend to it. If tax revenues are Congress’s “allowance” (as Milton Friedman, envisioning Congress as a spendthrift teenager, once put it), then purchases of Treasury securities (by U.S. government trust funds and by the domestic and foreign banking systems) are its “credit cards.” But the congressional teenager’s spending won’t be constrained by a cut in allowance unless the indulgent parents also cut up the credit cards.

Consider the evidence. Not including the debt absorbed by federal trust funds (particularly Social Security), the federal government’s general operating deficit from 1980 through 2007 has averaged 4.2 percent of GDP. Federal investment in government-owned assets like office buildings and warships represented about 1.3 percent of GDP; this part of the deficit was almost exactly equaled by federal borrowing from non-bank private investors. Current federal consumption of goods and services, meanwhile, has accounted for the remaining 2.9 percent of GDP. About a third of this was funded (mostly) by foreign central banks, and two thirds by spending government trust-fund surpluses to fund the general operating budget — thus expanding the budget while masking the deficit.

Relying on currency-reserve financing to expand government spending for current consumption is bad enough in itself. What made it much worse this time around was that Treasury bonds were joined in the mix by mortgage-backed securities issued by Fannie Mae and Freddie Mac and implicitly backed by the government. This funneled inflation (and then deflation) into residential real estate at the very time when Congress was forcing Fannie and Freddie to lower the quality of their mortgage loans drastically to promote homeownership. In the fall of 2007 Rep. Barney Frank, chairman of the House Financial Services Committee, said: “I’m not worried about Fannie and Freddie’s health. I’m worried that they won’t do enough to help out the economy. That’s why I’ve supported them all these years — so that they can help at a time like this.” The result: Fannie and Freddie became insolvent and were nationalized, while Frank continued (as he still continues) his role as financial “watchdog.”

The housing deflation hasn’t stopped yet, partly because foreign monetary authorities (and recently the Federal Reserve) have been selling Fannie and Freddie’s securities (as an analysis of the recent Federal Reserve balance sheet shows). If these sales continue, it

will trigger more deflation of real estate, stocks, and commodities, as happened in the U.S. after 1928 and Japan after 1989. The current crisis did not strike suddenly and unexpectedly; signs of its approach were abundantly clear for years before. Despite these signs and the historical precedents, the Federal Reserve had neither the understanding, nor the interest, nor the will to stop the massive, inflationary accumulation or the subsequent sale of dollar reserves abroad.

Similar facts explain why U.S. international trade has swung from a chronic surplus in the early 1960s to a chronic and growing deficit ever since. Increased American consumption and reduced saving have caused an increasing U.S. current-account deficit, and therefore an equal surplus in countries that acquire dollar reserves.

These international imbalances consist almost entirely of goods and services purchased from foreign producers, ultimately paid for by federal deficit spending and financed largely by U.S. official borrowing from foreign monetary institutions. But the private balance of payments — the money U.S. citizens owe to and are owed by foreigners — actually shows a net surplus, proving that the dollar's reserve-currency status and the related federal deficit spending, rather than American consumers' private profligacy, are the driving force behind U.S. international-payments deficits.

The dollar's reserve-currency status provides short-term political advantages to U.S. congressmen seeking reelection, but these are far outweighed by the perennial disruptions it has caused to the world and U.S. economy and to financial markets. There has also been a heavy political cost for presidents whose well-intentioned and sophisticated advisers have not, for two generations, grasped the perversities of the dollar-based world monetary system. This is why the Fed has been surprised repeatedly by large changes in U.S. prices, including housing-price deflation, stock-market selloffs, and commodity-price gyrations.

Ben Bernanke, for example, was a respected economics professor who specialized in the Great Depression before becoming a member, and now chairman, of the Federal Reserve's board of governors. Responding to Milton Friedman's thesis that the Federal Reserve had turned a mild recession into the Great Depression by permitting the U.S. domestic money supply to decline, in 2002 Bernanke addressed Friedman with these words: "Regarding the Great Depression: You're right, we [the Federal Reserve] did it. We're very sorry. But thanks to you, we won't do it again." However, with all respect to that great economist, it must be said that Friedman was wrong on a crucial point: believing that only *domestic* official monetary liabilities (currency and commercial-bank reserves) matter — a view that Bernanke and Tim Geithner, the New York Fed president and Barack Obama's nominee for treasury secretary, seem so far to share. Excluding the role of foreign dollar reserves assumes the model of a closed economy, not an integrated global trading system.

The evidence we have reviewed shows that, exactly as Rueff argued, official dollar reserves are a form of high-powered money — adding up to a sum now several times the Fed's own holdings. The Treasury and federal-agency debt securities held by foreign monetary authorities substantially exceed those held by the Federal Reserve itself,

approximately by a factor of five.

A TESTED SOLUTION

How can we end the reserve-currency curse? While acknowledging the complexity of the century-old problem, we must in this article simplify the necessary remedies. The essential requirement for restoring a stable international monetary system is that the major countries agree to replace all official foreign-exchange reserves with an independent monetary asset that is not ultimately some particular nation's liability. Many standards are theoretically possible, but monetary authorities still hold nearly 900 million ounces of gold, and the simplest, most effective, and most tested solution is a modernized international gold standard. This would require changes in U.S. law and an international monetary agreement.

There are two primary conditions for the success of such a reform. First, the gold values of all national currencies must be properly chosen to preclude the deflationary mistakes of the 1920s and 1930s. This requirement now suggests a gold price not less than \$1,000, but a more precise calculation will be necessary when the reform is to take effect. Second, existing foreign-exchange reserves must be removed from the balance sheets of national monetary authorities by consolidating them into long-term government-to-government debts that will be repaid over several decades — much as the Washington-Hamilton administration funded domestic and foreign Revolutionary War debt.

Similar proposals have been made repeatedly — in the 1920s, in the 1960s, and in the 1980s — but in each case they were rejected by “experts” who predicted that raising the gold “price” (from \$20 to \$35 in the 1920s, from \$35 to \$70 in the 1960s, or, still later, from \$300 to \$500 in the 1980s) would be wildly inflationary. The deflationary collapse of the 1930s, the inflationary collapse of the Bretton Woods system in 1971, and the recent financial crisis were all consequences of this shortsightedness. The gold price soared from \$35 in 1971 to nearly \$200 by the end of 1974, and hit \$1,000 an ounce in March 2008 (it is now around \$800).

The proposed reform would bring many advantages. First, it is worth remembering that convertibility of major currencies to gold produced by far the best performance of price stability in American history. From 1879 to 1914, average annual CPI inflation was 0.2 percent, with average annual volatility (up or down) of only 2.2 percent. No other standard comes close in combining low average inflation with low volatility. The volatility in the period from 1971 to the present (2.8 percent) is a close second to the classical gold standard, but it has had the worst average inflation: 4.6 percent. The 1862–79 Greenback period had the lowest average inflation (0.1 percent) but the worst volatility (8.8 percent).

Second, the plan would provide not just an American but a vast worldwide countercyclical “stimulus package” — one *not* financed by yet more government debt — since when all other prices decline, the gold “price” would stay constant, stimulating gold mining (in which America now rivals South Africa). Third, relieved of its reserve-currency burden of being the world's “spender of last resort,” America would see the competitiveness of U.S. industry quickly restored and the chronic U.S. trade deficit

quickly return to chronic surpluses. Fourth, since the whole world would have what amounts to a trade surplus with itself, equal to the increase in official gold reserves, pressure for trade protectionism would diminish sharply. Fifth, the chaos of floating currencies would end along with the reserve-currency curse. The gold standard best integrates the world trading system, by bringing about prompt adjustment of balance-of-payments deficits.

Sixth, the reform would halt the proliferation of debt resulting from the current currency system. Seventh, not the least benefit would be to recapitalize the balance sheet of the Federal Reserve System itself. In the course of its massive bailout of private institutions, the Federal Reserve's loan-to-capital ratio has risen to about 50 to 1 — worse than the troubled major private banks it is trying to save! Revaluing U.S. gold reserves from the current \$42.22 to at least \$1,000 an ounce could bring this ratio down to 7 to 1, providing the liquidity necessary to deal effectively with the crisis.

Finally, ending the dollar's reserve-currency "privilege," and its inflationary financing of the federal budget, would make it not only necessary to limit budget deficits — which could no longer be financed by foreign central banks — but also for the first time politically and economically practicable to do so. We joined in proposing a comprehensive (but never enacted) plan to the 1995 National Commission on Economic Growth and Tax Reform, based on the Reagan strategy of combining a low-rate, broad-based income tax with a balanced, pay-as-you-go Social Security system. The plan remains eminently feasible.

Neither reforming the international monetary system nor balancing the federal budget could be done without serious national and international discussion. But the technical problems have been long studied and are relatively straightforward. The main action item for President Obama should be to put the reserve-currency addiction on the way to extinction before — not after — its congressional and foreign monetary co-dependents irreparably harm themselves and all the innocents they have heedlessly placed in harm's way.

Doing so would require Obama to overcome objections from the dominant factions in both parties. Yet putting the common good ahead of political expediency is what distinguishes a great president from a mediocre one. The challenge is great, but so is the reward for doing the right thing.

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