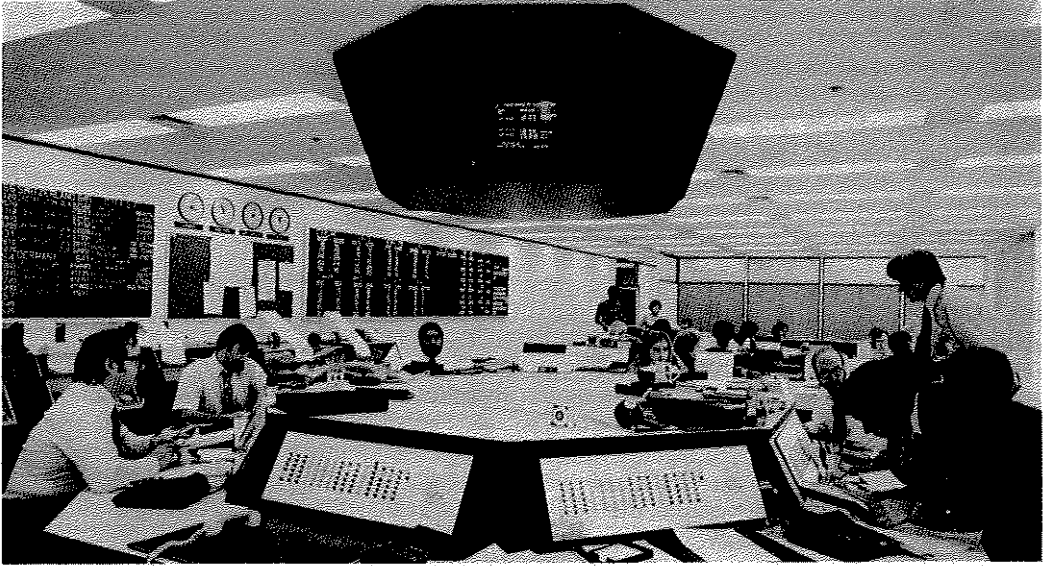


MANHATTAN REPORT SPECIAL EDITION

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Alternative International Monetary Systems

Recent years have witnessed an ever-increasing degree of monetary disorder worldwide. Over the past decade, and particularly during the last year and a half, the U.S. bond and money markets have been characterized by unprecedented interest rate swings. It is now generally agreed that financial market volatility is primarily caused by changing inflationary expectations and that these changing expectations, in turn, reflect volatile fluctuations in monetary growth. However, wide differences of opinion do remain on how to best eliminate excessive monetary growth and corresponding inflationary pressures.

The stated aim of current Federal Reserve policy is to slowly reduce domestic monetary growth. Despite this goal, the dramatic swings in monetary growth which have occurred during this credit cycle have raised questions about whether it is possible to achieve a steady reduction in monetary growth under the existing international monetary mechanism. Accordingly, the long-term viability of the current international monetary structure is again coming under question.

The purpose of the ICEPS symposium on monetary systems was to discuss three possible alternatives to the existing international monetary framework. An examination of these three alternative international monetary mechanisms raised critical questions about the existing system. In so doing, the ICEPS symposium provided a number of insights on how best to eliminate inflation and the financial-market instability which it was brought about.

The speakers, and their recommended currency regimes, were as follows: (1) Louis E. Lehrman (**gold standard**)—President, Lehrman Institute and Chairman of the Executive Committee, Rite-Aid Corporation; (2) Professor Wilson E. Schmidt (**flexible currencies**)—Professor of Economics, Virginia Polytechnic Institute and U.S. Executive Director-Designate of The World Bank. Author of *The U.S. Balance of Payments* and *The Sinking Dollar*; (3) Dr. Eugenie D. Short (**currency denationalization**)—international economist, Southeast Banking Corporation, and Fellow, The International Center for Economic Policy Studies.

George Gilder—As Program Director of The International Center for Economic Policy Studies, I welcome you to this afternoon's forum. The subject is "Alternative International Monetary Systems." Our chairman for today's session is James B. Ramsey, chairman of the economics department of New York University. He is the author of several books on econometrics and energy, among other subjects, and he's a very tough and incisive moderator as I can attest from previous sessions. So without further ado, I'd like to introduce James Ramsey.

James Ramsey—Thank you, George. We have three major speakers. The rules of the game, roughly, are as follows. First of all, I would like to introduce the major speakers in turn. They will have a chance to have their say for about 15 to 20 minutes.

Now, our three speakers for today—our first, Mr. Lewis E. Lehrman, who favors a true gold standard. I say a gold standard since in history there have been several various versions and attempts, and he is going to propagate one of them, so it's best—if one is to criticize—to criticize that which is being propagated rather than some other. Mr. Lehrman endorses the classical gold standard but opposes the gold-exchange and reserve currency systems. Next will be Professor Wilson Schmidt from VPI and also the infamous—for some, famous—Shadow Open Market Committee. He is going to recommend that we move from dirty floats to clean floats. Last is Dr. Eugenie Short, economist for the Southeast Banking Corp. in Florida, who is going to argue for a competitive, non-government supply of money. In short, this lady has the courage of Milton Friedman's convictions.

For some brief opening remarks, last time I moderated an ICEPS conference I tried to guide the listeners slightly. I do this because, as an "intellectual" (I'm not really, but people think I am) I have the intellectual arrogance to suggest that there are things that people should pay attention to when the speakers speak. One thing that I would like you to consider today is the distinc-

tion between economic effects and efficient economic arrangements in the abstract versus the effects of the political mechanism and the actual outcome that would evolve from those abstracts given the nature of the political process. Indeed, the cynic might say that there is no economic system which some politician somewhere at some time cannot beautifully foul up. The caveat regarding political power is moderately well illustrated by a debate I had with then-Senator Muskie. I had pointed out that if one was concerned about governmental deficits that there was an easy, quick, and relatively painless way to eliminate them within 24 hours; namely, we should make sure that each politician was personally responsible to one one-hundred thousandth part of whatever the deficit might be. As I predicted, within 24 hours the entire deficit would be eliminated; in fact, if you gave them a share of the surplus, surpluses would be generated at a fast and furious pace. Ah, but Muskie had me, and he replied, "Congress would merely redefine the word 'deficit.'" He was right!

The point of this anecdote is that any successful resolution of the monetary system must recognize the effects of the powerful political pressures and the propensity of politicians to seek most effectively (indeed, for many of them, far more effectively than you or I) their own self-interest. And with that, ladies and gentlemen, may I give you our first speaker today, Mr. Lewis E. Lehrman of the Lehrman Institute, who is going to argue that the answer to this ticklish and partially political problem is to advocate a gold standard. Ladies and gentlemen, Mr. Lehrman.

Lewis E. Lehrman—Thank you very much, Jim. Last winter, on the pages of the *Wall Street Journal*, Milton Friedman wrote, "Despite vigorous efforts by the Fed to implement the October 6, 1979 Volcker monetary policies [otherwise known as the "Saturday Night massacre"] monetary growth has varied over a wider range since October 6, 1979, than in any period of comparable length for at least the last two decades.

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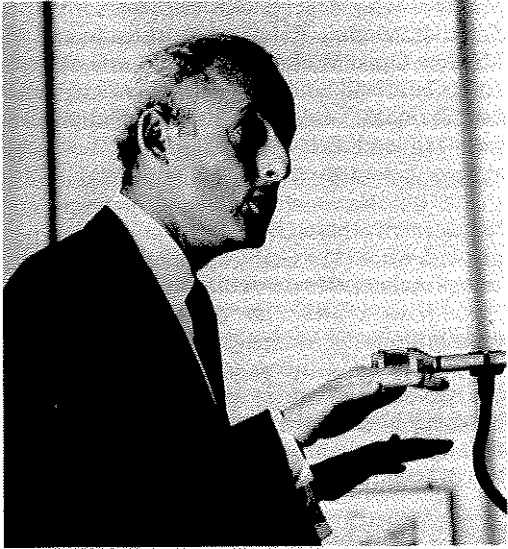
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"It's a serious question in a free and open society whether one should have—expressly conveyed by statute—a monopoly in the money markets."

—Lewis Lehrman



Lewis Lehrman, *Lehrman Institute*

That fact is recognized by the Fed itself," Mr. Friedman went on, "by its defenders and by its critics." Professor Friedman's remarks go to the heart of the problem of the Federal Reserve system. The Fed's governors honestly believe they can attain a goal that is not within their power to reach, namely, to fix the quantity of money in circulation in the market—a world market bounded by four billion people, trillions of dollars and active participants, whose supply and demand for dollars in the market varies according to taste and market conditions. These governors also believe they can fine-tune the world's most complex economy by changes in credit policy and by monetary-base manipulation.

Monetary-base manipulation leads to the Fed's daily interventions in the money and capital markets. One only has to be in the financial markets as a bond-buyer to know the extent of Fed interventions and the destabilizing effects they have when they are unanticipated, or even when they are anticipated. These so-called Fed "open-market operations" have led to the systematic expansion of the government securities portfolio of the central bank. Now, not only has this process indirectly financed the government deficits of which the government securities in the Fed's portfolio are merely the representation, but they have led to a perennial eight to nine percent increase in total, adjusted Federal Reserve bank credit and monetary-base expansion (about three to four times the rate of growth of real output over two decades).

Through this mechanism of open market operations—the buying and selling of govern-

ment securities on a discretionary basis by the Federal Reserve system—the Fed has become the engine of world inflation. Now, it's important to understand that in a free market order, neither the amount of money in circulation nor its growth rate can be determined by the central bank. For, quite simply, the Fed does not possess all the necessary global market information; nor does it have the proven operating techniques, as recent and past history demonstrate. Nor does it have the providential foresight to anticipate the expected rate of growth of real output, the expected level of cash balances actually to be desired in the future, and the amount of dollars demanded in a market which is fully integrated through the mechanism of arbitrage among the various countries of the major trading nations. It is true that the Fed can influence the conditions governing the supply of money and credit, but it is the users of money in the market who determine their demand for it. It is you and I, participants, buying and selling, trading, desiring new goods and services, desiring to repay debt, who alone determine the level of dollar cash balances that we desire to hold. And in no market interval can the Federal Reserve system precisely specify that quantity of cash balances which we determine to hold for our own account.

Moreover, it is also true that no money-supply growth rate during a specific market period is necessarily correlated with a specified rate of inflation. The money supply cannot even be precisely defined or measured, as all of you in this room know from reading the newspapers day in and day out. The Federal Reserve redefines the money stock on an annual basis, if it does not do so quarterly and monthly! It's either M_1 , M_1A , M_1B , M_2 , M_3 , L or any proxy which seems to show a higher correlation coefficient for a certain preceding market period which gives the analysts at the Fed a certain degree of comfort for their failures in the past. The fact of the matter is that the Federal Reserve system has gone through systematic redefinitions of the money supply since the enactment of the statute itself in 1913—either every decade, or as has been the case recently, every year.

My view is that instead of the Promethean urge to specify the quantity of money in circulation through reserve requirement manipulations, open market operations, and insufficient movements of the discount rate, the goal of the central bank should be reasonable price level stability. That's what the American people want, and in a free and open society, their will should prevail. Reasonable price level stability is a goal that can be achieved. Not perfectly—no human institution can be perfect. But we have a whole

"For the purposes of anchoring the price level over the long run, we should establish the dollar as a weight of gold."—Lewis Lehrman

history of monetary policy where reasonable price level stability was achieved over decades, indeed, over generations.

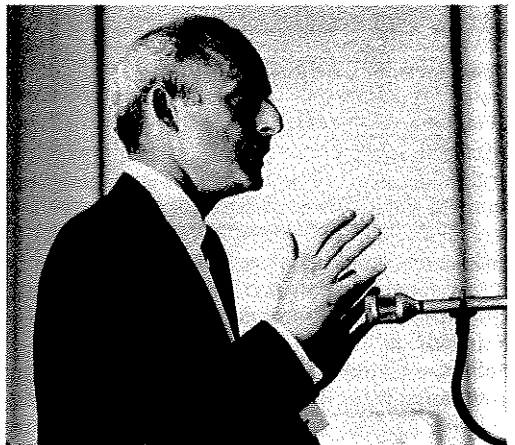
I think it's a serious question in a free and open society, whether indeed one should have, expressly conveyed by statute, a monopoly in the money markets. But if we must have a monopoly central bank, we have learned—George Stigler having shown to my satisfaction—that a monopoly operates efficiently only when it simulates the operations of the market. For these purposes, I have recommended in the past the use of the discount rate, which is the price of credit, as the mechanism by which the flow of new money through the sluice gates of the central bank is controlled. And though the discount rate is a superior technique for allocating the quantity of credit in the markets, it is only good in the short run. The discount rate or open market operations is a technique for making the supply and demand for credit elastic in the markets, with respect to the trade cycle.

For the purposes of anchoring the price level over the long run, one establishes the dollar as a weight of gold. One chooses gold not because it is a perfect commodity for this purpose, but because it is the least imperfect of the commodities which history, economic analysis and theory give to men and women to use for the exchange medium in an advanced industrial society. For that again we have the data and the statistics. In my view they are compelling, even if they will not produce a utopia. Comparing any period of the gold standard (which lasted, in effect, from 1821 in England until the recent post-Second World War period with the emergence of dirty floating exchange rates, the end of the gold standard, and substantial manipulation of the credit markets by the central bank) suggests that on all counts the gold standard (a) produced reasonable price stability over the long run, never varying by more than two percent annually per year, (b) accompanied stable rates of gain in income and output (in pre-World War I American history, subsequently placed under the Federal Reserve managed currency regime), and (c) accompanied high rates of investment and savings with people sure of the future value of their savings, given the constant purchasing power of gold. It's for those reasons that I recommend it for your consideration, and as a means by which President Reagan will be able to bring about not only stability in the credit and bond markets but a stable dollar. If we remember that President Reagan's two economic goals are an end to inflation and sustained economic growth, we have but to look to the classroom of history to observe that the successful history of the West is accompanied by the gold standard.

Ramsey—Our next speaker is Professor Wilson Schmidt, Virginia Polytechnic Institute and the Shadow Open Market Committee, who is going to recommend that, while we currently enjoy "dirty floats," environmental protection laws ought to lead us to "clean floats."

Wilson Schmidt—Thank you, Jim. I'd like to thank Bill Hammett for organizing this conference. It's a pleasure to meet on the dais people with whom I basically agree on almost everything—except this particular issue.

I have a quotation from what Lewis Lehrman wrote in the Morgan Stanley monthly publication in May of this year, called "The Case for the Gold Standard." I quote, "The technical meaning of the gold standard is that countries that belong to it are prepared to buy and sell, at the official rate, all the gold offered and all the



gold demanded." I think Lewis Lehrman is wrong. He is a fixed exchange rate man. "Gold standard" means fixed exchange rates.

In 1948, I was in my second year of graduate studies at the University of Virginia (and may I say that this is an unusual occasion—you have two University of Virginia Ph.D.s on the same dais—this is the first time in the history of New York that this has occurred). I was sitting there in the class, and it was an exciting period of time. Frank Shakespeare will probably remember it. The Fund had just been created, the World Bank had just been created, Ragnar Nurkse here at Columbia had written a fabulous book called *The International Currency Experience*. He told us all how bad floating rates were in the 1930s, and in 1948 I was sitting there absorbing all that information and all of those ideas. Then one morning Roy Mikesell, who was my professor—whom some of you may know—said, "If you really believe in free enterprise, you'd be in favor of floating exchange rates." And it hit me like a rock. I was being duped by the Fund and the

"The gold standard means having fixed exchange rates. . . exchange rates should be free just like any other price."—Wilson Schmidt

World Bank and by Ragnar Nurkse and by the conventional wisdom of that time. Roy Mikesell pointed out to me that the exchange rate should be free just like any other price. We should not have price controls in the foreign exchange market. And I submit to you that that is what Lewis Lehrman and the many of you who honestly agree with him are really asking for.

Now let me remind you of what is obvious to everyone in this room—that price controls lead to other kinds of controls. I ask you to dredge up your memories. In 1959 our president, Mr. Eisenhower, ordered the Development Loan Fund to spend its money solely on American goods and services. The Development Loan Fund was an aid agency to help LDCs. By that act our revered president made our tax dollars go less far than they otherwise would have, and



Wilson Schmidt, World Bank

caused extraordinary foreign policy consequences. I still remember the day that the Minister of Finance in Nigeria stood up in the Parliament of Nigeria and denounced the United States for this kind of mercantilism. And may I respectfully suggest that there is an element of mercantilism in what Mr. Lehrman is saying because he is so conscious of gold.

Now, fortunately, this administration in the person of Beryl Sprinkel and the Secretary of the Treasury has largely, if not almost entirely, renounced foreign exchange intervention. The record of such intervention is dismal. The Treasury and the Federal Reserve have simply been stupid if you look at the record. Dean Taylor, writing in the November 1980 issue of *Euromoney*, figures that the losses of the major central banks in the period since the start of floating were \$10 billion dollars, of which two billion belongs to the United States government—two billion of your dollars thrown away by bureaucrats who think they know more about the future price of the currency than the market does.

Jack Bennett, who was Under Secretary of the Treasury in much of this early period, said the most sensible thing I ever heard about the subject. Now, Mr. Lehrman, listen to what Jack Bennett says. He's an intelligent man who made a lot of money, too. He's met the market test. Jack says, "I worked long enough as a bureaucrat to know that there is no special wisdom accorded to officials which is not available to other market participants. Government interveners have no special powers of foresight." In other words, Jack Bennett says the Treasury and the Fed don't know what the exchange rate ought to be.

I submit to you that gold is a useful product. It should not be hoarded by the United States government. The government should not hoard things that are useful to you and me. I've got here two arcane reports—one, the *Anton Gold Seminar* report, talking about the uses of gold. One use is the protection of radioactive wastes. The people in Sweden are in the forefront of this, where they have found that to encase radioactive wastes in gold provides the surest way to protect them against leakage or contamination of the environment for 1,000 years. Why hoard such a useful thing? Coating glass for buildings is another use mentioned in this report. I wasn't aware of this. Seven pages of this report deal with the private uses of gold. Do you realize that the U.S. Treasury has 260 million ounces of gold sitting in Fort Knox? They won't sell. They're holding out on you. It's something you could use. Why hoard it? That's one case against the gold standard.

Now I happen to believe that the problem does not require the solution that Mr. Lewis Lehrman is proposing. I look at the numbers, for instance, the velocity of the monetary base divided into GNP—it looks quite predictable to me. I know that there's a close relationship between the monetary base and the money supply and M_1 . I can look at the tables. I've got them all here. Here are consumer prices and M_2 and they look closely related. Not perfectly; I don't require price level stability every day. But it does seem to me that controlling the monetary base will control the money supply which will control the price level. And while I happen to think that times are tough and there's no clear evidence that the board has gotten control of the money supply yet, I believe they can do it. And I pray that they do, largely because I think Mr. Lehrman's solution is a very inefficient, very costly, wrong-handed approach to solving what is really the most serious problem of our time. We've got to focus attention on the monetary base. Otherwise, under Mr. Lehrman's proposal, we'll go to fixed exchange rates, and that's going to bring all

"It is cart-before-the-horse reasoning of the worst sort to say that fixing the price of gold in dollars is price-fixing."—John Exter

sorts of controls on you and me that are very, very undesirable. Thank you very much.

Ramsey—In order to speed things along, with no further ado, I will give to you Genie Short.

Eugenie Short—The kind of interest rate movements that we've seen in this world economy since the "Saturday night massacre" that Mr. Lehrman spoke about is such that we now hear comments about interest rate volatility and unprecedented interest rate swings. We hear these comments not just from professionals who follow money market conditions on a day-to-day basis; we hear these comments from the public at large. It is now widely believed that this interest rate volatility is primarily caused by inflation. Inflation and concerns about the economic consequences of inflation are such that a growing number of individuals are at least becoming receptive to the idea of free-market banking and private currency competition. Now, although it clearly is not something that we're going to see in the near future, I want to talk to you about my thoughts on private banking or private currency competition and what kind of a monetary framework such a system would involve.

Both alternatives presented so far this afternoon—the gold standard and a freely floating exchange rate system—reflect concerns about how best to constrain the central banks. Yet, despite this concern, both of these alternatives are constructed from the currently accepted monetary framework where domestic currencies are issued by governments and supplied by central banks.

The case for private currency competition addresses the current monetary problem at a more fundamental level, in my view, than the other two alternatives presented here today. It does not merely raise the issue of rules versus discretion, of monetary constraint via gold backing or constitutional amendment; rather, it directly addresses the issue of whether the competitive market process can provide a preferable monetary system to a system where each nation's central banking authorities have the responsibility of controlling the nation's money supply and, hence, the value of its currency.

Much of what I say does come directly from Friedrich von Hayek's work on the denationalization of money. The Hayek proposal requests that countries agree by formal treaty not to place any barriers obstructing free currency exchange among both existing domestic currencies and any other currencies which the legally established or other financial institutions might issue. At the outset, this ruling would merely require the removal of any kind of exchange control or regulation prohibiting the movement of money between countries as well as the removal



John Exter addresses the panel

of any restriction inhibiting the use of these privately-issued currencies for establishing contracts or maintaining accounting records. The expected impact of the extension of free trade to money, including privately-issued currencies, is that the competition which would develop among the issuing institutions would impose a much-needed discipline on both the monetary authorities and the other competing issuing institutions.

To understand how this process would work, it is important to emphasize that each issuing institution would provide its own unique currency to the marketplace. And this currency would be readily distinguishable from the currencies offered by competitors. The ability to differentiate from among competing currencies is of critical importance for the viability of this proposal, since it is only through the ability to differentiate that the competing institutions would be constrained from overissuing their identifiable currencies. In order to induce the public to hold its currency, an issuing institution would most likely commit to redeem its note at a stated redemption value. That redemption value would probably be denominated in whatever commodity equivalent the public deemed desirable, given their revealed preferences.

If by overissue the market value of a cur-



rency was below its redemption value, the holders of the currency would sell the note back to the issuing institution and that institution would take the loss. And that's the critical key—the institution has to take the loss. We don't have that today. The holders take the loss today. If we assume that the public could easily differentiate among competing currencies and that these currencies could be freely traded at variable exchange rates, the public—via the market process—would be able to drive out currencies of questionable value and in so doing would provide a strong deterrent against any institution's propensity to overissue. This is not to say that no institution would overissue. Poor management would exist in a free-market banking system just as it exists today. Some issuing institutions would fail under this system and some individuals would lose money, just as people lose money when they buy and sell in today's globally-linked international capital markets. However, by utilizing the profit motive to minimize the potential for overissue, this market-oriented solution does provide, in my mind, the best potential, long-run solution to the recurring problems generated by stop-and-go monetary policies and the resulting inflationary pressures and unstable currency values which now characterize today's monetary framework.

The necessary regulatory changes needed to usher in this free banking alternative are not likely to appear in the foreseeable future. However, I think it's important to recognize that even under the present system, market decisions to substitute among available currency alternatives have provided the major source of constraint against the continuation of expansionary monetary policies. Individuals prefer to hold currencies which are relatively stable in value and make portfolio allocation adjustments accordingly. These adjustments have imposed a form of constraint against the continuation of inflationary policies. Recognizing this, it seems reasonable to suggest that in order to solve the current financial problems, policies should be aimed at enabling individuals to more freely choose among competing currencies. Measures aimed at facilitating the market process rather than inhibiting the market process would work toward improving current financial market conditions.

Ramsey—I am impressed by the general agreement on objectives amongst three speakers who view themselves as being from disparate viewpoints. There is, however, considerable disagreement on means, and I suspect from listening to the speakers that this is due mainly to a differential reading of history. There are some key differentials that have been brought before us. There is the distinction between a monopoly versus a competitive supply, and that issue—notwithstanding Eugenie Short's excellent short speech—has not been fully addressed. The alternative is that if we have a monopoly supply, should it be a government controlled supply or a supply which is privately controlled? If you feel this is a ridiculous issue or rather one that is irrelevant, you should remember that the Bank of England was originally a private bank.

Always one should recognize that if one has, in this day and age, a private monopoly control of the money supply, it will, as everything else, be made subservient to the political process. Another question, which was eloquently raised by Mr. Lehrman, is: Can there be monopoly control? And, perhaps more relevant to the present, Does it actually exist? He posed the question in a slightly different way, pointing out that no one could come to an agreement over a definition of the money supply. And if you're not too sure what the money supply is, it becomes very difficult to control.

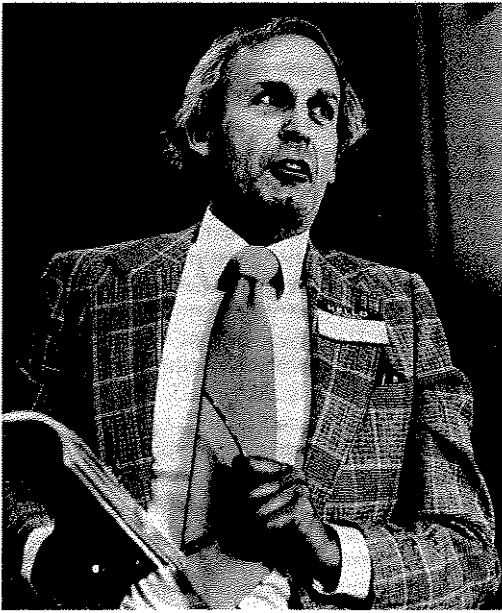
One final point which refers to Professor Schmidt, who has been left out of this brief discussion here so far. As someone who was brought up in Britain and, indeed, who gained his early experience of matters economic during the '50s in Britain, I might say that even the

"No one here is really against control; you're all just saying it's better for government to control quantity at one point and price at another point."—Paul Davidson

"dirty float" (much less a "clean float") was of enormous benefit to Britain, since I recall that ever since 1947, Britain went through its biannual foreign exchange control crisis on the basis of trying to maintain fixed exchange rates. As one who loves the country from which he emigrated many years ago, thank God that at least in one small matter Britain survived, and she survived only because of the "dirty float" if not the early penalties imposed by fixed exchange rates.

We are now open to discussion, comments and queries from the floor.

John Exter, private consultant—I am very much on Lew Lehrman's side in this argument, so my criticisms are directed toward Wilson Schmidt and Genie Short. I think they both missed the



Paul Davidson, Rutgers University

main point. I'll direct my remarks to Wilson first. He's heard me say this over and over again. In your mind, you think that the paper dollar is money. And I submit to you that you do not decide—neither you nor Milton Friedman decide—what is money. It is the marketplace that decides what money is, and it is cart-before-horse reasoning of the worst sort to say that fixing the price of gold in dollars is price-fixing. Gold does not get its value from the paper dollar. The dollar gets its value from gold. In fact, paper has no value. The only thing that gives paper value is the ink on it. And the ink on it has to be the promise to pay something. And the reason the dollar had value was that that was a

promise to pay gold—for a long time at \$20.67 an ounce, and then \$35 an ounce, and now nothing. The dollar is an IOU-nothing currency and so are all the other currencies in the world. As such, they are bound to lose their value in the marketplace. The principal value and function of money is to serve as the store of value, and irredeemable paper money can never be a store of value, so the price of gold at \$500 to date is going to be \$5,000 shortly and then \$500,000 and so on. So I think the whole argument that you've made about price-fixing is erroneous.

And I also want just to direct this last point to Genie Short. She forgets, too, that Hayek—and I hate to say it because he's a good friend of mine, and I'm a Mont Pelerin society member—but Hayek forgets that any currency must be a promise to pay something. And so I'm in favor of free private banking, but I'm an old Citibanker and just to give you the point, Citibank has deposits which are promises to pay U.S. dollar IOU-nothings. They have travelers checks which are also promises to pay U.S. dollar IOU-nothings. They are also now issuing gold certificates. And these gold certificates are backed by gold 100 percent. I want to point out to Genie Short that if they weren't backed by gold 100 percent, the marketplace would never accept them. And that's the problem with free banking.

David Meiselman, Virginia Polytechnic Institute—I have one simple question, which is this. Would each of the speakers elaborate on what is the money-supply rule under their system?

Ramsey—I will take that question in reverse order of original presentations. Genie Short?

Short—The money-supply rule in my system is clearly not the same one as in Professor Meiselman's system where he defines it as M_1A or M_1B or whatever other. The money supply in my system would be the aggregation of the supply of currencies issued by private institutions. Just as today you have the aggregate supply of money denominated in dollars, we'd have the aggregate supply of money as the consolidation of all the available issues issued by private institutions.

What I'm arguing is that political pressures do exist which always put the Fed in a position to try to anticipate not only what the market is going to do but how the economy is going to operate. Can the Fed restrain political pressure to utilize the printing presses to finance government expenditures? That's the issue we face today. Can it be done? Would we be better protected against the potential for utilizing monetary expansion to finance government expenditures if, in fact, you had the market clearly operating? Let the market operate and find out.

"In order to solve the current financial problems, policies should be aimed at enabling individuals to more freely choose among competing currencies."—Eugenie Short



Eugenie Short, Southeast Banking Corporation

The institutions are constrained by the profit and loss mechanism; if they over-issue, they go broke. That doesn't happen today.

Schmidt—John Exter has one characteristic which I admire greatly—persistence. I've disagreed with him for a decade. John, you don't understand the nature of money.

Exter—That's your trouble, Will.

Schmidt—Money is what other people accept from you in order to buy something. It's not because it's backed. That's silly. John, you're just simply wrong. As for David Meiselman's question—what money-supply rule would I follow? I wouldn't follow a money-supply rule. I would follow a monetary-base rule. That's a very important technical difference, and David shouldn't ask the question that way. It's the monetary base that relates to the nominal GNP more closely than M_1B . And as for Dr. Short, you know, Fritz Hayek is a brilliant scholar, and I agree with John Exter—I disagree with Hayek. The trouble with Fritz Hayek's idea is simple. You can see it right in this room. How many of you have a Deutsche mark in your pocket right now? One. That has been a stable currency for a very long time. You could have used it for settling contracts, for making payoffs, for making payments. You could have used it. It's a competitive money, but you haven't used it. I don't think that Mrs. Short's solution makes any sense at all in the real world in which you and I live.

Brian Summers, *Foundation for Economic Education*—But what about legal tender laws, Professor Schmidt?

Ramsey—Each speaker will get a chance to pick up those most crucial points, those most irritating points of controversy at the end.

Lehrman—First I want to say that Genie Short's conditions for free banking and free competition in the supply of money are precisely the conditions which one establishes for the regime of the

gold standard. The true gold standard is denationalized money. Secondly, David Meiselman's question: "What is the money-supply rule?" As a businessman one always wants to ask the question, "What can I do? What do I have in my power to do?" and "What is not in my power to do?" So my view is that you do not try to fix the money supply, because you cannot. You try to fix the standard. You see, the value of money—a phrase which I think Wilson just used—is an economic question. There are only two ways to regulate an economic magnitude, whether you're a businessman or an economist. You can either regulate the quantity or you can regulate the price. Now, the whole idea of a monetary standard is that like the 36-inch yardstick, you stipulate the "weight" or the measure by which economic activity and the value of economic articles in the market will be measured. And if you were looking for a concrete example of this, I can tell you about my own company, which is a public company. We retain many accountants merely to report for the financial standards accounting board in order to adjust all of our assets and our working capital in accordance with the new rules and regulations, because the monetary standard, the paper dollar, does not yield either constant or reliable results for stockholders.

So the idea of the monetary standard is very simple. You have to imagine that the federal government might make the yardstick 32 inches one morning, 39 inches the next morning, 40 inches in three weeks. And, indeed, when it did not suit the government—as recently it did not in the realm of money—the government might cut the value of the yardstick from 36 inches to 18 inches. Money is a standard of value. It is a standard by which you measure the value of all other economic articles of wealth relative to one another.

Here, the relationship between annual growth rates of the monetary base and M_1B are very clear. The evidence is available. The base growth fluctuates narrowly between 7.2 and 9.2 around a mean of 8.2. And it is interesting to note that in '74 when M_1B grew at its lowest rate in the last ten years—4.7 percent—the base grew at one of its most rapid rates—8.8 percent.

I'm only making the point that if you go to the data and the statistics on the correlation between the monetary base and M_1B or the monetary base and nominal GNP or real growth, you will find that the correlations are virtually meaningless. And as a result the monetary rule—namely steady rate of growth of the monetary base—itself has to be meaningless.

Eugene Birnbaum, *Wharton World Economics*—I liked Wilson Schmidt's comment about how it

was so nice that we're gathered together with so many people that agree on everything with the exception of one point, because that one point is a very important one. It seems to me, Wilson, that it gets back to the comment also that John Exter made that defining the weight of a unit of money in terms of gold—in terms of using a standard—is not price control. I think it's the case given in today's *Wall Street Journal* by Lindley Clarke where he attributes what's happened in France in the move from Giscard to Mitterand to what money was doing in France and what inflation was doing in France. I would say that the trouble with that view is that it doesn't bear in mind political control. And no monetarist is going to explain what's happening. So again, the idea of the gold value weight in exchange for a monetary unit is to give stability and confidence in the future of the control over political events. Now, maybe it won't hold, but that's the idea. And to argue that we should have no control and just let the currencies go without some external force trying to discipline the politicians, I don't think that's a step in the right direction. It's a step in the wrong direction.

Schmidt—You know, I think Gene Birnbaum has got the point right. What we're really arguing about is how the hell you get political control over these guys. That's all it is. That the bureaucrats will get hold of the balance of payments again and they'll put controls on you and me—American businessmen and investors—just like they did in the '60s and the '70s. Now that's a judgment call. But I think your diagnosis and mine are exactly the same. How do we get control over the political process? Now, my answer, frankly, to that question—which I didn't address in my opening remarks—is maybe kind of crazy. I happen to believe in a monetary constitutional rule. The question that David Meiselman raised. I think that's the way to go. That's my political judgment. Now, Gene, you make your political judgment. I think we would be better off—you and me—if we joined forces to work for a consensus. A consensus that apparently has been achieved by the president by his election to move to put the constraints on the stock of money. I would happen to put it in terms of monetary base. There's not much gulf between us, Gene.

Duncan Bailey, W.R. Grace & Company—There's been an argument for 20 or 30 years that two percent is a magic number, that the money supply or the monetary base or whatever we're using should grow at a level of about two percent a year. Economists have argued elsewhere that the gold supply for a long time has grown at about two percent a year. And that's true. But

over a short period of time it has grown at violently different rates in Europe, and in the United States between the Civil War and the Great Depression there were periods of panic when gold went up and down. Tying this into a specific question here, assuming that we're going to have, as Professor Schmidt suggested, a fractional reserve or a fractional holding fraction, how do we keep the politicians from meddling with the relationship between paper and gold when we have problems with economic growth?

Lehrman—You establish the fractional reserve banking system through the monetary constitution—the phrase that Wilson Schmidt used. As if you were in the Bureau of Weights and Measures, you establish the value of money as a weight of gold once and for all. And then the rate of growth of money varies with the demand for credit in the market, and with the growth of the monetary standard itself—in this particular case, though it could be others, gold. Now, the rate of growth of the monetary standard, gold, over long period of time—centuries and generations—has been around two percent. It is a first approximation of Milton Friedman's own monetary rule. But the rule of gold—2 percent growth—is a proven proportionality to the growth of real output over the long run. The difference in the gold standard is that it has been done. It has worked, whereas monetarism has rarely been done and thus far wherever it's been tried, it has not worked.

James Grant, Barron's—Mr. Lehrman, would you answer the objection that Professor Schmidt raised on the physical limits of the gold supply? For backing of the currency there was an implausibly low fraction cited as the available backing. Does that matter?

Lehrman—Jim Grant asked whether or not there is sufficient gold to provide for the gold standard. Positively, yes! The classical period of the gold standard which lasted a hundred years—from 1821 to 1914—had as its center the monetary system of England. At the turn of the century approximately 5.5 percent of the world's gold reserves were held in England and no more than three percent in the English banking system alone. The whole essence of a convertible currency rule—a monetary standard—is that fractional reserves are always prudential and therefore sufficient. As Genie Short remarks, all bankers will hold that volume of gold reserves which are required to meet the daily encashments for payment by check being drafted against gold in their accounts. We know about five to ten percent of the total stock of money has been held as reserves, because there is a regular flow of payments through checking ac-

"Should we sack the members of the Federal Reserve Board and replace them with the members of the Shadow Open Market Committee?"

—Maxwell Newton

counts which are not demands for reimbursement in the monetary standard. Historically the case is clear that there is more than sufficient gold, approximately 130 billion dollars at present values. It seems to me by any theory of fractional reserve banking we know, that one never has to hold full reserves for the demand deposits outstanding. For example, the Federal Reserve system today only requires that three percent of time deposits and 12 percent for demand be held in reserve at the Central Bank, which itself suggests that all you need in a fractional reserve banking system is a very modest fraction of the total quantity of money in circulation in order to give it a stable underpinning.

Grant—Would you have reserve requirements in your regime?

Lehrman—No, I believe legal reserves, mandated by government, are innocuous and I would eliminate them. I believe that under a free system the market would be able to establish what is the prudential level of reserves.

Maxwell Newton, *New York Post*—In today's practical monetary policy situation, Professor Schmidt, would the logic of what you're saying come down to this — that the Fed and the people running the Fed are either willful or stupid and that the solution would be to sack the Federal Reserve Board and replace them with the Shadow Open Market Committee?

Schmidt—Mr. Newton, thank you very much for that question. I'll volunteer. The last meeting of the Shadow Open Market Committee came up with a recommendation that the board establish a target, tell the world, and if it missed the target by one percentage point on either side, it submit its resignation to the president with an explanation as to why it missed the target and the president has the choice of accepting or rejecting those resignations. That is our current recommendation for how to handle the problem of the Fed.

Paul Davidson, *Rutgers University*—Once you accept the law of contracts as determining things, you have already taken control of the monetary system. There is always some control via laws of contracts. Eugenie Short wants people to have complete control over all contracts. In other words, people could use "banana-republic" laws to enforce their monetary contracts. Lewis Lehrman wants nature to control the quantity of money and the government to control the price of dollars vis-a-vis other currencies. And Wilson Schmidt wants the government to control the quantity of money, and the international free market to control the price. So no one is really against control; you're all just saying politically it's better for government to con-

trol quantity at one point and price at another point. And I don't know how you resolve that problem. Wilson Schmidt has the judgment that somehow controlling the quantity is going to do it. Lehrman has the judgment that controlling the price is going to do it. My own guess is that government merely controlling the quantity or the price alone won't be enough.

James Ramsey—I promised originally that the speakers would be able to rebut in reverse order of presentation. That means Eugenie Short comes first.

Eugenie Short—I think that the main thing I'd like to say is that I do see some similarity between my position and Mr. Lehrman's if, in fact, gold would be that which private currencies would be redeemed against. The issuing institutions would establish a contract stating that they would redeem their notes at a stated redemption value, and that redemption value may, in fact, be redeemed in terms of gold. But the market would determine that, and so it might be gold, it might be something else. But it would be a market system. And so I guess our systems are similar if, in fact, you would be in favor of allowing the elimination of regulations that prohibit institutions from issuing their own liabilities. In terms of the question on whether or not banking institutions today would be willing to accept unlimited liability, I think that that's an excellent point. I know that in my own institution the CEO would probably fall down if he thought that he



Maxwell Newton, *New York Post*

could issue his own currencies, and many institutions would. In the model you're basically saying that you're going to let the market work. And in those institutions you may actually have a system where the government provides the money, if that's what the people want to demand. But it's my assumption that, in fact, private institutions will provide more stable currencies than we currently have.

Wilson Schmidt—On the earlier question about the fractional gold standard, I don't think Mr. Lehrman really quite met that valid question which you posed. I don't think Mr. Lehrman answered that question because he didn't explain how the government would be prevented from changing the fractional relationship. Now, I don't know the answer to that question, but he's got to come up with that answer. On Mrs. Short's point about the law and Deutsche mark contracts, there is not a thing in the world that prevents me from entering into a contract with Duncan Bailey in DM right now. I bid 2.32, and we can do any kind of business we want. There's nothing which prevents Morgan Guaranty from doing business with Chase Manhattan. As for Paul Davidson's question about price controls versus quantity controls, I think there's a very important difference between the two kinds of controls. Price controls, it seems to me, affect the allocation of a private good, whereas the quantity controls on money that I'm talking about affect the allocation of a public good. Now, if you don't buy the argument that money is a public good, then you're with Mrs. Short, and you're logically consistent.

Lehrman—In a fractional reserve banking system, reserve requirements are discretionary, as under Genie Short's system of denationalized money. That is to say, you hold that volume of gold reserves which are necessary always to redeem, at market, the volume of your liabilities which holders wish to convert. If you are unable to redeem your liabilities on demand, you are extinguished—by a little-used institution called bankruptcy. And that is one of the reasons why Genie Short's system would be very efficient and why its analog—the true gold standard—would be efficient. The gold standard regime has to be seen not only as the fixing of the monetary standard; but it has to be seen as eliminating the power over the supply and demand for money by politicians, by legislators, by bureaucrats or governors of the central bank, or monetary economists, or unhinged debaters like us who wish to try and decide what the optimum currency regime is. The true gold standard, a monetary constitution, regulates out of the money market the politicians and the bureaucrats who for several generations have presumed to control and to define it.

Ramsey—Well, ladies and gentlemen, you've had an exhausting session. It could go on, but all good things come to an end eventually. And so with that may I ask you to thank the three members of the panel—who showed up today to be harangued, queried and argued with by yourselves—and the International Center for Economic Policy Studies for making this discussion of radical ideas possible. □

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