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Towards a Stable Monetary Policy

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Fiscal Issues **3**

Towards a Stable Monetary Policy

Monetarism vs. the Gold Standard

**A debate between
Allan Meltzer and Alan Reynolds**

**Moderated by Edwin J. Feulner, Jr.
With an Introduction by
David G. Raboy**

The  **Heritage Foundation** & **iret** Institute
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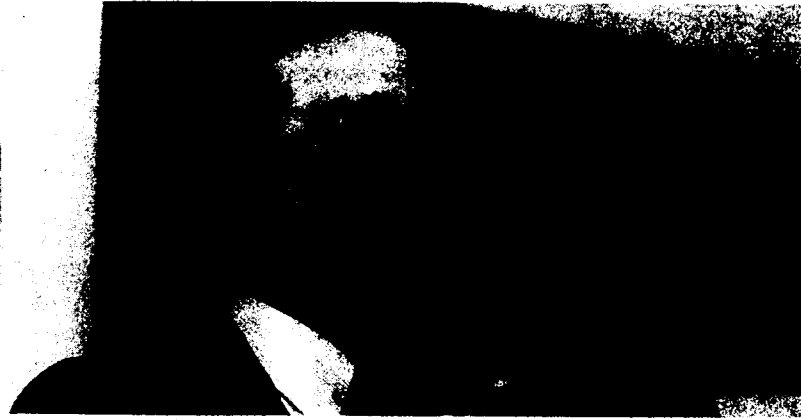
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Monetarist Allan Meltzer.



Alan Reynolds defends the Gold Standard.



Moderator Edwin J. Feulner.



Meltzer listens as Reynolds makes a point.



David Raboy asks a question.



left to right: Edwin Feulner, Allan Meltzer, Alan Reynolds, and David Raboy.

Introduction

Ronald Reagan was elected on the basis of a dramatically different philosophy: The belief that the free market offered the best vehicle for the efficient allocation of scarce resources and that government intrusion in the economy, in all its forms, should be minimized.

The pragmatic application of this philosophy took the form of a four point program. The first plank recognized that resources were being wasted because government was preempting activities better performed by the private sector. Thus, the level of real government expenditure had to be cut back, in order to decrease the amount of resources being extracted from the market. It was also recognized that the method by which government expenditures were financed was, itself, a source of disruption. The second plank dictated that the tax system be reformed so as to minimize the distortion of market information. Similarly, excessive cost inefficient regulation was inhibiting economic growth. The third portion of the program addressed this problem. Finally, it was recognized that markets could not function efficiently without a stable means of exchange. Volatile monetary policy had seriously undermined the ability of markets to function, and the President called for a slow, stable monetary policy.

The fourth part of the program has not received as much attention as some of the other planks, particularly spending and taxing. This is unfortunate because it is the specter of stubbornly high interest rates that threatens, at least politically, to wreak havoc with the basic program; and the solution to high and volatile interest rates lies primarily in the monetary arena—not in narrowing the deficit as the press, in its own narrow way, constantly proclaims.

Conservative economists in the postwar period have produced a considerable body of literature on the issue of a stable monetary policy. Notable contributions have been made by Milton Friedman, Allan Meltzer, Philip Cagan and many others. The key theoretical and policy precepts of the "monetarist" camp are that inflation is primarily a monetary phenomenon; that the amount of money needed by an economy bears a stable relationship to other macroeconomic variables; and that a nation's central bank can control the supply of money and thus create a situation where markets function efficiently within a non-inflationary environment.

More recently, a few economists within the conservative camp have quarreled with the teachings of monetarism. The leading figures of this

school are Alan Reynolds, Arthur Laffer, and Jude Wanniski. Although they would agree with the first monetarist proposition, that inflation is a monetary phenomenon, they are less than certain that the demand for money is a stable function, and certainly would argue against the belief that a central bank can control the money supply. In contrast to the monetarist policy prescription for a "monetary rule," they propose a return to a gold standard in one form or another.

The purpose of this volume is to present the proceedings of a debate on the topic of a stable monetary policy. The debate, co-sponsored by IRET and The Heritage Foundation, was held on April 20, 1982 in Washington, D.C. Representing the monetarist view was Professor Allan Meltzer of Carnegie-Mellon University. Representing the pro-gold standard view was Mr. Alan Reynolds of Polyconomics. The session was chaired by Dr. Edwin J. Feulner, Jr., President of both The Heritage Foundation and IRET.

Each of the four planks of President Reagan's free market economic program depends upon the success of the other three for its own success, and today the monetary question seems to be the key stumbling block. A careful reading of these proceedings should serve to enlighten the reader on an important debate among conservative economists.

David G. Raboy
Executive Director
IRET
August 26, 1982

Proceedings

DR. FEULNER: I'm Ed Feulner. On behalf of the Institute for Research on the Economics of Taxation, of which I'm president in my spare time, I want to welcome you to this little encounter session on the question of gold.

We have two of the foremost economists of a more or less conservative/libertarian stripe in the country today available to us. They both have U.C.L.A. in common. They also have a fair number of disagreements, as I'm sure we will see during the forthcoming session.

Our first speaker, selected to be first through an arbitrary decision which need not concern him, is Professor Allan Meltzer, John M. Olin Professor of Political Economy and Public Policy at Carnegie-Mellon in Pittsburgh. He has also been on the faculty of various other institutions, both here and abroad, including Harvard, Chicago, Rochester, the Yugoslav Institute for Economic Research, the Austrian Institute for Advanced Study, and other institutions in Europe and Latin America. His reputation in the field of money and capital markets has brought him frequent assignments to testify before congressional committees, and to consult for various government agencies, including the Treasury Department, the Fed, and various foreign governments and central banks.

Dr. Meltzer is, perhaps, at this stage, best known as the co-founder and co-chairman of the Shadow Open Market Committee, which is written up in this morning's op ed page of the *Wall Street Journal* by Lindley Clark. His activities there, I'm sure, are well known to many of you. And he is here today to discuss his perspectives on the role of gold in the world economy. Allan?

DR. MELTZER: Thank you. Discussion of the gold standard reminds me of a story about Brezhnev and the supply side. Brezhnev is very interested in the supply side, because his supply side has a lot of problems.

It seems that Brezhnev was reviewing the May Day parade. First the Red Army drove by. He looked at the Red Army and he thought it was very impressive, so he turned to his aide and said, "Splendid, splendid." Then came the rockets. He turned to his aide and said, "Remarkable."

Finally, along came a small contingent of men carrying briefcases. Brezhnev turned to the aide, a little bit puzzled and said, "Who are

those men?" The aide said, "Sir, those are supply siders." "Supply siders," he said. "What are they doing in my military parade?" "Why," said the aide, "sir, you wouldn't believe how destructive they can be."
(Laughter.)

The truth is that some of my best friends are supply siders. But like all hyphenated economists—and even more, hyphenated journalists—supply siders are inclined to overstate what is known and to confuse beliefs and hopes with evidence and fact.

From the way the debate about the gold standard is reported in the press, one might even say conducted in the press, an unbiased observer might believe that those who favor the gold standard include a large number of economists actively pursuing this great truth through their research. Nothing could be further from the truth. There is only one academic economist of any repute I know who favors a return to the gold standard, and that economist is Robert Mundell of Columbia. We will consider some of his proposals shortly.

But make no mistake. Mundell recognizes that the only gold standard worth discussing is an international gold standard, a standard which binds all participants, most major trading countries, to follow the same rules and to seek to achieve the same objective. And that objective is not and has never been price stability. It is exchange rate stability. Annual or decennial price stability would result from a gold standard only by chance. The contrary belief is the result of a remarkable historical accident that is not likely to be repeated.

The historical accident occurred because the Bank of England, having fixed the price of gold in terms of sterling in 1737, did not change the official price for 194 years. England abandoned the gold standard in 1793. Between 1793 and 1815, the price level of commodities approximately doubled. The price of gold in terms of sterling rose, reflecting the rise in commodity prices. The Bank of England had to choose a price of gold at which it would buy and sell. The Bank rejected the advice of Ricardo, who told them to go back on the gold standard at the higher market price of gold and avoid a deflation of commodity prices. Instead, the Bank decided to go back on the gold standard in the 1820's at the price that had prevailed in 1793. The decision was followed by a difficult, hard adjustment that eventually brought the market price of gold, in terms of sterling, back to where it had been when England left the gold standard in 1793.

On several subsequent occasions in the 19th century, the Bank of England again chose to abandon the gold standard. Subsequently, the Bank could choose to go back on the gold standard at the new price or go back on the gold standard at the old price. It always chose, on those occasions and again after World War I, to go back to the old 1737 (or 1743) price. Had it not done so, the gold standard would not have had the reputation for enforcing price stability that it does. There would

have been a random walk, as economists now say, in prices. Each time the gold standard was abandoned, the Bank of England would have allowed the price level to go up permanently or down permanently. Looking back, we would not find the historic association that we think we observe between long run movements in gold and long run movements in prices.

Perhaps over millenia, or some sufficiently long period, higher or lower prices of commodities eventually would have induced the sufficiently large increases in gold or the sufficiently small increases in gold to restore some fixed relation between the prices of commodities and gold. It might have turned out that the main truth of the gold standard would have occurred if we waited long enough. But the fixity of prices in terms of gold—which shows that about every 50 years the gold price level and commodity prices reached approximately the same levels—even that meaning of price stability would not be found.

We should begin the debate or discussion with these facts in mind. Further, we must accept the related point that the gold standard, as it would operate in the modern world of multiple power centers, would have to be a multilateral standard. As far as I know, all competent students of monetary economics accept the point that a single, unilateral gold standard would not achieve the objectives that some of its advocates claim for the standard. Once we accept that there is no international consensus on the return to gold, the practicality of the proposal disappears.

Let me, then, in the spirit of academic discussion—because when we talk about a unilateral gold standard, we are talking about something which is, I think, of academic interest only—offer a few observations about a unilateral gold standard for the United States.

A unilateral gold standard commits the United States to buffer all major shocks in the world. Oil shocks, which cause people—the Arabs—to take the revenues they receive from the price of oil and invest it in gold raise the price of gold. Under a unilateral gold standard, the United States would be the supplier of gold to the world. Thus to maintain the gold standard, we would sell gold, reduce our money stock, and deflate our economy.

Now, a gold standard proponent might say that we wouldn't have any increase in the demand for gold under those circumstances, because people would believe that the price level would remain constant. That, or course, isn't true. Having experienced the supply shock—the higher price of oil—we would have experienced a rise in the price of commodities all over the world, eventually offset by a decline in the United States. It is no comfort to describe the rise in the world price level or the decline in U.S. prices as temporary changes. These changes would be temporary only if the world eventually produced the requisite quantity of gold. That's a response which we have to measure in years, if not in decades, rather than in days or weeks.

The oil shocks were real shocks. They were followed by an increased demand for gold. Under a unilateral gold standard, we would have had to deflate enough to satisfy the world's increased demand for gold.

Suppose we look at a second shock, the shock that followed the Iranian crisis. Again, a real shock. Again, people ran to gold, believing, perhaps mistakenly and perhaps correctly, that when the United States collapsed as a result of its lack of power to deal with the Iranian crisis, that they were going to take that gold and sell it to Brezhnev. Whatever they believed, they drove the price of gold up. Under a gold standard, especially a unilateral gold standard, the United States would have had to buffer that shock, adding the economic impact to the political impact of that disastrous set of events.

There is the Polish crisis. The Europeans scrambled for gold, thinking that perhaps the hordes were coming from the East. Under a gold standard, if there is a scramble for gold, the United States would supply the gold and deflate.

The Falklands crisis is only the last and most recent of this set of events, a real event. The Argentinians divined that the outcome of that war was not likely to be a lower rate of inflation or greater stability. They scrambled for gold and got out of currency. Lines could be seen forming at the banks to sell the Argentine peso and other currencies. What did that do to the price of gold? It sent the price up 15 percent in a few days. Should the United States have buffered that crisis by maintaining stable gold prices for Argentina at the expense of deflation here?

The same answer is obvious to me. There are real shocks in the world over which we have no direct control. We cannot prevent them. Under a unilateral gold standard, we would stabilize prices for the rest of the world at our own expense, allowing the world to run in crisis from money and commodities to gold.

We could speculate on a number of other kinds of crises, real crises, that have wider effects now that economic power and political power are distributed far more widely than in the nineteenth century. If the object is to provide a world public service at our expense, I believe, the proposal is a costly way of doing it.

Let me turn to a related point. Currently, the chief monetary problem in the United States is the high real rate of interest. The problem is caused, in part, by the high rate of growth of money and the high variability of money growth. All of our problems would not go away if we had stable money growth, but advocates of the gold standard do not show how a unilateral gold standard reduces real interest.

A unilateral gold standard doesn't tell us anything about what the rate of money growth is going to be. The rate of money growth in the United States would be whatever is required to satisfy the world demand and supply for gold. Nothing more can be said. The variability of money growth, as I've explained, depends on the nature of the real shocks that

occur all over the world and the monetary shocks that occur all over the world. If some country chooses to inflate and the citizens of that country decide that they want to be in gold, rather than in pesos or pounds or marks or Swiss francs or yen or whatever, they would buy dollars and exchange dollars for gold at the United States Treasury.

If we agreed to maintain stability, we would be discussing a multilateral gold standard. There isn't very much demand for such a measure, so that clearly is a discussion of academic interest only. The issue before us, as I understand it, is, "Should the United States peg the price of gold?" And my answer, as you might have guessed by this time, is no. It is not in the interests of the citizens of the United States, and we should not provide that public service to the world.

There are some serious monetary problems in our economy. The Congress has been negligent. The Federal Reserve should not have been permitted to pursue the kinds of policies that it has for as long as it has. The Fed produces too much variability in money growth. It produces, on average, too much money growth. I believe variability can be reduced, and if that were done, real interest rates would decline. We could provide a more stable framework for real growth.

The ways to reduce variability are well known. Many of us have repeated them on a number of occasions. The principal changes that are required have to do with operating procedures. Under present policies, however, they are described, the problems that arise, arise because the Fed, in one way or another, has an interest rate objective.

Now, they say, "We're not pegging the interest rate. What we're doing is estimating the demand for borrowed reserves." How do they estimate the demand for borrowed reserves? They do that by estimating the interest rate at which the demand for borrowed reserves is compatible with their monetary target. When they miss on their estimate of borrowing, they miss their money targets.

The problem is exacerbated by other features of the Federal Reserve's control technique, but the problem arises, as it has for the last 25 years, from the fact that the Fed tries to forecast the demand for money and the demand for borrowed reserves based on interest rates. It misses its forecasts all the time. It corrects and overcorrects.

Currently we are far above the target. If anyone believes we will hit the target rate of money growth that the Fed has announced for this year, two and a half to five and a half percent, he has to believe that we're going to tolerate money growth in the neighborhood of two percent at annual rates for the rest of the year. Unless you believe that's what the Fed is going to do, you'd better believe that we are back on the track of inflationary money growth. We're going to have to go through another one of those ratchets in order to get down from the current high rate of growth.

The problems are serious, as I have said. But, they have solutions. The gold standard doesn't happen to be one of the better ones. One fur-

ther reason is that no one knows what the equilibrium price of gold is or how it changes. It is not a constant. The Fed's procedure currently is to estimate interest rates, as I just said; to set the interest rate and accept the money growth that results. Under the gold standard, instead of setting the interest rate, the gold price is fixed. Exactly the same kind of problem arises.

In order to operate the gold standard effectively and efficiently, one must know where to set the price of gold, just as under the present system one must know where to set the interest rate. If the gold price is too high, gold will flow to the United States and the money growth will be too high. If the gold price is too low, gold will flow out of the United States, and the money growth rate will be low or negative. No one knows the correct price of gold. Robert Mundell who, as I say, is the principal academic advocate of the gold standard tells us that the price of gold could be set somewhere between \$300 and \$650. That's a rather wide range. As a matter of fact, it tells you how little is known about where the price of gold should be set.

These are not my only objections to the gold standard as proposed by Robert Mundell. He has an 11 point program. My time does not permit me to give you all of the 11 points, but let me tell you some of the proposals. They include suggestions, very interesting suggestions and useful ones that we would all like to see implemented, for cyclically balanced budgets in all the gold standard countries. That seems like a rather unattainable prerequisite for the operation of an effective gold standard, however. Mundell also wants an incomes policy to set prices and wages, or at least to interfere in the price and wage process. Read that as price and wage policies pursued by the federal government, and ask yourself whether, if that is a requirement for the gold standard, the cure might not be worse than the disease.

Also, Mundell says there must be coordination of interest rates across countries to prevent capital movements. This sounds to me like a bad and unworkable idea. We cannot reach agreement on interest rates between one side of Pennsylvania Avenue and the other, or between the Congress and the executive branch, or between the Treasury and the Federal Reserve. This proposal asks us to agree on what interest rates should be on a multicountry basis. Coordination of interest rates to prevent capital movements sounds to me like a step toward capital restrictions. And there are more proposals of a similar type.

When I read about wage and price controls or steps in that direction, restrictions on capital movements or steps in that direction, it seems to me that, again, the proposed cure is far worse than the disease. That's why I believe that the gold standard is an idea whose time is past, long past.

We must be concerned about the problems that we face in this country, and particularly the monetary policy problems that we face. We must seek solutions. It happens that the gold standard is not the best solution.

Thank you.

(Applause.)

DR. FEULNER: Thank you very much, Professor Meltzer.

Our second speaker, Alan Reynolds, is vice president and chief economist of Polyconomics in New Jersey. Previously he served as vice president and economist of the First National Bank of Chicago, where he also edited the bank's "First Chicago World Report" newsletter. Prior to that, he was senior economist at Argus Research in New York and economics editor of *National Review*. He remains a member of the editorial board of *National Review*, *Reason Magazine*, and the *American Spectator*.

Over the past decade, Mr. Reynolds' work on economics has been published in a variety of journals, including the *New York Times*, the *Wall Street Journal*, *Fortune*, *Havard Business Review*, and *Chief Executive*. Like Professor Meltzer, he has served as advisor to numerous groups, including the U.S. Chamber of Commerce, the U.S. Industrial Council, and the Lehrman Institute. He has been involved in government, having worked actively during the transition from the Carter to Reagan Administration, and has recently served as a consultant to both the OMB and the CIA. Mr. Reynolds?

MR. REYNOLDS: On the issue of monetary reform, there are, of course, moderates and extremists. The moderates are those who wish to evacuate the Federal Reserve building and burn the furniture in piles, tear down the building and drop the stones in the ocean. And of course the extremists are those who'd like to do all that and then sow the ground with salt.

(Laughter.)

Both Professor Meltzer and I are in the moderate category, I think, on this. He was telling jokes about supply siders. I guess I have only one short joke about monetarism. It's called M-1.

(Laughter.)

Essentially, Reaganomics is monetary policy. Nothing much else has happened yet, despite some rather valiant efforts. Non-defense spending is up from 15.9 percent of GNP in '79 to 17.7 percent. Marginal tax rates aren't down; they're up. And if they put the surcharge on, the system will be more progressive than ever before, at least in the middle ranges. We no sooner got some tax relief in the corporate sector than the Treasury was fielding some ideas for "revenue enhancements" that basically repeal a good deal of that, leaving business wondering what the future tax system is going to be. So nothing much has happened except a very dramatic change in monetary arrangements.

The problems that we face are not new, they didn't begin with Reaganomics. It isn't as though we were quite pleased with the trend of interest rates up until the day President Reagan took office. I think it's useful to go back to the early '60's, to those heady days of "demand manage-

ment" when Professor Meltzer and I were at U.C.L.A. together and I had the good taste to drop out.

(Laughter.)

In those days, we were deluded into believing that if we would just eliminate a lot of those obsolete institutional barriers to the conduct of monetary policy, you'd do all sorts of marvelous things. We could manage demand in such a way as to counter business cycles. We could achieve a perfect point on the Phillips Curve of four percent inflation, four percent unemployment. If inflation got up too high, you'd just throw a little more unemployment on it and vice versa. We played that game back and forth until we got to nine percent inflation and nine percent unemployment. England has managed to push that up to 12 and 12. It didn't work.

What happened in that period? In '64, with full academic backing, we pulled the silver out of the coins; in '65 we took the gold cover off Federal Reserve notes; in March of '68 we went to two-tier pricing of gold, essentially letting the free market price it, making the \$35 price a joke; and then in August '71, we reneged on the promise to convert dollars into gold. The impetus behind Nixon going to the wage and price controls, et cetera, was the fact that England asked for some gold. Then, of course, in '73 we were officially left with a system of whim.

And there were always promises that, after we abolished all of these old fashioned institutional constraints, we were going to replace them with something. We still hear the promises. There's always one more trick. There's a technical fix. There is a monetary rule, somewhere. But I've waited 10 years, and essentially, that's why I'm losing patience.

What happened since we tried this experiment with scientific money? Well, since mid-65, long-term interest rates have tripled. Mortgage interest rates since '73 have gone up every single year. A lot of young people think that's normal. They don't think there's anything wrong with that. It's 17 percent this year, it's going to be 18 the next, maybe it will be 20 the next. This is *not* a normal procedure; it's very strange, very disastrous.

World trade under the Bretton Woods system expanded by seven percent a year. After that, the growth dropped by half. World output was rising by five percent a year; that dropped by half. Last year, world trade fell by one percent. The entire dollar economy, worldwide, is precariously dependent on short-term debt. The corporate sector has never been more illiquid, not since the Great Depression. The long-term financial markets are essentially dead. Everything is operating on shorter and shorter-term credit, and the string is getting very tight, very dangerous.

We're in the worst of both worlds. We are, in many sectors, *experiencing* deflation and at the same time *expecting* inflation in the years ahead. The experience of deflation causes bankruptcies and risks of default, and that keeps rates up. And the fear that there will be an inflationary solution to that problem, sooner or later, keeps the long-term interest rates high, keeps that market dead. Cotton prices are down 25

percent; the last time that happened was 1932. Aluminum is down 27, year-to-year. Broad ranges of commodity indices are down 15, 20, 25 percent over the year. Everyone is liquidating whatever they can in order to get their hands on cash.

There was really only one prolonged depression under the old gold standard, around 1894-97. Yet the worst price declines in the 1890's that I was able to find were a 17 percent drop in cotton in 1898, a 13 percent drop in copper 1894. I think if William Jennings Bryant were around today he'd probably be in the Farm Belt, talking about the Cross of Paper.

(Laughter.)

You know, we used to argue, a few years ago, that real interest rates could be too low, and they were. They were below the inflation rate and that gave you an incentive to borrow like crazy in order to buy before prices went up, in order to speculate, in order to hedge against rising prices. You could just arbitrage between credit and goods. It was a lot of fun. And that fueled inflation, that's quite true.

Now obviously, if interest rates can be too low, they can also be too high in real terms. If that happened, you would expect everything to unfold in the opposite direction. You'd expect people to liquidate inventories, commodities, farmland, businesses, houses, assets, stocks, and bonds—and indeed, this is pretty much what we're observing. We're observing a massive liquidation, a global "going out of business" sale, and that, indeed, does depress some of our measures of price, some of our measures of inflation. We take great credit for that. But there is a world of difference between selling what you *have* at a falling price and producing *more* at a stable price. It's the latter that we ought to be trying to achieve.

What we've achieved, instead, is a great reduction in wealth in the economy. The value of home equity is down. The value of stocks and bonds is down. And what that means is that the cost of living in the *future* is going up, because the wealth that we had accumulated in hopes of preparing for the future has less value. We'll have to work harder and earn more in the future to maintain that living standard.

Faced with this problem, Congress is searching for a fiscal fix for what is essentially a monetary crisis. It did the same thing in 1931. We pushed England off the gold standard, there was a run on our gold, and Hoover, around October '31, said, "I know what we need. We need the biggest tax increase in peacetime history. That will restore confidence in financial markets." That was the argument. Taxes were raised by one third. It didn't work. Not very well.

In '68 we had a tax surcharge, a few months after we went to the two-tier pricing in March '68. It was supposed to get interest rates down. Interest rates went up every single month from August '68 to January of 1970. The T-bill rate rose by 55 percent, right through a budget surplus. It was a monetary problem; it wasn't a fiscal problem.

We really aren't in a position to fix the government's budget at the expense of the private sector. The private sector can't afford it. Federal revenues were up almost 16 percent in the last calendar year. Well, if farm income was up 16 percent or profits were up 16 percent or personal income was up 16 percent, there might be a case for taking some of that and giving it to the poor government, whose income is only going up by 16 percent. But in point of fact, that wasn't the way it was. No one else was doing that well.

What would the budget's position look like if interest rates were remotely close to normal? And by normal, I mean that long-term rates for 200 years of our history were five, six percent at most. They usually were three or four percent. What would the budget look like in that situation? Well, the interest outlays obviously would be much lower. The corporate sector would be generating more taxable profits. Detroit wouldn't be going belly-up. Aid to the cities and unemployment insurance could go down. The budget would be massively in surplus. So we have, essentially, a fiscal symptom of a monetary crisis.

Now, how do we solve this? I think that Meltzer and I will agree that what we need is a credible, *long-term* monetary policy. Essentially, we have no monetary policy. All we have is fourth quarter to fourth quarter, single-year estimates for a variety of M's. Those goals can be changed at any time. If you hit one, that's fine. If you miss it, so what? Last year they undershot on M-1 and overshot on M-2 and nobody knew what that meant until they finally saw the results. It's total chaos. We need better tools, we need better targets and we need some long-term objectives so we know what monetary policy is going to look like 10, 20 years out, so we can have 20-year bonds and mortgages again.

Last September Professor Meltzer wrote a piece in the *Wall Street Journal* and he said that the Fed's eyes are finally on the money supply, and "Let's hope they stay there." Well, hope is not a policy. Hope is not a rule.

Should a monetary rule aim at a quantity or should it aim at a price? That's question number one. I don't doubt that $MV = PT$. The question is, should we use M to try to indirectly hit the P or should we aim directly at a price? Shall we look at results, in other words, in terms of inflation or deflation?

Now, if anyone could count and control a meaningful measure of M, and if they could predict its velocity, and if they could, then, decide how that nominal GNP would be split between real growth and inflation, then you could use M to control the P. But there's an awful lot of slippage in there.

The definition of money: How can you formulate a long-term monetary rule in terms of an M when the definition of money changed four times in the last three years? Last year they threw in travelers checks. It was the only thing they could find that wasn't going up. Then they took

some of M-2, put it in M-3 and put some of M-3 into M-2. Doubtless, useful reforms.

Eric Heineman, on the Shadow Open Market Committee, speaks of "the hopelessly difficult task of measuring money." It is, indeed. Allan Meltzer likes the monetary base. Bob Weintraub is here; he likes M-1. Philip Cagan and David Laidler prefer M-2; now he talks about 10 week changes in M-1. And there are lags. David Meiselman has a seven-quarter lag, Beryl Sprinkle is down to one. As I interpret an article by Lawrence Roos in the *Wall Street Journal*, he appears to have a zero lag.

The problems are just beginning. My Dreyfus account just notified me that I can now pick up the telephone and move money from my money market fund into my checking account and back again. With a telephone call it goes from M-2 to M-1 very quickly.

(Laughter.)

Mastercard is about to introduce something called a sweep account that previously was only available to affluent people. You tell them, "I don't want my account to go above here or below here, and if it moves in either direction, move it in and out of various kinds of new monies—money market funds, overnight RP's, overnight Eurodollars, whatever, in order to get the highest yield that's available at that time." What this means is that if the Fed happens to count money at the wrong time of day, there might not be any.

(Laughter.)

The problem of velocity: Most of our equations for predicting velocity worked pretty well in the stable world after Bretton Woods. Since then, they have broken down. Laidler says they broke down in '72, St. Louis says they broke down in '73, '74. It's a coincidence, maybe, but they don't work very well. You have trends. You can draw a line between points and say the trend is three or three and one half percent. Sometimes that's zero, sometimes it's six. In the most recent expansion we have—third quarter '80 to third quarter '81—there was a six percent increase in the velocity of M-1. Is that a trend? I don't know. Velocity was down four and a half percent in the second quarter, up almost 11 percent in the third. Not very stable. So we've got a little trouble with M, we have a little trouble with V. The whole scheme is rough, it's crude.

So the first point I would like to raise is that one thing we're suggesting is a price rule. Bob Genetski has one I like pretty well. He's on the Shadow Committee with Professor Meltzer. The price rule works very simply. It says, if you see a lot of prices falling, it's a pretty good sign your monetary policy is too tight; and if you see a lot of prices rising, it's a pretty good sign your monetary policy is too loose. Skip M, V, and T, and focus directly on P.

Now, you can use 13 commodities, you can use 22 commodities, or you can use one commodity: gold. Now, gold may sound more arbitrary than a dozen. I would argue that it's not. In point of fact, some of those

other commodities you probably shouldn't put in there, because they'd be subject to droughts and things like that. But if you want to use a wider basket for that purpose, that would work. That's fine. Any prompt and sensitive index of commodity prices would tell you when you're going too far in one direction or another. If you want to supplement that by looking at an M, I have no objection. But basically, you're judging monetary policy by price stability: Does it stabilize price? Judge it by its results.

Others have suggested a nominal GNP target. That's not *too* crazy an idea, but it doesn't tell us how to divide it out between price and real output. I'd rather go right for the price.

The second more controversial part, is the gold standard. The standard means just what it sounds like—a standard of weights and measures. A yardstick is 36 inches, it's not 32 one day and 42 the next. You know that it's 36 inches. Well, a gold standard is a legal definition of the dollar in terms of a weight of gold. That's what it means. It doesn't imply that you necessarily have a cover, or "backing," or anything of that sort. It simply defines the dollar as so much gold. The government buys and sells at that price. When France went back in '26, they said the French franc is worth 65.5 milligrams of gold. The Central Bank will buy and sell at that price. End of law. Very simple, very clean. They had a percent real growth per capita, 50 percent inflation went down to zero, the bond market rallied, and the economy performed very well until 1936.

What are the advantages of a gold standard vis-a-vis a quantity rule? It's very conspicuous. It's unambiguous. You don't have to worry about M-1 going down and M-2 going up. You can see that gold is going in or it's going out, people are rushing to convert to gold or not. It's a guarantee. It in effect allows the citizenry to call your bluff. If they don't want the money, they come in and say, "Wait, this stuff looks a little fishy to me. I've been going to the supermarket and it's not buying anything. Give me gold." It's efficient. It's fast. You're constantly putting the supply and demand for money in balance at a stable price, assuming, of course, gold is a reasonable proxy for other prices—which, of course, is the major bone of contention between us. Okay, it's "a" major bone of contention. The other is that there's supposedly only one economist who favors the gold standard—you can do that by redefining "economist" to meet your purposes.

(Laughter.)

DR. MELTZER: Academic economist.

MR. REYNOLDS: *Academic* economist, okay. We just lost Bob Genetski that way. How about Tom Sargent, Robert Barro, Roy Jastram, Robert Aliber, Jurg Niehans? A Heritage Foundation poll found about 45 economists favoring a gold standard—almost a third.

If a quantity rule were believed, obviously the incentive to economize on cash balances would be reduced; that is to say, interest rates would

fall. People would say, "It's convenient to hold more cash, it's convenient to hold more in a checking account." In other words, velocity would at least not rise very rapidly; it might even fall for a short period of time. That's quite a difficult adjustment problem for quantity rule. Eventually, you'll get to equilibrium, and it's okay, but don't kid yourself, there are adjustment problems with any disinflation plan.

A gold standard has no such limit. A gold standard simply says, "We'll supply it." If you supply too much, it will come back in the gold window through conversion. There's no absolute limit. In the first three years after we went back to gold in the 1870's, the annual growth of M-2 was 19 percent a year. Yet there was no increase at all in the consumer price index, a small one in the wholesale index. Why was that? People trusted the money. They wanted more of it; they held it. There was also a huge increase in transactions; net national income rose 16 percent in the first year we went back to gold. Try having a 16 percent increase in real growth with a quantity rule sometime. It's a little tight.

Now, there are standard objections to any kind of significant change to any rule. One of them is that any rule is likely to be bent; therefore, we should skip the rule and go directly to the bending. Since we're going to change it every 36 years, why not change it every 36 seconds? Another is that every standard is going to have to be managed. Therefore, you should skip the standard and go to pure, unrestricted management. A third objection is that you have to stop inflation first, before you institute any scheme to deal with it. But that doesn't work, particularly with expected inflation. Stopping inflation has not convinced people that it won't begin again. Still another is that if we had enough discipline you wouldn't need the gold standard. That's true of laws against public nudity, laws in favor of safety belts, and almost any other law you might imagine.

The worst thing that happens if the rule has to be suspended, because of some external shock, is that we'd be back on the exact same non-system that we're on right now. That is, indeed, a terrible thing, but at least it would only be temporary, instead of having to live with it day in and day out.

The question is, what is the right price? The right price is that price at which you observe neither deflation or inflation. We are currently observing, according to any commodity index, a deflation. Am I suggesting that we reflate? No, because if commodity prices go up, I'd move in the opposite direction—tighten. But a sharp drop in prices is not stability. Stabilizing commodity prices would have worked better from September to April, when M-1 gave poor advice.

One of the toughest critics of the gold standard is Herb Stein. I'd like to quote something he wrote in 1980, because I heartily endorse it. He says, "One can hardly imagine a hyperinflation and all its attendant uncertainties going on while government honored a commitment to sell

gold at a fixed price. Some version of a gold standard may, therefore, be useful to provide assurance that there is a limit beyond which inflation will not go. This function does not, however, require a continuous tight link between the quantity of money and the quantity of gold. The purpose could be achieved by a commitment to sell gold at a fixed price (I would add "buy"), the government remaining free to manage monetary policy by whatever rules or lack of rules it chose, so long as it protected its ability to honor that commitment."

One minute left. Well, we will get into the history, I hope, at some point. I think history is only indirectly relevant but has been rather grossly distorted. We have basically slandered our ancestors to keep ourselves from looking foolish. It's much easier to attack change per se, any kind of change, than it is to defend the existing non-system. We're dealing with an unpredictable monetary system that simply isn't viable and we have to do something about it.

The unwillingness to commit savings to long-term uses is profoundly serious. People simply do not trust the money. Chasing the elusive M's from week to week is not a solution, it's the problem. There is only one way that confidence in currency, once lost, has ever been restored and that's by adopting a gold guarantee.

Thank you.

(Applause.)

DR. FEULNER: Thank you both very much. To lead off our discussion, the format is as follows: We'll hear from David Raboy, IRET's director of research, and we'll open it up to comments and questions from the floor. Then at a pre-set time, which I will have to sit down and calculate, we will go back to our two main speakers for 10 minutes each of final rebuttal. David?

MR. RABOY: I just want to sum up a bit and make a few comments and then ask a few questions. I'm supposed to be sort of impartial. I'm not supposed to let anyone know what my position is, but the winner of this debate will receive the Milton Friedman medal.

(Laughter.)

Just a couple of comments to begin with concerning whether or not money is controllable and whether or not the Fed is responding to political pressures. You know, before the election, in that summer there was a large money supply blip, and that's kind of standard. We've seen the Fed do that before—try to throw a little liquidity into the system before an election. Then, after the president was elected—and remember that part of his economic program was one of tight and stable monetary policy—possibly coincidentally, you see this contraction in the monetary supply.

A little while later Murray Weidenbaum goes on television, and Secretary Regan is in the media saying, "Well, we've got this problem because this tight money is threatening the recovery." And lo and behold, money increases again. Then the president goes on nationwide TV, and

he says that the real problem is that money is loose and volatile, and mysteriously money comes down again.

I'm just wondering, though, and this would be one question that I would put to you two gentlemen, if the volatility of the money supply is, in fact, primarily political or is it due to some technical things, as Dr. Reynolds implies.

I am also interested in this gold standard that Dr. Reynolds discusses. He makes light of exogenous shocks under a strict type of gold standard. Yet there is some evidence in our history, for instance the Jacksonism era, that such shocks are not insignificant. There was a very severe contraction which was preceded by a very severe inflation during Jackson's presidency, and in retrospect, it seems that these changes were related to the trade situation between England and the Orient. The English had been purchasing tea and silks from the Orient, and paying with specie. Then the English discovered that they could pay not with silver and gold but with opium, and there was a large surplus of specie which flowed into Mexico and then flowed into this country. As a result, there was inflation, and then when England had some internal problems, English precious metal stopped flowing into this country and there was a very severe contraction.

Well, the type of gold standard that Dr. Reynolds suggests is different. He says if there are exogenous specie flows, we can realize it, we ignore them. If the Soviets flood the market with gold, if the South Africans flood the market with gold, we can ignore them. And what I'm wondering—and this is one question I would advance to you, Dr. Reynolds—is once this discretion is placed back in the system, in the hands of the Fed, aren't we back where we started, that is if the volatility of the money supply has political causes?

Then I would ask Dr. Meltzer to comment on whether or not he feels money is itself controllable, and what suggestions he would make concerning Federal Reserve operating procedures. For instance, I would ask him if he would like to put reserve requirements on mutual funds, money market funds, and that sort of thing. I would ask Professor Reynolds if it were possible—I'm sorry—Dr. Reynolds. You just got promoted.

MR. REYNOLDS: Neither one. My titles keep getting higher and higher.

MR. RABOY: If it were possible to institute a strict money rule where the monetary base grew at three percent or something like that, what would be the economic effects? Would price stability result from that? That will start it off.

DR. FEULNER: Who wants to go first?

MR. REYNOLDS: The last question's really the one to get my hands on. I don't think that the movements of M-1 are tightly correlated with the statements coming out of Washington. It's possible, but I don't think so. I think I've tried to get at it when I said if we could de-

fine a meaningful measure of M, predict velocity and so on, we'd know what would happen.

So suppose you were to say, prohibit the Fed from monetizing debt or limit the monetization of debt. That's a simple quantity rule. It's a negative. It doesn't really tell you what to do. It tells you what not to do. But I think there might be some virtue in that. If we try to quantify it suppose we quantify it at zero growth of the monetary base. What would be the effect? If the market believed that you were going to stick with that rule, the initial effect would be a Draconian deflation because of the collapse of velocity. The eventual effect might be price stability, maybe, but nobody really knows the right amount of cash. Only the market knows.

MR. RABOY: What about a statutory rule that said three percent per year?

MR. REYNOLDS: Of what?

MR. RABOY: Of the money base.

MR. REYNOLDS: The question then becomes a connection between the base and M, and between M and the nominal GNP, and how much of nominal GNP is price and how much is real. Too many questions. And all those linkages are getting slipperier every day.

DR. MELTZER: May I just respond to that question? The monetarists' proposals are very simple. We don't ask the Federal Reserve to do anything difficult. We ask them to control the size of their own balance sheet. They can do that from day-to-day, certainly from week-to-week, and undoubtedly from quarter-to-quarter.

I'd like to respond to how variable the velocity of the monetary base is. We've heard all this talk in the newspapers and Alan Reynolds repeated how variable monetary velocity is and how difficult it is to control money. We have done computations. Willy Fellner has done similar computations, Phil Cagan has done computations. So it is not just my word. Let me repeat to you what the annual rates of growth of base velocity are and what the variances are. For the 1950's, the quarterly growth rate of base velocity, annualized, was 2.92 percent; it was 2.2 percent in the 60's, a slower rate of growth, and 2.36 percent in the 70's. The average is 2.44 percent for the last three decades. The variability that we have computed for base velocity is in the range of 0.1 percent. We find no problem whatsoever in controlling the monetary base.

Any central bank could do it. The record of central banks that have tried is very clear. The Swiss control the monetary base. They manage to do it. No one has a problem defining the monetary base in Switzerland. There is no credibility problem about Swiss intentions. In short, base control works in Switzerland. There's no economy which is more open than Switzerland's. There's no economy with more money, as newspapers like to describe it, sloshing around, with money flowing in and money flowing out.

Do the Germans have a problem controlling money growth? For most years, they do not. What do they control? They control central bank money. What is central bank money? Central bank money is the monetary base.

Why did the Germans choose to control central bank money? I think the answer is interesting. There are two reasons. One, they wanted to put the government on notice that they did not intend to finance the entire deficit. The deficit has to be financed either by borrowing or by taking money from the central bank, increasing the monetary base. The central bank wanted to tell the government how much of the deficit they were prepared to finance, which could be translated into a number of dollars, or D-marks. Second, they wanted to put the labor unions and other price setters in the economy on notice as to what they were prepared to do. It is, if you want, a type of incomes policy, but a proper type of incomes policy. It is an incomes policy that tells people where to set prices and wages. It tells people what the expected rate of inflation is likely to be, what the government intends to do.

If we put enough regulations on interest rates, on reserve requirements, on other variables, we can make money difficult to control. Central bankers have made it difficult to control money. The problem is to make it easy to control money.

The government has imposed various kinds of restrictions that it can remove. The restrictions encourage innovations designed to circumvent the rules. Many of the changes we hear so much about are attempts by people to get around the controls that the government has imposed. If you impose a zero interest payment on demand deposits and you run inflation rates up to 12 percent, is anybody surprised that the stock of demand deposits goes down, that people discover that there are better ways to make payments? Suppose that we didn't impose controls. Would money be as difficult to manage? I don't think it would be, and the record of experience in other countries is that money is not out of control. Money growth is variable, there also, but people ignore the variability because they have confidence that the central bank, controlling the monetary base, will do what it promised to do.

Our problem is not simply that money growth is variable. It is less variable in the United States than in other countries. The problem is that when people see the variability in the United States they draw inferences about the future. When they see money growth go up, we know the inferences they draw: They believe it's going to continue to go up. And when they see it do down they say, "Well, perhaps it is going to go down. Perhaps the Federal Reserve will stay within the target."

The Treasury team with which I am pleased to be associated has made some estimates of the effects of variability. If we had had zero variability in money growth from quarter to quarter over the last 20 years, the very worst case is that the variability of GNP would have been smaller, not

much smaller, but smaller than it actually was. The reason that's the very worst case involves some technicalities. I'll be glad to explain if someone wants to know. Let me say that my own estimate, which is not complete, is that we could reduce the variability of GNP, with a constant rate of growth in the monetary base, to one half of what it has been, approximately, over the last 25 years. But under the very worst case we would not increase variability.

Under those circumstances, interest rates would be lower. The variability of money not only causes variability in the real economy, it causes variability of interest rates. Again, the Treasury team with which I am pleased to be associated has made some estimates. We conclude from the estimates that the current interest rates are four to six percentage points higher because of variability. Variability would not be reduced to zero under present control procedures, but we could reduce interest rates by two or three percentage points on the long end of the bond schedule.

Our choice is not limited to the present regime or some new system that will have very undesirable consequences. We have it within our power to do much of what needs to be done, by doing what some other countries do. The Federal Reserve must be made by the Congress to do what is in the public interest.

DR. FEULNER: Bruce Bartlett from the Joint Economic Committee.

MR. BARTLETT: Professor Meltzer, are you saying that if we had gotten the same money growth that we did in fact get, but we got it at a steady rate on average, then the current interest rates would be four to six percentage points lower than they are today?

DR. MELTZER: I said that if we compare the current record with the past, we find increased variability in monetary growth. I believe we could reduce those interest rates substantially, more than the two to three percentage points. But if we just return to the variability which we experienced before 1979, our estimates say that interest rates would today be two to three percentage points lower, or to put it another way, there's a risk premium of two to three percentage points in interest rates.

Why is that? The answer is, in technical jargon, because money is a random walk. People see large fluctuations. We're halfway through the year and we have about nine percent annualized growth. Who believes that money growth will stay at a two percent annual rate for the rest of the year? Suppose money growth is in the range of six to seven percent. Who believes that the inflation rate is going to go down permanently with that rate of growth? The risk of future inflation is high. That's why interest rates on long-term bonds remain high.

Now, I want to insist, again, that the gold standard is not a solution. There is a risk that the policy of disinflation will not be sustained because the cost is high. We should discuss meaningful steps to reduce that cost.

DR. FEULNER: Howard Segermark.

MR. SEGERMARK: Thank you, Ed. I wonder if we don't have a little problem here. First of all, on the question of academics, which is fascinating, never has truth been established by 50 percent of all academics plus one. Needless to say, I'm surprised that Allan Meltzer is putting himself in the company of such notable economists as Amati Etzioni when he talks about the international aspects of the gold standard.

I wonder if perhaps part of the problem that monetarists have concerning this isn't the question of demand. If in fact there is a change in the international situation concerning one currency before another, in this case Argentine or British currencies, and there is a shift out of those currencies into other currencies, there is no necessarily direct relationship to a change in the value of both (and let's suppose the United States did have a convertible currency). There are approximately two billion ounces of gold above the ground. For the value of that stock to change substantially—which is what would happen under Professor Meltzer's scenario for the Falklands crisis under a gold standard—you have to have a change in that gold stock if you're going to have a disruption in the monetary system. In fact, the only way the value of the world's gold stock changes is if there is a millennial change. If, for example, someone discovers a means of treating cancer with gold or if someone discovers a means of getting gold out of the Potomac at five dollars an ounce. In fact, that doesn't happen. One reason you pick gold is because, as Professor Roy Jastrum showed us in *The Golden Constant*, its purchasing power is extremely near constant, certainly far more constant than anything we can hope to have under the present system.

DR. MELTZER: All I can say, Howard, is that before the Argentine crisis the price of gold was fluctuating between \$300 and \$310 and maybe going lower, and now it's fluctuating around \$350. It's up 15 percent. Now, why is it up 15 percent? Well, if you believe the press reports, people in Argentina believe the war is going to be followed by a period of instability. Now, they may be wrong. That's their conjecture. But they bet on it by demanding gold. The increased demand raises the price. The price has gone up by 15 percent.

Of course if we pegged the price, the price wouldn't go up. What would happen? People would draw on the U.S. gold stock. Why? Because there would be an increase in the demand for gold with no increase in the supply and we would be the residual supplier at the existing price. If we're not willing to sell gold to everybody in the world at a fixed price, then goodness knows we'll have a hard time keeping the price of gold pegged at \$300 or whatever number is chosen.

DR. FEULNER: Briefly.

MR. SEGERMARK: A little follow up, and that is in relation to a statement you made at the Gold Commission Hearings, Allan: your accusation that a gold standard is a supply rule. Of course it is not a

supply rule. If in fact the demand for dollars (in this case dollars are convertible into gold) shifts out and people want more dollars, in order to maintain a stable gold/dollar relationship there would have to be more dollars in the system. Under the monetarist rule, if in fact there is a world demand shift for dollars and the monetarists hold tight to their rule, what happens? You have a real change in the value of the currency instead of the supply and you have a real impact on the economy.

DR. MELTZER: I understand that by a supply rule you mean the idea that you're going to set the supply of base money. In this case, the central bank controls the base by buying or selling as much gold or as little gold as people want to exchange.

MR. SEGERMARK: No, no, no. Supply of gold is not relevant to the value when you peg it to dollars.

MR. REYNOLDS: I think I have to translate here, as I often do, between goldbugs and monetarists. We're talking about a ratio between dollars and gold. The fact that the Argentines want gold isn't relevant. The question is how many dollars do they have to offer for it? How do they acquire those dollars? They trade pesos. If they want to dump pesos in order to get dollars to get the gold, then of course the peso will sink and so on. But the implication that every time somebody wants gold we just give it to them is wrong. We give it to them only for dollars. They get dollars only by giving us claims on their goods.

Run through some exercises. Suppose the Soviet Union dumps its entire gold hoard in order to acquire dollars. What are they going to do with the dollars? They buy grain. Well, that may have an inflationary impact in its initial round. Grain prices will go up. When people see inflation, gold becomes a relative bargain. Its price is fixed. They convert: They then turn in the excess dollars and get gold. All that ends up happening is that Americans are holding the Soviet gold and the Soviets are holding the wheat. Under the existing system it's pretty much the same except the Soviets hold wheat and we hold their IOU's. That's really dumb.

DR. MELTZER: Well, let's just follow that up. I mean, what is the outcome of that whole set of steps that you—

MR. REYNOLDS: Zero inflation.

DR. MELTZER: Of the gold price. But what about other prices? If there's a supply shock to wheat, if there's an increase in the demand, there's—

MR. REYNOLDS: If there's a change in the terms of trade, there will be a change in the terms of trade—regardless of monetary system. You can't change the terms of trade by altering the unit of account. . .

DR. MELTZER: Let's let some of these other people come in.

DR. FEULNER: Okay.

MR. REYNOLDS: I don't believe you can believe that.

DR. FEULNER: Let's make our final points when we come back for our final rebuttals if we can.

MR. RABOY: Weintraub must have something.

MR. WEINTRAUB: I would like to ask Alan Reynolds a question. I think I understand what Allan Meltzer wants. He wants to control the monetary base. I listened to Alan Reynolds and I must say I hesitate to reveal my ignorance about what you were saying, but at some points it seemed to me you want a fixed price of gold, but fluctuating exchange rates—that's what you're saying about the peso dropping and so forth—and then you had a very funny kind of monetary rule that I wish you'd straighten out. It sounded to me like something once proposed by one of my previous bosses, Wright Patman, who in the 1930's sponsored legislation that would have controlled a price level. He picked the Wholesale Price Index. He wanted to have enough money printed to bring the index back to the 1926 levels in 1933—a reflation, so to speak, which is what you appear to be in favor of—and thereafter he would have let money grow two to four percent per annum. He defined money strictly as currency. Today some might do it as the base, or some others might do it as M-1. I don't think it really matters too much.

I'm trying to figure out where you're coming from. Do you want to control the price of gold or a commodity price index like the Wholesale Price Index? Which of these things is it that you want to do, and what are you saying about exchange rates? Is the Argentine peso to float vis-a-vis the dollar, or are you going to fix it?

MR. REYNOLDS: Fair enough. No problem. First of all, when you're talking about stabilizing a price index, I just use that because people find that easier to handle than gold. I can't envision gold going up to \$500 without a general inflation taking place either very soon thereafter or simultaneously. Gold is a very sensitive barometer of "excess demand." It's a very stable measure of value, not only at the present time but in the future.

Use a wholesale index? No, it's too slow, too inaccurate, too broad. I'd prefer a fast commodity index. Something like the *Wall Street Journal's* index, the *Economist's* index, the Commodity Research Bureau's index. I don't care. Pick one. To stop a deflation in the index is *not* to reflate. I would not agree with Wright Patman. To stop a deflation is to stop a deflation. It's to stabilize. Then if you see the prices start to rise for a month, for two months, you move in the opposite direction—tighten.

Monetary policy can only do one of two things: It can control the quantity; it can control the price. I'm suggesting that, because the quantity is becoming more and more ambiguous, the monetary authority should focus on price.

MR. WEINTRAUB: If your index drops below your trigger level, do you not reflate?

MR. REYNOLDS: Not reflate, stop deflating. I don't know what you mean by reflate.

MR. WEINTRAUB: Trying to get it back up to the level that you wanted it.

MR. REYNOLDS: Suppose I give you a hypothetical scheme using gold.

MR. WEINTRAUB: You set it at 100 today. Let's see what happens in 1994.

MR. REYNOLDS: Suppose we put a floor and ceiling on the gold price—I'll give you something you can shoot at here. Okay?

MR. WEINTRAUB: Okay.

MR. REYNOLDS: An initial floor of \$300 on gold and a ceiling of say \$400.

MR. WEINTRAUB: \$400?

MR. REYNOLDS: \$400. Herb Stein's idea, my number. Pretty wide band. All right? The \$400 ceiling gives you some assurance that at some point we *are* going to tighten. All the conventional Fed tools can be brought to bear, raise reserve requirements, hike the discount rate, sell bonds. Later, we'll narrow the range toward a single price.

MR. WEINTRAUB: I have to ask a question, if I might here. How do you make that operational? Because as a speculator, knowing that that's what the Federal Reserve is going to do, I'm going to be in that market with a standing order to sell short at 399.9 and to buy more at 301.1.

MR. REYNOLDS: Well, maybe we won't tell you what we're going to do. We'll just do it. Gradually tighten as the gold price rises, and vice-versa.

DR. MELTZER: Whoops. Won't we have some expectation? Or are we just going to increase the variability of our—

MR. REYNOLDS: Wait a minute. The function obviously of what we're trying to get at is to grope towards a single price at which there's no inflation or deflation.

DR. MELTZER: Assuming that there is such a price.

MR. REYNOLDS: You have a re-entry problem. Well, there is such a price. By definition there is with a broad enough index, and with a narrow enough index we go back to the question, which I think is the main one between us, of whether or not gold is a reasonable proxy for prices in general, whether it's a reasonable measure of long-term purchasing power.

MR. WEINTRAUB: Suppose you have a secret price. Is this somehow going to be hidden from the public for—

MR. REYNOLDS: No, I'm trying to find that price. We have a re-entry problem. It was always easier before because there was some other country on gold, so you could pay them.

MR. WEINTRAUB: Where are the prices found? When you find it, will I know it?

MR. REYNOLDS: Oh sure. At that point we have a—

MR. WEINTRAUB: Then I have a standing order to buy at one penny above that price and to sell at one penny below your selling point when you have the Fed selling securities. You're never going to get to your triggers.

MR. REYNOLDS: You might make a penny that way, but there's more opportunity for speculators to push toward the middle of the range, helping us find the right price. What you're saying is that you can't operate a gold standard.

MR. WEINTRAUB: I am not saying that at all.

MR. REYNOLDS: I'll make the observation that it has been done. It is no harder than stabilizing interest or exchange rates, which has also been done.

MR. WEINTRAUB: Not that way. That's not the gold standard as I understand it.

MR. REYNOLDS: A gold standard eventually is a price. I'm trying to find the price and then we'll stick to it. Where will it be? Three and a quarter? I don't know.

I didn't answer the question about exchange rates. Excuse me. I don't favor imposing fixed exchange rates on anybody. It seems to me in a world with a solid currency—

DR. MELTZER: Except on us.

MR. REYNOLDS: No, no. We didn't impose fixed exchange rates under Bretton Woods. Other countries peg to the dollar. If they chose to peg to the dollar, and I think they surely would, then you would have a gold bloc as we have always had, and that would solve your multilateral problem. Over 40 countries still peg to the dollar, though it's hurting them now.

MR. JENKS: I'm Joe Jenks with Abbott Laboratories. Dr. Meltzer, if you were Volcker today, faced with what we're faced with now—and supposedly the Administration and Volcker are on the same track, but this volatility gets lost in the shuffle here—what would you do today to turn this economy around?

DR. MELTZER: If I were Volcker?

MR. JENKS: Right.

DR. MELTZER: That's not a hard question to answer at all. I would remove the lag reserve accounting and other steps which cause short term variability. I would stop trying to estimate the demand for money or the demand for borrowing and the influence of interest rates. I would announce publicly what the path for total reserves of the monetary base would be for the next six months. Those aggregates are items on my balance sheet, I would make damn sure that I hit the target every

month, month in and month out, I expect that at the end of six months that people would have greater confidence that I intended to do what I said I was going to do.

MR. REYNOLDS: For the next six months.

DR. MELTZER: I would have a decelerating path for money. If we had five percent last year, we would not have more than five percent this year. We would have one percent lower the following year, and I would show them that I was able to deliver exactly what I said I was going to deliver. Then expectations would improve. Income variability would be smaller, interest rates would be lower, as they have been and are in other parts of the world.

MR. JENKS: Do you think that doing that, and disregarding fiscal policy and the fact that the government is borrowing almost half of what's out there to borrow, you'll get the rates down? Do we have to do something on a fiscal basis?

DR. MELTZER: It would be helpful if we reduced the size of government. That's a separate issue. The deficit issue is, I think, one of the most misunderstood issues. People talk about the interest payments on the national debt, but that's mainly a return of capital. The critical issue here is the relative size of government. When that issue is resolved the economy will have a higher real growth rate if it uses its resources more efficiently.

The main issue about the size of the government is this. How efficiently do we use our resources? Monetary policy, leaving aside the transitional problems, is primarily about the rate of inflation. As Chairman of the Fed—that was the position you put me in—I would reduce the rate of inflation to zero and keep it as close to zero as I could keep it. I don't believe that there is anything difficult about that as long as the political process allows me to do that.

We will have higher growth if we use resources more efficiently. That has to do with the effective tax rates and the size of government. We will have lower growth if we have less efficient use of resources. That's why the other parts of the Reagan program are important: deregulation, reducing the size of government, making more efficient use of our resources.

DR. FEULNER: Yes sir.

MR. REAM: Roger Ream of Congressman Ron Paul's office. Both speakers seem to assume that the objective of monetary policy should be price stability, whereas I see it as being a stable quantity of money, not stable prices. And in the example of Soviet Union, say they are selling gold in order to get dollars and buy wheat, they increase the demand for wheat. Wheat prices rise. There's not a general increase in price levels because presumably if the price of wheat rises, people spend more money on wheat, less on other goods and those prices fall.

MR. REYNOLDS: We printed money to buy the gold. I was assuming that that's the case.

MR. REAM: Okay, but if we didn't.

DR. MELTZER: Let me go back to your main point.

MR. REAM: I'd like to ask you what you think the object of monetary policy should be, stable prices or stable quantity?

DR. MELTZER: The objective of economic policy in any civilized country is to reduce the risks which people have to bear to the minimum amount. That should be our goal.

Now, what are those risks? They are the risks of price variability and output variability, employment variability and interest rate variability. That should be our objective. Monetary policy cannot do very much about all of those on a long-term basis, but it can make sure that prices vary as little as possible, given the world in which we happen to live. It should not be to try to keep the quantity of money fixed. If you could conceive—as I think you would have difficulty doing—that with a very, very wide range of variability in the growth rates of money we would have greater price stability and more real output growth from the same amount of resources, I would be in favor of having a variable quantity of money.

MR. REAM: I would just challenge that assumption that it's the role of government to try to reduce risks.

DR. MELTZER: No, no, to the minimum. Not to shift risk from one person to another which may be what you hear, but to reduce it. We have insurance contracts, we defend our country, we have other arrangements. What is the purpose of defending our country? It's to reduce the risk of foreign interference. I want to reduce the level of risk, not to shift it from one person to another.

DR. FEULNER: Yes sir.

MR. ROBBINS: Yes, I have two questions for Mr. Reynolds. It seems that you've proposed two very different gold standards. The historical example you gave was when the currency unit was defined as a specific weight of gold. That was the example that led to currency destabilization, but you also came up with this price range of \$100 as your proposal. Is there any historical precedent for that, and which type of gold standard are you actually advocating?

MR. REYNOLDS: The \$100 range is only a first step. It's a question of transition, how you get from where you are to where you're going. I am ultimately advocating convertibility, meaning that people can convert within practical limits—maybe you want to put a minimum amount on it. Maybe you want it to be just international like Bretton Woods was. People can still convert dollars and gold through international commerce. The two become virtually interchangeable at the margin. In point of fact people very rarely do convert. It's just there as an

error signal. When you are printing too much money, you begin to see some people trying to convert and conversely when you're deflating.

Let's take some realistic examples. In '29, '30, early '31, gold was flowing in at a very rapid rate. Had we played by the rules of the game, that should have told us that we were in incipient deflation, as indeed we were. And then in the 60's gold was flowing out—we violated the rules again and abandoned them. Rules will be violated; it is true. I want a long term rule. If I could be persuaded it could be done in terms of a quantity, fine, but six months isn't a long enough period of time. That is to say I want something that tells me that I'm going to have a stable unit of account over a 10, 15, 20, 30 year period so we can revive the mortgage market, so we can revive the long-term bond market, so there can be some confidence that a dollar today will not be worth a dime 10 years from now. That's all we're trying to get at.

I'm purposely not narrowing it down. I want as much convertibility as I can get as soon as I can get it, and if you want to supplement it with various monetarist devices, like lagged reserve requirements, that is a good idea. I think that a month or so ago, maybe a couple of months ago, the Shadow Open Market Committee reported that *in addition* to considering a commodity standard, the Administration should consider other things. They list about 10 items, like lagged reserve requirements, floating the discount rate, etc. You give me convertibility and I'll take the rest, because I have no great quarrel with any of those technical adjustments.

I just want a long-term institutional rule, put it in cement as best we can so that we can plan ahead. I thoroughly accept Meltzer's point, that the function of monetary policy, and of fiscal policy, is to provide a stable institutional framework in which people can make plans and decisions and not be surprised. That's the whole idea.

MR. ROBBINS: Do you think institutionally the gold rule is somehow going to be more long lasting than a quantity rule?

MR. REYNOLDS: It has been observed to be so. You're really talking about a hypothetical system when you talk about a quantity rule.

MR. ROBBINS: That implies that there was a time we were on a quantity rule.

MR. REYNOLDS: No, some countries have tried it: France in 1919-25. In the year 1925, they changed the quantity four times. It became like the U.S. debt ceiling: "Whoops, we bumped up against it. Let's raise it again."

Switzerland is supposedly monetarist, yet M-1 rose 23 percent there in 1978 and fell 7 percent last year.

MR. ROBBINS: Why is the gold rule going to be somehow institutionally more long lasting? I mean why is one—

MR. REYNOLDS: Do you mean has it been *observed* to last longer?

MR. ROBBINS: In the past.

MR. REYNOLDS: In the past, and even in the recent past.

MR. HAMBURGER: Well, of course, we haven't tried the monetary rule in this country. You talk about France and about Switzerland, but I don't think we ever tried the monetary rule here. Can you speak to that?

MR. REYNOLDS: I would think if I were sitting in your position—

MR. HAMBURGER: Have we ever had a monetarist monetary policy in this country?

MR. REYNOLDS: If I were in your position, I would ask myself two questions: "If not now, when, and if not us, who?" If this Administration won't implement a monetarist policy, I think we have to consider a quantity rule a joke.

MR. HAMBURGER: Okay, have we ever had a monetarist monetary policy in this country?

MR. REYNOLDS: No, but you could at least try.

MR. HAMBURGER: Because I thought you started out blaming some of the problems we've had and some of the problems you've observed in the world on monetarism. Some of your writing suggests that part of our current problems now are the result of monetarism.

MR. REYNOLDS: Yes.

MR. HAMBURGER: But, if we haven't implemented monetarism yet, I don't know how monetarism—

MR. REYNOLDS: Well, the problem with monetarism, as I see it—we will all agree that it's not done well, okay? But policy is surely paying more attention to measures of money, less to results.

MR. HAMBURGER: No, I'm not asking whether it's done well. Has it ever been tried?

MR. REYNOLDS: Has monetarism ever been tried?

MR. HAMBURGER: Yes.

MR. REYNOLDS: You mean in this country? It depends on how you define monetarism.

DR. FEULNER: That's the question for the day.

MR. REYNOLDS: Well, look at this. I mentioned that we've got four or five monetarists in this room. As far as I know they have different lags and different M's.

MR. HAMBURGER: I doubt it.

MR. REYNOLDS: There's a different policy for each one. Well, maybe you can get together and decide on some M, and M, arbitrarily. Professor Meltzer raised the whole objection just a minute ago. He said that there's some interest rate at which you can drive M-1 down to virtually zip. Why? Because all the money will go into money market funds, overnight RP's, and overnight Eurodollars. I think that's right. And the trouble that it poses for the base is that the high interest rate not only gives people an incentive to economize on their M-1 balances, and therefore M-1 becomes artificially low, it also gives the banks a

very strong incentive to minimize their reserve requirements, and they're getting very clever about it. Therefore, the relationship between base and nominal GNP gets very slippery. First quarter '81: 3.8 percent growth in the base. What happened to nominal GNP? Up 19.2 percent. Second quarter; base 7.8; nominal GNP, 4.7.

MR. HAMBURGER: You said awhile ago you're concerned with 10, 15, 25 year stability. Now you're worried about one quarter—

MR. REYNOLDS: But Meltzer just told me that these wiggles are the whole reason long-term rates are up. I don't believe that.

DR. FEULNER: Okay. Alan why don't you hold your comments there for final rebuttal? Joe Cobb do you have a question?

MR. COBB: Yes. I'd like to ask Allan Meltzer. It seems to me that the debate here has shifted a little bit away from the economics of monetary policy per se and more into the politics of institutional behavior. I think everybody in the room agrees that we have to figure out some way to compel the Federal Reserve to behave itself. How it should behave or what rules it should follow would be debated.

Now, the question is: If Meltzer agrees that the Fed hasn't followed monetarism and if Reynolds agrees, of course, that the Fed is not following the gold price rule, is there any way that we can actually assure that the Fed might follow a steady growth in the base? I've thought often that maybe if zero were the rate of expansion of the Fed's liability, you could actually monitor it from week to week to see if it was doing it. What do you think of that idea?

DR. MELTZER: I would accept it at zero.

MR. COBB: Zero.

DR. MELTZER: Zero. That's right. I think the transition would be difficult but I don't care much what the constant rate of growth is, if it is in a non-inflationary range. I don't see any reason why it's any less difficult to monitor zero than it is to monitor one percent or two percent. If we could agree that it should be zero, that there simply will be no change in total base money, that would be acceptable to me. Any rule would be better than what we now have because it would reduce variability. But some rules would be better than others.

Zero growth would be acceptable as a substitute for the system that we now have. If you just read the press you learn that no one knows what the rate of money growth or base growth is going to be. Some say, "It's very high in April. It'll be down in May." Why will it be down in May? What confidence can you have that it will be down in May? I don't have any confidence that it'll be down in May. As a matter of fact, it may be up in May more than it was in April. We have no basis for making those assertions. Money is a random walk.

MR. COBB: If you were Chairman of the Fed, installed tomorrow, how long would it take you to get from a transition to a zero point?

DR. MELTZER: To get to a constant growth rate, let us say—

TOWARDS A STABLE MONETARY POLICY
Debate between A. Meltzer and
A. Reynolds (Heritage Foundation)

COBB: No, say zero.

MELTZER: Any constant growth rate. It would take a little to remove the impediments, like lag reserve accounting, and the borrowing rules.

: Congress _____

MR: No, those do not require Congressional action.

within the control of the Fed. So give me a month, two

of those changes, and get them accepted within the

After that we just will simply put out the amount

of a month, whatever you want, that is required.

controlling the size of the Fed's balance sheet.

men, we've reached the magic hour. I would

to now give us his closing statement in 10

in order. Mr. Reynolds first.

MR. REYNOLDS: I think the thing I didn't deal with enough was the international aspect, except to answer the Soviet Union kind of question. To me the oil shock was not entirely a real phenomenon. The dollar price of oil had something to do with the value of the dollar, after all, and when we had a combination of price controls on energy and ran up a rather horrendous inflation at the same time, the dollar price of oil soared like the dollar price of many, many scarce commodities. We had ourselves a problem. This was apparent in 1972 and 1973, long before the Arab embargo.

The kinds of disturbances that you have associated with wars come about because wars are perceived of as inflationary, and indeed England might reflate if it were to get in to a war and that would affect us. The hope that one can somehow insulate the United States against foreign disturbances is, I think, an illusion—and not a very healthy one in the sense that it's divisive among nations. Of course, I favor an international monetary system. That's the whole point. Someone has to take the initiative. It obviously, I think, has to be the United States, although I have spoken of other countries, such as Canada, about taking the lead.

I wanted to talk about the history of the gold standard a little bit as well. In the kinds of discussion that you get in the Annual Report of the Council of Economic Advisors—and I exempt Bill Niskanen because he was obviously on vacation when they wrote that section—they do things like use the ancient Wholesale Price Index as a measure of the value of money. That price index, the Warren-Pearson Index, was computed from New York newspapers and it is very heavily weighted with agricultural commodities. I think it proves conclusively that the price of wheat went up and down under a gold standard, as it does today, but it doesn't really prove that the value of the dollar did. And to compare that ancient index with a modern producer price index is deliberately deceptive.

Another thing that's quite deceptive is to talk about the entire post-

war period and to say, well, in the post-war period prices and incomes were more stable than they were under the classical gold standard. That's of course true, but most of the post-war period consisted of a time in which the dollar was convertible into gold internationally and in which other countries were pegging to that gold-based dollar—in other words an entirely different regime. And if you want to make a relevant comparison, you have to start the comparison with '68 or '71 and talk about what's happened since then. If you do that, you find considerable price variability, almost no real income growth per person or per worker, and a pretty anemic performance worldwide ever since we've abandoned these rules.

There is always an insinuation when we talk about the ancient history of the gold standard, that every crop failure, every bank failure was connected to the gold standard. In point of fact, that's not true. It doesn't show up in Friedman and Schwartz or anyone else who looked at it seriously.

It turns out that Victor Zarnowitz has done some work on the period and he found that three of the recessions that we used to think happened during that period simply didn't exist. When you pull them out, you find that the average expansion was about 39 months rather than 22 as one thought. That was a pretty fair performance. It was a lot of real growth, a lot of prosperity, considering the fact they had no deposit insurance, they didn't have a huge stable service sector as we have today, they had no central bank or discount window, they had no unemployment insurance, and so on—considering those disadvantages I think it's quite wrong to slander our ancestors. I think they had a feeling for some of these institutions which we should have held onto. We've lost something.

One of them was the balanced budget rule. That was something that was felt by the people. Government was violating something if it ran chronic deficits. I am not particularly concerned about it from an economic point of view. I think our numbers are phony. That is to say that, if we inflation-adjust the government's balance sheets, we find out that some of the deficit is not real.

But nonetheless these institutional rules served the purpose. Fixed exchange rates served a purpose. Gold convertibility served a purpose. If we are to re-establish some kind of rule, it has to be one that is credible, that people will believe. It has to be one that is difficult to violate. And in my judgment, looking at history, and I've looked at quite a lot of it, I think that has to be a gold standard of some sort.

(Applause.)

DR. FEULNER: Allan Meltzer.

DR. MELTZER: Not long ago the National Bureau of Economic Research had a gold standard conference at which a large number of economists, including Professors Barro, Stockman, Mundell, Friedman,

Schwartz, Brunner, and me, looked at the experience under the gold standard. There were papers from various countries, most of the principal gold standard countries. The record of that period is the only relevant history we have of the classical gold standard from 1870-1914. The record just does not bear out the claimed properties of the gold standard.

Countries had price stability even though they violated the gold standard rules frequently. Some countries didn't have price stability even though they stayed on the gold standard. There is not a record of consistent performance during that period. What is true, and that is about all that is true about price stability under the gold standard, is that between 1870 and 1914 the price index crossed the same point twice. In between, prices in the U.S. rose at a rate of about three percent a year and they fell at about a rate of three percent a year. They managed to come back to where they were before.

When Alan Reynolds talks about the gold standard, he tells about the wonderful things that might happen. When he tells us what will happen, he points to two things. He said it's a guarantee, and it is efficient. A guarantee of what? A guarantee of the price of gold. That's all that is guaranteed by the gold standard. Over some long period, if you believe that a rise in the price of commodities will bring forth sufficient production of gold to eventually restore the price level to what it had been during some period before, then we can say that there will be price stability. That means long-term price stability, perhaps useful for building railroads, not very important for the kinds of things that we produce in the modern world.

He tells us that, in addition to being a guarantee of the price of gold, the gold standard would be efficient. Efficient at what? Efficient at telling us about the price of gold.

I don't believe the gold standard solves the problems of modern economy adequately. One problem that we ought to discuss is how we sustain a system which gives us the benefits after we pay the costs of disinflating. That's our current problem. It is a serious and important problem.

There is a second, related problem. After we have paid the costs and returned to a more stable economy, how do we make sure that it all won't happen again. That requires institutionalization. Here Alan Reynolds and I find common grounds. We ought to be talking about the balanced budget amendment or some substitute for the balanced budget amendment that will encourage stability. I would personally favor an enactment of the balanced budget amendment.

That brings me to my last point. Alan Reynolds says we attribute every shock in the world price of wheat and all these other things during the 1870's and 1880's to the operation of the gold standard, but he attributes all of the problems of the 1970's to the operation of the monetary system. Of course, that's not true. We had the oil shock. We had the rising size of government. We had a large number of problems that

occurred during that period which did not reflect directly the operation of the monetary standard.

We face some serious and important problems. We should be discussing how we can get from where we are to where many of us would like to be—an economy with more growth and no inflation. The gold standard is not the best way, in my opinion, to get there. The gold standard is an idea whose time has passed.

DR. FEULNER: Thank you both for a very stimulating and provocative session. Everyone will agree that it was lively and fruitful and expanding in terms of our own horizons. The proceedings today will be transcribed and published, I would guess, within six to eight weeks, and I hope that you will enjoy reviewing them at that time. Thank you all for being here.