A.B. Laffer Associates

Economic Study

REINSTATEMENT OF THE DOLLAR: THE BLUEPRINT

by Arthur B. Laffer

The issue of a gold based monetary system has again come of age. The impulse originates in the debacle of the current system in which inflation and rising interest rates have reached epidemic proportions. The threat of monetary disintegration provides fertile ground for a radical change in the world's monetary system; an early reinstatement of the dollar as a world currency convertible into gold no longer is inconceivable. The pressing issue is whether a return to a gold standard will be used to avert a financial collapse or come in its aftermath.

Restoration of a link between gold and the dollar does not, *per se,* guarantee stability. Done improperly, such a policy change could cause enormous dislocations to the economy. The blueprint for a successful return to dollar convertibility, presented here, includes a transition period to assure that it is the gold market, not the economy, that makes the initial adjustment inherent in a return to a gold based monetary system. "Safety valves" also are provided to minimize the chances of altercations in the gold market being forced upon the economy as a whole.

This paper makes extensive use of Federal Reserve Chairman Paul Volcker's ideas as found in the 1972 U.S. proposals to the International Monetary Fund.* By virtue of his position, Volcker is key to reinstatement of the dollar. Implementation of such a policy change would spur growth in real output, personal income and corporate profits. Stockmarkets throughout the world would rise and interest rates fall in recognition of the benefits that would accrue to the global economy and political order from the U.S. reaffirming its responsibility to provide a stable, world numeraire.

February 29, 1980

*See also: Charles W. Kadlec and Arthur B. Laffer, "The Monetary Crisis: A Classical Perspective", A.B. Laffer Associates, November 12, 1979; and James C. Turney, "Gold", Economic Study, A.B. Laffer Associates, January 25, 1980.

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REINSTATEMENT OF THE DOLLAR: THE BLUEPRINT

by Arthur B. Laffer

From Anthony Solomon's commencement address as newly appointed President of the New York Fed to Ronald Reagan's political rhetoric, the issue of a gold-based monetary system has again come of age. The current monetary system has, since its link to gold was severed, been an unmitigated debacle. Interest rates and inflation rates are hitting new highs virtually on a daily basis. Unemployment rates bottomed out quite some time ago at levels well above the "full employment level" and now are ascending even higher. At the same time, exchange rates, investment rates and growth rates are sinking to new lows.

A brief revisitation of the economic events surrounding the full demonetization of gold and the unhinging of the dollar illustrates the extent to which the monetary system has descended. The U.S. withdrawal from the gold pool and the elimination of private dollar convertibility into gold occurred in March of 1968. The establishment of a fully inconvertible dollar began August 15, 1971. While these two dates present a false sense of precision, they are nonetheless good points of demarcation for what was actually an emerging process. When juxtaposed against the previous period, the calendar years following these dates offer a starkly vivid picture of the decline of the American economy. In 1967 the official price of gold was $35 per ounce and traded at that price in private markets. By 1970 that price had risen to $47 and currently is in the range of $625-675. This rise reflects an eighteenfold increase in some thirteen years.

Other economic indicators display similar patterns. Inflation as measured by the Consumer Price Index rose from a 3% annual rate in 1967 to 5½% rate in 1970 and then surged to the 13.3% rate experienced in 1979. The pattern of three-month Treasury bill rates parallels the inflation movements remarkably well. In 1967 these three-month bill rates averaged 4.3%. By 1970 they averaged 6.5% and as of the writing of this paper are in the neighborhood of 13.8%.

In tandem, the dollar fell in value when measured in terms of German Marks, Swiss Francs, and several other currencies. In 1967, four Marks exchanged for one dollar as did 4.3 Swiss Francs. By 1970 the ratio had become 3.6 Marks and still 4.3 Swiss Francs. As of February 21, the full extent of the dollar collapse could be seen in that now dollars could be purchased at a price of only 1.74 Marks and 1.64 Swiss Francs.

The real side of the economy has suffered as well during the monetary collapse. The rate of unemployment stood at 3.8% in 1967. It rose to 4.9% in 1970 and now resides somewhere in the range of 6.2%. The Dow Jones industrial average in dollar terms today is roughly at its 1967 level. The decline when measured in units of purchasing power has been extraordinary. Even the federal deficit has become engorged over these years. In 1967 the red ink totaled $8.7 billion; in 1970 it was $2.8 billion; and in 1979, it stood at $27.7 billion.

THE RETURN TO A GOLD STANDARD

It is hardly surprising that, whatever its merits, the current monetary system is being barraged with heated assaults. Unless quickly rectified, which seems highly unlikely, the current state of monetary chaos appears to be a fertile breeding ground for a radical alteration of our monetary system. An early return to a gold standard is no longer inconceivable. In my view, the probabilities that the U.S. will return to a convertible dollar have become high enough to justify describing the likely shape and implications of a specific program to restore dollar convertibility. Of some concern is whether the return to dollar convertibility will avert a financial collapse or come in its aftermath.

A return to a gold standard should not be embraced impulsively nor implemented by surprise. Done improperly, dollar convertibility could cause egregious dislocations to the financial markets and the economy. If the price of gold were to be set too high, for example, inflation would continue to rise. Interest rates would reach new highs. If, on the other hand, the price of gold were set too low, the price level would fall, leading to deflationary pressures throughout the economy. Moreover, if the technical aspects of the program were defective, announcement of a return to dollar convertibility could create a speculative run on U.S. gold reserves that would abort the attempt to restore gold backing to the dollar.

A properly designed program should have as its initial goal the stabilization of prices generally at or near their current level. Secondly, the program must be credible and workable. And finally, it should be designed to protect the general economy from shocks to the gold market *per se*, disturbances that have nothing to do with monetary policy. Stated simply, a workable system of gold/dollar convertibility must not permit the economy to experience wrenching adjustments because of changes in gold. If shocks to the gold market do occur, any responsible system must permit the price of gold to do the adjusting. Therefore, safety valves must be included.*

As newly appointed Chairman of the Board of Governors of the Federal Reserve System, Paul Volcker's term does not expire for almost seven years. Any radical change in our monetary order, therefore, presumably would require not only Volcker's acquiescence, but more likely his enthusiastic support.

Based upon his posturing since the late 1960s it is, in my opinion, quite conceivable that Volcker could actually lead the search for a new order. While Undersecretary of the Treasury during the hectic monetary gyrations of the early 1970s, Volcker was reported to be the last to abandon the need for maintaining the dollar's convertibility into gold. In fact, it was rumored that even after the enormous dollar devaluations, Volcker expected and argued in favor of a return to convertibility.

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*This point explicitly addresses the reasonable criticisms as reflected in comments by a number of observers. Especially noteworthy are the *Wall Street Journal* columns by Lindley Clark.

Volcker is, in my view, the most knowledgeable high-ranking bureaucrat on monetary affairs in the United States. His history at the U.S. Treasury goes back to 1951 and covers positions such as Undersecretary of the Treasury, President of the New York Fed and now Chairman of the Board of Governors of the Federal Reserve System. He was one of the singlemost involved operatives in each of these positions.

Moreover, Volcker singlehandedly carried out the negotiations with the international community throughout the entire monetary reordering of the world in the 1970s. Of quite some importance, in my view, is the fact that the design of "The U.S. Proposals"[1] presented at the Nairobi International Monetary Fund meetings in 1972 was attributed to him. As the principal U.S. representative to these meetings, then Treasury Secretary George P. Shultz, formally presented the proposal.

THE BLUEPRINT

Given my perception of Volcker's native inclinations and the U.S. proposal at Nairobi, one could well imagine a reordering of the world's monetary system and the reemergence of gold convertibility in something of the following form:

The U.S. would announce a double-faceted program providing for the restoration of dollar convertibility into gold. The first part of the program would allow a transition period designed to permit the gold market in particular, and financial markets in general, to adjust to dollar convertibility before its implementation. The need for such a period was widely recognized in 1972. "The U.S. Proposals" stated:

> "We merely want to note that some generally acceptable transitional arrangements are necessary. This transitional problem is not unique to the proposed system. Any monetary system based upon concepts of equilibrium and convertibility will require special measures to deal with transitional problems."[2]

The second part of the program would provide the requisite technical specifications necessary to make the new monetary system workable and credible. As in 1972, the proposal outlined below visualizes

> ".... a system in which disproportionately large gains in reserves for a particular country indicate the need for adjustment measures to eliminate a balance of payments surplus, just as, in any system of convertibility into reserve assets, disproportionately large losses of reserves indicate the need for adjustment to eliminate a balance-of-payments deficit."[3]

The transition phase would encompass the following policy initiatives:

- The U.S. would announce its full intention of returning to a convertible dollar at some prespecified time in the future; say three months.

- At the time of this pre-gold price fixing announcement, the U.S. also would provide the financial markets with as much potentially relevant information as could be made available. Gold and other metal stockpiles would be enumerated precisely. This would require a resurrection of the Treasury's gold budget, which was abandoned in the early 1970s.

- The U.S. could announce that during this three month interval neither the Federal Reserve nor the U.S. Treasury would intervene in the foreign exchange markets or have any net intervention in the open market. Net loans of reserves to member banks in the Federal Reserve System through the discount window would also be frozen at their current level. Stated simply, during this three month interval, the Federal Reserve and Treasury would "take a vacation" so as not to disrupt the natural forces in the private market. The monetary base would, as a result of the absence of actions, remain literally unchanged during this three month interval.

The same announcement would outline the actual exchange mechanism linking the dollar to gold. It would read something like this:*

- Three months hence, the Federal Reserve has been instructed to establish parity between a dollar unit of its liabilities (currency in circulation and member bank reserves) and a fixed quantity of gold at that day's average transaction price in the London gold market. This will be the official value of the dollar and price of gold. From thenceforth on:

- The Federal Reserve will stand ready to sell gold to all demander's at a price 0.7% higher than the official price in exchange for units of its liabilities (Monetary Base).

- The Federal Reserve will stand ready to purchase gold from all sellers at a price 0.7% below its official price in exchange for units of its liabilities.

- When valued at the official price, the Federal Reserve will attempt over time to establish an average dollar value of gold reserves equal to 40% of the dollar value of its liabilities. This average reserve (AR) will be a "Target Reserve Quantity" around which policy operates.

- A gold reserve band will be instituted whereby a reserve level equal to 70% of the dollar value of the Federal Reserve's liabilities would be designated as the Upper Reserve Limit and a reserve level equal to 10 percent of its liabilities would be designated as the Lower Reserve Limit.

- Once established, the Target Reserve Quantity of gold will determine the mandatory policy trigger points. Within a band of 25 percent either side of the Target Reserve level, the monetary authorities would have full discretion in exercising control over the monetary base. As long as the monetary authority maintains the official price via direct convertibility, there will be no strictures placed on actions taken to change the monetary base. Open market operations, discounting and even exchange rate interventions would be solely under the discretion of the monetary authority as long as the dollar value of the quantity of gold was between .30 and .50 of the Monetary Base; i.e., within the 25 percent band of target reserves.

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*The specific values used in this paper are intended as illustrations. They are not definitive. Abstract description of such a system becomes almost incomprehensible.

- If actual reserves were, however, to fall within the range of .20 and .30 of the Monetary Base, then the monetary authority's discretion would be removed in its entirety. The monetary authority would be required to run policies such that the monetary base would experience absolutely no growth. This, in effect, means that the monetary authority would be required to offset fully any gold/dollar conversion as long as actual gold reserves fell between one half and three quarters of the target reserve level (.20 and .30 of the Monetary Base).

- If, in spite of the cessation of the growth of the monetary base, actual reserves fell between fifty percent and twenty-five percent of target reserves (.10 and .20 of the Monetary Base), the monetary authority would then be compelled to contract the monetary base at the rate of one percent per month. This means that the monetary authority must act to effectuate a decline in the monetary base of one percent per month, inclusive of the monetary base effects of maintaining gold convertibility. If the decline in the base due solely to gold sales were greater than, or less than, one percent, then open market operations would be used to limit or increase, respectively, the change in the base to the prescribed amount.

- A symmetric set of mandatory policy dicta result when actual reserves grow to between 1.25 and 1.5 of target reserves and 1.5 and 1.75 of target reserves. The monetary base rules in each of these ranges are an increase of one percent per month and two percent per month, respectively, again inclusive of all gold/dollar conversions.

- If the gold reserve protection measures fail to preserve the actual value of reserves between 0.25 and 1.75 of the target level of reserves while maintaining convertibility, all gold/dollar conversion provisions cease. The dollar's convertibility will be temporarily suspended and the dollar price of gold will be set free for a three month adjustment period.

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

Once the official price for gold is established, the actual reserves of gold held by the monetary authority would be different from the level of target reserves. If, as appears most likely for an initial move back to convertibility, the actual amount of reserves is in excess of the amounts needed for the target reserves, then this gold should be segregated and sold in a systematic manner. A reasonable solution would be to sell the entire amount in equal monthly installments over a five-year period. Quite symmetrically, if there were a deficiency, there should be a five-year plan to acquire gold in equal monthly amounts. The deficiency or surplus should have no bearing on the monetary authority's behavior. In the monetary authority's account for the purposes of maintaining dollar convertibility, the initial amount of gold would be the Target Reserve Quantity, or 40 percent of the Monetary Base.

With the value of the dollar defined in terms of gold, there would no longer exist any reason for the U.S. government to be concerned with the foreign exchange value of the dollar. The official policy of the U.S. should remain that the dollar would be free to seek its own level. The U.S. should neither concern itself with foreign official intervention nor with the fluctuations in

foreign exchange rates. It is quite likely that many foreign governments would be quick to reestablish parity between their currencies and the dollar. With the dollar as good as gold, the attraction would be great.

LINKS TO "THE U.S. PROPOSALS" OF 1972

The approach outlined above includes several key concepts put forward in "The U.S. Proposals" of 1972. First, the need for a "base" level of reserves, the "Target Reserve Quantity", was recognized.[4] Forty percent was selected as the illustrative amount in the above proposal because it approximates the pre-1934 relationship between gold reserves and the monetary base in the U.S. within the Federal Reserve Bank system.[5]

Second, changes in the level of gold or primary reserves is used as the key policy variable:

> Reserves are more comprehensive, more reliable and more quickly available indicators than other criteria of external balance. While reserves may be distorted in the short run, no other single series provides a superior basis for analysis. In a convertibility system, reserve data are necessarily indicative of disequilibrium in the adjustment process; this has always been understood in terms of inducements to adjust for deficit countries—and the concept applies with equal logic to adjustment needs for surplus countries.[6]

The use of reserve bands also was part of the 1972 proposal, and no doubt incorporates much of Volcker's technical inputs. "Under a reserve-indicator system," says "The U.S. Proposals", "certain points would be established above and below each country's base level to guide the adjustment process and to assure even-handed convertibility disciplines."[7] A "low point", "lower warning point", and "outer point" are recommended as trigger mechanisms for appropriate policy responses to restore equilibrium:[8]

> .... countries would not be expected to ignore imbalances blithely until their disequilibria had become so extreme as to prompt strong *international* concern through the indicator mechanism. Reserve fluctuations would signal emerging disequilibria; movement to outer indicators signalling strong *international* concern would occur only when countries failed to make the appropriate responses as the disequilibria built up.[9]

Later, the proposal states:

> The purpose of a reserve-indicator system is to provide strong incentives for countries to act in limited steps, using a variety of tools suited to their circumstances before their situation becomes so urgent as to involve international concern and action.[10]

PROBLEMS AND SOLUTIONS

The above proposal would attempt to rectify two serious defects inherent in most systems to return to gold convertibility. The original fixing price of gold no longer would be left to the vicissitudes of political pressures. With full knowledge, the market and its transactors who, with the threat of losses and the hopes of profit, would select the appropriate price for gold. This would thus avoid the necessity of making the overall economy adjust to some inappropriate price of gold.

As was pointed out in the 1972 monetary proposal by the U.S.:

> A decision to provide the system with too few reserves induces—and sanctions—a destabilizing and ultimately fruitless competion for scarce reserves. Creation of too many reserves pushes too great a share of the adjustment pressure onto surplus countries and facilitates world inflation.[11]

Allowing the price of gold to adjust would minimize this problem by permitting gold's original price setting to accommodate to the economy, instead of forcing the economy to adjust to a price set by government fiat.

The second criticism to which this proposal is responsive is to an explicit change in the market for gold itself. If gold became excessively plentiful or scarce due to conditions beyond the control of the monetary authority, it makes no sense whatsoever to force the economy to either deflate or inflate to accommodate an altered market for gold itself. Whenever such disturbances occur, the dollar would be defended until excessive reserves of gold were acquired or lost. At such a time, the price of gold would again be set free and allowed to adjust to the overall economy.

Another issue that invariably arises when discussing gold convertibility is the role to be played by gold coins. As a matter of practice, the issue is neither complex nor central to the workings of an effective system.

Nonetheless, if coins are to circulate and be used as money, the value of the coin when used as money must be greater than the value of the metal contained in the coin. If the value of the metal were equal to or greater than the monetary value, coins would be melted down and disappear from circulation. The value of the coin as a money need not be much in excess of the value of the metal. In fact, gold coins today have a premium of less than ten percent unless they have other characteristics. It would seem reasonable, then, that the monetary authority would mint gold coins and place them in circulation. Counterfeiting legislation should also be enacted to guarantee the quality of circulating coins. The minting of gold coins is a natural way for the monetary authority to rid itself of gold reserves in excess of those to be held against the monetary base.

IMPLICATIONS

A policy change leading back to dollar convertibility along these lines would change dramatically the outlook for inflation, the economy, and harmony among the industrial nations.

Inflationary expectations would fall precipitously. With the monetary system hinged to the real world through gold—a surrogate for all goods and services—price stability would return in short order. Announcement of the program alone would tend to increase confidence in the dollar, leading to an incipient excess demand for dollars relative to their supply. That is a necessary condition to arresting inflation. The growth in the monetary aggregates would tend to accelerate to accommodate this excess demand for dollars. Velocity would fall such that this increase in money would be consistent with lower rates of inflation.[12] For example, if the

velocity of money measured by nominal GNP divided by M1 were to decline to its 1965 level of 4.08, the money supply at today's level of real output could expand more than 50 percent with no change in the price level.

Interest rates over horizons both near and far would fall. Most likely, the greatest initial adjustment would be in short term maturities. As confidence extended out over longer time horizons, longer term rates would continue to decline. The more credible the program, the more precipitous the decline in interest rates.[13]

With the threat of unexpected inflation reduced, the relative price between inflation hedges and tax avoidance schemes on the one hand, and financial assets on the other, would shift in favor of financial assets. The value of such investments as gold, silver, antiques, *objets d'art*, real estate, oil and other tax shelters would fall relative to stocks and bonds. An absolute decline in their price is possible, but not certain.

Once the dollar were as good as gold, demand for dollars would surge in international markets as well. The foreign exchange value of the dollar would tend to rise. Foreign monetary authorities, however, might offset this shift in demand out of their own currencies into the dollar through offsetting foreign exchange operations; i.e., selling dollar reserve assets into the foreign exchange markets in exchange for their domestic money. Such a move by foreign monetary authorities would be all to the good. By securing the value of their currencies relative to the dollar, their monetary systems, too, would be linked through the dollar to gold. Inflationary expectations and interest rates would fall in these currencies as well.[14]

Benefits also would accrue to the real sector of the economy. Uncertainty over the value of money both in terms of goods and the cost of financing is itself an impediment to capital formation. It is an additional, external factor outside of the control of management that increases the risk of engaging in long term investments. Moreover, the sharp reduction in the rate of inflation that would ensue with a return to dollar convertibility would diminish the illusory component of corporate profits due to undercosting of goods sold and underdepreciation of fixed assets. Effective tax rates on corporate profits would fall. Real after-tax returns would rise. Corporate economic activity and profits would expand.[15]

The stock market would rise. Two factors would be evident. First, expected future after-tax profits would be higher, because of the expansion in corporate activity and the reduction in effective tax rates. Second, the real value of these profits would more closely approximate reported profits—smaller adjustments would have to be made to correct for illusory gains. Thus, price/earnings ratios based on accounting profits would go up.

Individuals would benefit by a return to dollar convertibility for similar reasons. Resources devoted to protecting savings from the danger of unexpected changes in the value of the dollar in terms of goods; e.g., purchasing gold coins, foreign exchange, etc., would be directed toward increasing production and wealth. "Bracket creep"—the rise of nominal incomes into

higher tax brackets even while real incomes remain constant—also would cease, removing the expectation of ever-increasing effective personal income tax rates without legislative relief.[16] Employment would rise, unemployment would fall.

The financial health of the government also would improve. Interest expense on the Federal deficit for fiscal year 1979 was $60 billion—the third largest budget item. A fall in interest rates, *per se,* would reduce the cost of financing the government debt. The expansion in the economy following a restoration of dollar convertibility also would increase the tax base—leading to an increase in revenues. In a healthy economic environment, demands for government spending decline. Higher tax revenues and lower spending reduce directly the deficit. The financial health of the Federal government would improve.

Finally, the return to dollar convertibility would reinstate the United States as central banker to the world. The importance of this change is difficult to underestimate. For almost a decade, the world has been without a numeraire, a North Star by which to guide international commerce and investment. The resulting cumulative economic inefficiencies have subtracted from the wealth of all nations. It is not too much to say that many of the political and social tensions of the era have been due, in part, to these real costs. With the dollar once again the world numeraire, these inefficiencies would be removed, and global resources freed would be employed toward productive ends.

New York's position as the center of world finance would be elevated and the competitive position of U.S. banks would be enhanced, relative to London and other overseas money centers. But all Western commercial centers would gain in the absolute expansion of global wealth. Assuming most of the major trading nations of the world would link their currencies to the dollar global inflation would be effectively arrested. Inflation's destructive impact on domestic economies would be curbed as well, although the need for global tax reforms would remain to offset the effects of a dozen years of inflation on fiscal systems.

Transcending these not inconsequential commercial considerations, though, are the benefits that restoration of the dollar as a stable world currency would bring to world political order. Protectionist pressures in the West would be mitigated, although not eliminated. And an element of cohesion would be returned to the Western alliance, which, along with the present monetary system, threatens fracture and disintegration.

Throughout history, it has been the world's premiere economic and military power that has put its strength and responsibility behind the maintenance of a stable world currency. The United States abandoned this element of global leadership when it unhinged the dollar from gold. It is not within the capacity of any other nation or cluster of nations to take on this responsibility. The United States can signal its willingness to resume this critical role by once again placing the dollar within the disciplined framework I have outlined here.

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FOOTNOTES

1. "The U.S. Proposals for Using Reserves As An Indicator of the Need for Balance-Of-Payments Adjustment", Supplement to Chapter 5, *Economic Report of the President,* January 1973, pp. 160-174.
2. *IBID,* p. 171.
3. *IBID,* p. 160.
4. *IBID,* p. 165.
5. Herman E. Krooss and Paul A. Samuelson, *Documentary History of Banking and Currency in the United States,* McGraw-Hill, New York, 1969, p. 2457.
6. "The U.S. Proposals", pp. 173-174.
7. *IBID,* p. 166.
8. *IBID,* p. 167.
9. *IBID,* p. 164.
10. *IBID,* p. 169.
11. *IBID,* p. 164.
12. Charles W. Kadlec and Arthur B. Laffer, "The Monetary Crisis:A Classical Perspective", Economic Study, A.B. Laffer Associates, November 12, 1979.
13. *IBID.*
14. *IBID.*
15. Arthur B. Laffer and R. David Ranson, "Inflation, Taxes and Equity Values", Economic Study, H.C. Wainwright & Co., Economics, September 20, 1979.
16. *IBID.*