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THE RELATIONSHIP OF MONETARY POLICY AND RISING PRICES

HEARING

BEFORE THE

SUBCOMMITTEE ON
DOMESTIC MONETARY POLICY
AND TECHNOLOGY

OF THE

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THE RELATIONSHIP OF MONETARY POLICY AND RISING PRICES

Thursday, March 17, 2011

U.S. House of Representatives,
Subcommittee on Domestic Monetary
Policy and Technology,
Committee on Financial Services,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:03 a.m., in room 2128, Rayburn House Office Building, Hon. Ron Paul [chairman of the subcommittee] presiding.

Members present: Representatives Paul, Jones, McHenry, Luetkemeyer, Huizenga, and Schweikert.

Chairman Paul. This hearing will come to order.

I want to welcome our three witnesses today, and they will be further introduced when they are ready to give their testimony.

The ranking member, Mr. Clay, is going to be coming later, but he has advised me that we can go ahead and start the hearing.

So I will start with an opening statement and those who want to give opening statements can do so, as well. I will advise that we will have some votes, probably in about 20 minutes or so, and we might have to take a 30-minute break. But we will deal with that when the time comes.

I consider these hearings very important. A few weeks ago, we had hearings on the Federal Reserve's relationship to the unemployment problem, and the Fed has been given two mandates: one, to keep low unemployment, which they haven't done a very good job of; and two, to maintain price stability. And the evidence is mounting that they haven't been doing a very good job with maintaining price stability either.

Most people refer to rising prices as inflation and that is the conventional wisdom. But many of us concentrate on things other than just rising prices and seeing rising prices as a symptom of the basic problem, which means that when a money supply has increased, the value of that currency goes down and inevitably it will lead to rising prices, unfortunately not uniformly, which means that some people suffer more than others.

But the one thing that is done when prices rise is that a lot of scapegoats are found. And this has been traditional throughout history.

As a matter of fact, as long ago as 40 centuries, 4,000 years ago, the very first known price controls occurred in ancient Egypt. They put on price controls because prices were going up and they didn't want to deal with the real issue, which was the monetary issue.

And that is a modern phenomenon too. The United States has done this during wartime periods, during wars in the 20th Century as well as another time in the 1970s, saying that if we can just control prices, we will take care of the problem.

So they are always looking for something to blame for the rising prices. Sometimes it is energy. In the 1970s, it was energy, and boycotts caused rising prices. Even today, the Middle East crisis is causing prices to go up and it does have an influence, but it is not the whole cause.

Any type of crisis will contribute to rising prices. Sometimes labor is blamed for the inflation of prices and sometimes it is weather. Sometimes the blame is placed on the speculators. Once prices start rising, well, if the speculators are doing it, they are buying too much stuff and they are hoarding and they become the scapegoats.

Also, business people, when they make profits, can be accused of contributing to the price inflation. And sometimes, we just blame foreigners for not managing their currencies quite well and causing our prices to go up.

But one of the most bizarre arguments by the conventional wisdom of those at the Federal Reserve, and other places, is that it is excessive growth. We are having too much growth these days and therefore we have to slow it up. And literally, that is what they do.

If they have an inflationary period and they are concerned about rising prices, I think if we just kill the economy, yes, it will. Decrease demand and you will have price adjustments. But that is a heck of a way to solve the problem, which is the monetary problem.

But growth, in itself, doesn't cause higher prices. If you have a healthy economy, you are more likely to lower prices with excessive growth.

We had tremendous growth in the electronics industry—telephones and computers and TVs. In spite of the monetary inflation, we still saw prices drop.

So this whole idea that you have to slow up the economy in order to keep prices down, in order to stimulate growth of the economy, all you have to do is print money, I think people are starting to realize that is a hoax and it is coming to an end.

The definition of inflation, by many of us, is the increase in the supply of money. Ludwig von Mises, the great Austrian economist, argued this case clearly. And I used to think it was just semantics, but he argued that it was more than that. It was deliberate, so that we in charge—the monetary people in charge didn't want to address the subject of money and why they are responsible, rather than these other issues.

I consider this very, very important because it is so unfair. If governments and central banks increased money, prices went up and wages went up and profits went up all equally, I guess no big deal, but why do it, if that is what is happening?

What happens, though, is some people benefit at the expense of others. And I think it is a reasonable assumption to say, which many have said in the free market school, that if you destroy a currency, you will destroy the middle class. A sound currency encourages the middle class. And I believe that the inflation of prices, when prices go up, are most damaging to the poor and low- to middle-income people because they suffer the consequences much more so than those who can protect themselves. And therefore, it is a tax on the poor and the middle class. They tend to lose their jobs and get the higher prices.

So to me, it is very, very important that we address the subject.

And now, I would like to yield to the vice chairman of the subcommittee, Walter Jones from North Carolina.

Mr. JONES. Mr. Chairman, thank you very much. And to the panel that is here today, thank you. I think I agree with the chairman that I don't—as a centrist in my philosophy, as it relates to the people in my district, I really believe this is a critical and very important hearing because the relationship between monetary policy and rising prices brings me to my brief statement.

I do the grocery shopping in my family. I have been married for 46 years, and I have been doing the grocery shopping that whole time. I found this editorial in the Wall Street Journal that I think tells why this is an important hearing today—t says I cannot eat my iPad—the subtitle was "Federal Reserve bombs in Queens." So let me just say that. But this is one of the comments in the article: "Come question time, the main thing the crowd wanted to know was why they are paying so much more for food and gas?"

Keep in mind, the Fed doesn't think food and gas matter in its policy calculations because they aren't part of core inflation. In other words, food and gas, in the eyes of the Fed, are not part of the core inflation.

So Mr. Dudley tried to explain that other prices are falling: "Today, you can buy an iPad 2, that costs the same as an iPad 1 that is twice as powerful. You have to look at the prices of all things."

Then from the crowd, someone quipped, "I can't eat an iPad." Another attendee asked, "When was the last time, sir, that you went grocery shopping?"

So, this hearing today is extremely important and I am delighted to be part of it and I look forward to the question period. But I want to see it end with one comment. I have my staff email my district every time that we are going to hold a hearing, Mr. Chairman. And when we hold a hearing, I bring to this debate, this hearing, comments from my district.

I just want to mention one and then I will close:

"I have been retired from Ma Bell for 22 years and my pension has only increased once. We did get a small cost of living too, but a couple of years ago, that stopped. For people like us, in this situation, we are getting drained. The way things are going, my wife and I will have to hope to die before we cannot afford to live."

That is why this is a very important hearing, and I thank you, Mr. Chairman, for the time you just allowed me.

Thank you, sir.

Chairman PAUL. Thank you very much.

Mr. Huizenga, do you care to make a statement?

Okay. There are no other opening statements, so we will now proceed to the testimony. I will introduce the three witnesses, and then we will proceed.

Lewis Lehrman will be the first one to give his testimony. Mr. Lehrman is an active proponent of the gold standard and former member of President Ronald Reagan's Gold Commission. After serving as president of Rite Aid in the 1970s, Mr. Lehrman ran for governor of New York on the Republican and Conservative party ticket. In addition to being a senior partner in his investment firm, Mr. Lehrman continues to remain active in a number of political and civic causes.

Next, we will hear from James Grant. Mr. Grant is a noted investor and publisher of Grant's Interest Rate Observer. A former columnist for Barron's, he is the author of five books on finance and financial history. He has appeared on numerous television programs and his writings have been featured in numerous publications, including The Wall Street Journal, the Financial Times, and Foreign Affairs.

And finally, we will hear from Professor Joseph Salerno, who is a professor of economics at Pace University in New York. He is also vice president of the Ludwig von Mises Institute in Auburn, Alabama, and has written extensively on monetary policy and theory, banking, and comparative economic systems. He received his MA and Ph.D. in economics from Rutgers University.

So we will proceed, and Mr. Lehrman, you can give us your statement.

All of your written statements will be made a part of the record, so we ask that you give us a 5-minute summary.

Proceed.

STATEMENT OF LEWIS E. LEHRMAN, SENIOR PARTNER, L.E. LEHRMAN & COMPANY

Mr. LEHRMAN. Mr. Chairman, and distinguished members of the subcommittee, I want to thank you for the time. I want to thank my colleagues, Mr. Grant and Mr. Salerno, who have carried on the most distinguished research in monetary history, monetary theory, and monetary policy.

Since the expansive Federal Reserve program of quantitative easing began in late 2008, oil prices have almost tripled. Gasoline prices have almost doubled. Basic world food prices, such as corn, sugar, soybeans, and wheat have almost doubled. The Fed credit expansion from late 2008 through March 2011 created almost 2 trillion new dollars on the Federal Reserve balance sheet alone.

This new Fed credit triggered, as the chairman was just suggesting, a commodity and a stock boom, because the flood of new credit could not be fully absorbed by the U.S. economy, then in recession.

Indeed, Chairman Bernanke recently suggested that quantitative easing aimed to inflate U.S. equities and bonds directly, thus, commodities, of course, indirectly.

But some of the excess dollars raced into the foreign exchange markets, calling a fall on the dollar on foreign exchanges.

Now with quantitative easing, the Fed seems to aim at depreciating the dollar.

Foreign mercantilist countries such as China purchased these depreciating dollars on the foreign exchanges, adding them to their official reserves. Issuing an exchange, they are pegged undervalued currencies. This new money is promptly put to work, creating speculative bull markets and booming economies in China. The emerging market equity and economic boom of 2009 and 2010 was the counterpart of sluggish economic growth in the United States during the same period.

But in the year 2011 and 2012, we will witness a Fed-fueled economic expansion in the United States. Growth for 2011 in the United States will, I believe, be about 3.5 percent or more, unless there is an oil spike. Another oil spike, combined with even greater catastrophe in Japan.

The consumer price index, the so-called CPI, will be suppressed because unemployment keeps wage rates from rising rapidly. The underutilization of physical and industrial capacity keeps producer prices and finished prices from rising as rapidly as they otherwise would. Thus, the flood of new Fed credit has shown up first in commodity and stock price rises.

But commodity and stock inflation inevitably engenders social effects. Two generations of inflationary, monetary, and fiscal policies have been a primary cause of the increasing inequality of wealth in American society.

Bankers and speculators have been and still are the first in line, along with the Treasury, to get zero interest credit from the Fed. The bankers were also the first to get bailed out. Then, with the new money, they financed stocks, bonds, and commodities, anticipating, as in the past, a Fed-created boom.

A very nimble financial class, in possession of cheap, near zero interest credit, is able, at the same time, to enrich themselves and to protect their wealth against inflation. But middle-income professionals and workers on salaries and wages and those on fixed incomes and pensions are impoverished by the very same inflation that subsidizes bankers and speculators.

So if the problem is an unstable dollar, inflation and deflation, boom and bust, what is the solution? I remember Senator Robert Kennedy saying once, "If you do not have a solution, you do not have a problem."

The solution is a dollar convertible to gold at a fixed value. This is the necessary Federal Reserve discipline, to secure the long-term value of middle-income savings and pensions and to backstop the drive for a balanced budget.

The gold standard would terminate the world dollar standard by prohibiting foreign official dollar reserves. Thus, the special access of the government and the financial class to limitless Fed and foreign official credit would end with the gold standard.

Equally important, the gold standard puts control of the supply of money into the hands of the American people as it should in a constitutional republic.

If the Fed creates more dollars than the people at home and abroad desire to hold, they can exchange excess paper for gold at the fixed value, requiring the Fed to slow down credit creation in order to maintain the statutory gold convertibility of the dollar.

To accomplish this monetary reform, the United States can lead: first, by announcing future convertibility on a date certain of the U.S. dollar, the dollar itself to be defined then in statute as a weight unit of gold, as the plain words of the Constitution suggests;

second, by convening a new Breton Woods Conference to establish mutual, multilateral, gold convertibility of the currencies of the major powers at a level which would not, lower nominal wages; and third, to prohibit by treaty, the use of any currency but gold, as official reserves.

The gold standard is not perfect. But it is the least imperfect monetary system tested in the only laboratory we human beings have available to us: the laboratory of human history.

The dollar as good as gold is the way to restore America's financial self-respect and to regain its role as the equitable leader of the world.

Thank you, Mr. Chairman, and members of the subcommittee.

[The prepared statement of Mr. Lehrman can be found on page 33 of the appendix.]

Chairman PAUL. Thank you.

We will go next to Mr. Grant.

STATEMENT OF JAMES GRANT, EDITOR, GRANT'S INTEREST RATE OBSERVER

Mr. GRANT. Mr. Chairman, good morning. I have the honor of testifying—thank you.

The original Federal Reserve Act said nothing about zero percent interest rates, quantitative easing, inflation targeting, stock price manipulation or indeed, paper money.

The law, rather, projected an institution, "to provide for the establishment of the Federal Reserve Banks to furnish an elastic currency to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes."

We should have known.

"For other purposes" was the operative phrase. Mission creep is endemic to bureaucracy, of course, but few government departments have crept, indeed galloped, faster, further toward a more unhelpful direction than our own Federal Reserve.

Central banking has elited into a kind of central planning.

And to top it all, the Fed has unilaterally added a third mandate to the two Congress conferred on it some years ago. The "Bank of Bernanke" is today the self-appointed booster of stock prices.

Now, the progenitors of the Fed, notably Senator Carter Glass of Virginia and the economist H. Parker Willis, had no time for Wall Street. They were rather devoted to commerce and agriculture and to decentralization of finance.

It would sorely grieve those two to discover that in their absence, the Fed's zero percent funds rate has simultaneously served to starve savers and to fatten speculators.

It should likewise grieve us, the living.

There is something deeply and fundamentally wrong in American finance.

According to Chairman Bernanke, himself, in private testimony before the Financial Crisis Inquiry Commission in November of 2009, 12 of this country's largest 13 national institutions were at the risk of failure in the fall of 2008.

In our Great Recession, nominal GDP was down top to bottom by no more than 4 percent or less.

In our Great Depression, 1929 and 1933, nominal GDP was down by 46 percent, that is to say the economy was virtually sawed in half, yet most banks did not fail.

The predecessor to today's Citigroup was notably solvent. You do wonder if only one 21st Century American financial institution could stand up to anything like the Depression of yesteryear, well not eager to find out, the Fed insisted once, no truck with even the statistical absence of inflation, let alone with outright deflation.

Still less of course, with the Depression, so it boons its balance sheet and it presses its interest rate to the floor. That is not of course the end of the story. The dollar is thereby materialized, the interest rate thereby suppressed, have unscripted consequences.

They inflate prices and investment values, and because prices and values are the traffic signals of a market economy, the Federal Reserve unintentionally becomes the cause of crashes and pileups on our financial streets and highways. Some of these accidents, notably the 2007, 2009 residential real estate debacle are the monetary equivalent of a chain reaction on a foggy California freeway.

The trouble with our monetary Mandarins is that they believe impossible things. They have persuaded themselves that a central bank can pick the interest rate that will cause the GDP to grow, payrolls to expand, and price to levitate by just 2 percent a year, no more mind you, as they measure it.

It is impossible, experience and common sense both attest, yet they hold it to be true. Today's dollar, it is weightiness uncollateralized by anything except the world's faith in us. That too seemingly in history's judgment would be an impossibility yet here it is.

Yet that faith justifiably is today fading. William F. Buckley famously and persuasively said that he would rather be governed by the first 400 names in the Boston phone directory than by the faculty of Harvard.

Unaccountably, this Congress has entrusted the value of the dollars that we own, we transact, to an independent committee dominated by monetary scholars. In one short generation, we have moved to the Ph.D. standard from the gold standard.

I submit, Mr. Chairman, it is past time to reconsider.

[The prepared statement of Mr. Grant can be found on page 28 of the appendix.]

Chairman PAUL. I thank the gentleman, and we will go on to Professor Salerno.

STATEMENT OF JOSEPH T. SALERNO, PROFESSOR, PACE UNIVERSITY, NEW YORK

Mr. SALERNO. Chairman Paul and distinguished members of the subcommittee, I am very honored to be here.

The old argument has come back into vogue that modern inflation is desirable to prevent the far greater evil of deflation. This has been given a scientific sounding name of "inflation targeting."

In the past decade, this view has been promoted both by former Federal Reserve Chairman Greenspan and current Federal Reserve Chairman Bernanke. But this view is based on a fundamental confusion. It confuses deflation with depression, which are two very different phenomenon. Falling prices are, under most circumstances, absolutely benign and the natural outcome of a prosperous and growing economy. The fear of falling prices is not the phobia, a deflation phobia which has no rational basis in economic theory or history.

Let us look at the experience of the past 4 decades with respect to the products of the consumer electronics and high tech industries. For example, a mainframe computer sold for $4.7 million in 1970 and probably is the size of this room, while today, one can purchase a PC that is 20 times faster for less than $1,000. The first hand calculator was introduced in 1971 and was priced at $240, and by 1980, similar hand calculators were selling for $10 despite the fact that the 1970s was the most inflationary decade in U.S. history.

The first HD TV was introduced by Sony in 1990 and sold for $36,000. When HD TV began to be sold widely in the United States in 2003, their prices ranged between $3,000 and $5,000. Today, consumers can purchase one of much higher quality for as little as $500.

In the medical field, the price of Lasik eye surgery dropped from $4,000 per eye in 1998 when it was first approved by the FDA to as little as $300 today.

No one, not even a Keynesian economist, would claim that the spectacular price deflation in these industries has been a bad thing for the U.S. economy. Indeed, the falling prices reflect the greater abundance of good which enhances the welfare of American consumers.

Nor has price deflation in these industries diminished profits, production or employment. In fact, the growth of these industries has been as spectacular as the decline in the prices of their products. But if deflation is a benign development for both consumers and businesses in individual markets and industries, then why should we fear a fall in the general price level, which of course is nothing but an average of the prices of individual goods?

The answer given by theory and history, is that a falling price level is the natural outcome of a dynamic market economy operating with a sound money like gold.

Under a gold standard, prices naturally tend to decline as technological advance and investment in additional capital goods rapidly improve labor productivity and increase the supply of consumer goods while the money supply grows very gradually. For instance, throughout the 19th Century and up until World War I, a mild deflationary trend prevailed in the United States.

As a result, an American consumer in the year 1913 needed only $0.79 to purchase the same basket of goods that required $1 to purchase in 1800. In other words, due to the gentle fall in prices during the 19th Century, a dollar could purchase 27 percent more, in terms of goods, in 1913 than it could in 1800.

Contrast this with the current-day consumer who once paid $22 for what a consumer in 1913 paid only $1 for.

The secular fallen prices under the classical gold standard did not impede economic growth in the United States, in fact deflation coincided with the spectacular transformation of the United States from an agrarian economy, in 1800, to the greatest industrial power on earth by the eve of World War I.

Ironically, while Chairman Bernanke just reaffirmed again a few days ago that the Fed will persist in its inflationary policy of quantitative easing to ward off the imaginary threat of falling prices, signs of inflation abound.

I will skip over, in my testimony, the review of inflation in the commodity markets which was given by Mr. Lehrman. But let me just add that as a result of skyrocketing prices of agricultural products such as corn, wheat, soybeans, and other crops, the price of farm land in the United States has been soaring, particularly in the Midwest, where land prices increased at double-digit rates last year and regulators now are fearing a bubble.

And just today it was reported that wholesale food prices in the United States rose by 4 percent last month, the most in 46 years. That is since the stagflationary 1970s.

Not only does Chairman Bernanke seem unfazed by these inflationary developments, but what is more astounding, he appears to welcome the rapid increase in stock prices as evidence that QE2 is working to right the economy. He seized on the Russell 2000 index of small cap stocks, which has increased 25 percent in the last 6 months, stating, "A stronger economy helps smaller businesses."

In other words, despite the stagnant job creation and sluggish growth of real output, Mr. Bernanke has declared Fed policy a success on the basis of yet another financial asset bubble that threatens again to devastate the global economy. This would be farcical if it were not so tragic. But what else can be expected from a leader of an institution whose very rationale is to manipulate interest rates and print money.

And I will just end on the following. Just today, hot off the presses, USA Today reported substantial evidence that a new tech bubble is starting to grow. Facebook is estimated to be worth $75 billion on private markets and is reported to be bidding against Google for a $10 billion purchase of Twitter.

Over the last year, there have been 48 tech IPOs, which is 28 percent of all deals. And the stock prices of these tech IPOs have jumped 19 percent on their first day of public trading.

Thank you.

[The prepared statement of Professor Salerno can be found on page 48 of the appendix.]

Chairman PAUL. Thank you. There are votes on the Floor, so we are going to take a recess, but we will be back shortly.

[recess]

Chairman PAUL. The committee will come back to order and we will go into the question session right now. I will start off by taking 5 minutes for that.

I do want to welcome once again, the three witnesses and I appreciate very much you being here, and talking about a very important subject. Not only for our business climate and our employment, but also for all Americans who suffer the consequences of rising prices. This hearing has been set up mainly to sort out the relationship of monetary policy and why prices go up.

A lot of people, as I mentioned in my earlier statement, would like to blame everything else and try to avoid the Federal Reserve completely. But I do want to start off with a question about the opposite of what people call inflation, and it was touched upon in the testimony, and that is the deflation.

Deflation of course, for some of us, would mean that the money supply is shrinking as it did in the 1930s but other worry about prices going down and there is—I guess there are some people who justifiably worry about it especially when they are overextended and they have to pay their debts. But overall, if we are on a sound monetary system, if we are on a commodity standard it may well be that prices would go down.

I would like to ask Professor Salerno to distinguish between these two, between deflating the money supply and prices going down and who then would best benefit if prices actually dropped?

Mr. SALERNO. If we use deflation to mean falling prices, it is the mechanism by which people are benefitted, even on a fixed income, when we have increases in productivity, increases in productivity result from technological progress and more savings and investment in the economy. So workers become much more productive, more goods are produced in a given hour, and at the same wages their standards of living go up because their dollars become more powerful in exchange.

If you prevent this drop in prices, then many people who were not involved in the original increase in productivity, people who are in other industries or people, especially on fixed incomes, people on pensions, and insurance policies, will benefit from the falling prices. Their real incomes go up.

Chairman PAUL. Thank you. I want to ask Mr. Lehrman a question about the long-term effects of gold. You brought up the subject of gold and some of the advantages. There have been studies done with gold and stability of prices over long periods of times. Even with an imperfect gold standard, do we not have a fairly good record of stability in prices when it wasn't a Fiat currency?

Mr. LEHRMAN. We do, Mr. Chairman. If you will permit me to wave a piece of paper at you, in my testimony, I have charted the price of gold or the value of the dollar—was all that heard before?

We do have the history of the general price level under the gold standard and I have prepared in my written testimony a chart which shows that since the end of the gold standard, that is to say the class of gold standard in 1914 on the eve of the First World War, the value of the dollar as measured by the CPI, adjusted for the available statistics, before 1920, has fallen to $0.05. The value of an ounce of gold in March, well on March 15th, or I should say even March 17th, today, 1910, was $20 per ounce of gold.

On March 15th or March 17, 2011, one century later, the price of gold is approximately $1,400 per ounce. So the price of gold is, as it were, the reciprocal of the fall in the value of the dollar over the same period.

During the history of the American Republic from let us say the Constitution of 1788, 1789, we can chart the price level quite accurately. And in my testimony I submit such a chart, with Coiny Jack of 1792, essentially Alexander Hamilton's, Coiny Jack, the 1792, which made the dollar convertible to precious metal, primarily under the circumstance that the silver is first but by 1834 we were on to the gold standard.

If you take the price level under the gold standard, from 1834, and of course make the exception for the Civil War which went on for a very long period was a convertible of suspension. But if you take from 1834 until 1914, you will find under the gold standard that the general price level or the CTI as we would say today was exactly in the same position.

In other words, over the long run, near a century, there was neither a fall in the general price level, siflation, as Professor Salerno might describe, nor was there any general inflation. So that is—in testing monetary theory, or even economic theories we have only one laboratory, it is the laboratory of human history.

And in the laboratory of human history, we find that the gold standard, proven by the price level stability from 1834 until 1914 for example, that the gold standard provides virtual stability in the price levels on the average level of general prices.

Chairman PAUL. I thank the gentleman and we will go on now to Mr. Luetkemeyer for his 5 minutes.

Mr. LUETKEMEYER. Thank you, Mr. Chairman. Mr. Grant, you made an interesting statement during your testimony that, "The only thing holding up our dollar was the faith in it." Would you elaborate just a little on that, I have some agreement with you on that. And that I think that our whole system right now seems to be held together by the confidence that we will be able to pay something back and forth versus the actual collateralization, the actual asset backing of the actual—there being some value there.

I think—it would appear to me that the whole system is held together by just the confidence between you and I, that we can do business versus the actual asset that is there.

Could you elaborate a little bit on your statement and whether you think that is the right perception or not?

Mr. GRANT. Yes, Congressman, I do. To a degree, every monetary system is faith-based. One must have confidence in the quality of the metal, if there is collateral behind the currency.

Never, I think until the present day, has the world been on a system of pure paper. The dollar is the Coca Cola of monetary brands. It is a remarkable achievement in that it is today treated as good money, the world over, though the cost of production is essentially nothing.

And this is a pretty flattering expression of confidence by the world in America and its institutions. However, faith must be continually refreshed. It is not perpetual. I think that the very size of this so-called quantitative easing program has crystallized doubts as to the nature of the currency and of its underlying value.

In the language of modern finance, the dollar is a derivative. It used to derive its value from the collateral behind it, mainly gold. In 1971, if you were a foreign official institution, you presented your $35 to the Treasury and said you would prefer to have an ounce of gold and you got it.

Over the past 40 years that has been of course, out the window. And so the dollar is in the language of modern finance, a kind of a nonsequitur; it is a derivative without an underlying asset.

Sometime recently, a reader of the Financial Times wrote to the editor and said, "Sir, the scales have fallen from my eyes. I think I finally understand the meaning of quantitative easing. I think I finally get it. What I no longer understand is the meaning of the word money."

I think the very size and the audacity and the physics of the project of materializing $600 billion effortlessly has captured the imagination and the doubt of the American people, and indeed of the world's money-holding population.

May I close with, to me, the greatest crystalizing, clarifying line about money in American literature, and it happens to be from a novel. It is a Laura Ingalls Wilder novel called, "Farmer Boy." And this is a story of a boy growing up in Upstate New York, hard scrabble, dairy country, in which—campaigned for governor, he carried all of this country, by the way, with a huge majority.

But Alonzo, this child turns up at the county fair and he asks his father very definitely for a nickel and his father miraculously materializes $0.50 from his pocket and he says to the kid, not wanting to let the moment pass without the moral instruction, he says, "You know what this is?" And the boy actually can't think of anything to say. And the father says, "It is money, do you know what money is?" And the boy again, is silent. And the father says, "Money is work." And for the past 40 years, money has been a concept. It has been the project of a Ph.D., and I think the world would like it to be work.

Mr. LUETKEMEYER. Okay, along those lines, obviously the key too is considering it to erode the confidence in our dollar and right now the dollar is sort of the gold standard around the world. What happens if our dollar goes away or like some other people are trying to look to a different currency. How does that impact out country, in your view?

As no longer being the standard—

Mr. GRANT. I think we have to answer the question. I think we have to consider our unique privilege in creating a currency that is treated as good money the world over and which only we can lawfully create. This is called the Reserve Currency Privilege and both Professor Salerno and Mr. Lehrman have written really important stuff on this. But the nature of our franchise, of American franchise is that we import, we pay with our dollar bills created at essentially no marginal cost.

These dollars we ship effectively to Wal-Mart suppliers in Asia, the dollars wind up, because the suppliers don't need it, on the balance sheet of the central banks of our Asian creditors. The Asian creditors turn right around and buy Treasury securities.

So it is as if the dollar has never left the 50 States. So that is what we have and if the world were to lose this astounding confidence in the institution of the Federal Reserve we would lose that franchise, this privilege of seignorage, this reserve, this—what was the last term they—exorbitant privilege.

Mr. LUETKEMEYER. Exorbitant privilege.

Mr. GRANT. And we would quickly find that we, like Paraguay and other nations not uniquely blessed with a reserve currency would have to suffer a lower standard of living.

Mr. LUETKEMEYER. Okay. Thank you very much. Thank you, Mr. Chairman.

Chairman PAUL. Congressman, I wonder if I may just add a couple of numbers to the question?

Mr. LEHRMAN. May I interrupt?

Chairman PAUL. Yes, you may, but I wanted to advise the members if they would like, there will be a second round of questioning, also.

Yes, go ahead Mr. Lehrman.

Mr. LEHRMAN. Mr. Grant's comment is so compelling, and I think the numbers themselves are illuminating. The official reserves of foreign central banks held in custody at the Federal Reserve System itself, published in the balance sheet of the Federal Reserve every Thursday evening at 4:00, those official reserves now amount to $3.5 trillion invested in U.S. Government securities, primarily in U.S. Treasuries, the residual in Federal agency securities.

That just gives you a quantitative estimate of the mechanism that Mr. Grant just described. The best way also, if I might say, to think about this is that this is the credit provided to our government, to the Treasury in deficit by the purchases by foreign central banks who are mostly mercantilists wanting to maintain undervalued currencies. This is the credit provided to our U.S. Government.

Until we end the official reserve currency system and, I might add, the unlimited discretion of the Federal Reserve to buy $600 billion worth of U.S. Government securities in a mere 8-month period, until we end that, all efforts to control the deficit will be unavailing.

All of the great conscientious efforts of so many of the Congressmen, especially freshman Congressmen, Republicans and I believe some Democrats too, all of them will be unavailing. We have gone through 40 to 50 years of every President declaring that he was going to reduce spending and the deficit, even President Reagan, a great President, wound up with deficits running somewhere between 3 percent and 7 percent output.

The reason is that the U.S. Government grows through the deficit spending which is authorized and then it is financed in combination by the Federal Reserve System and the official reserves which are accumulated and reinvested in U.S. Treasury by foreign governments making limitless credit available. When limitless credit is available event to an individual, over a very long period of time, we can be assured that they will make use of it.

Chairman PAUL. Thank you.

Now, to Mr. Schweikert, from Arizona.

Mr. SCHWEIKERT. Thank you, Mr. Chairman. That limitless credit as an individual would be an interesting concept.

Can I go—something I have ultimately wanted to ask and if our two—the two trading partners that actually buy most of our debt which is China and Japan, what happens—what sort of cascading effect, at all if there is, let us say Japan right now; bless them with their disasters and things they are facing, begins to have fairly substantial steps up in inflation. All we were seeing, regionally, rather aggressive inflation in areas of China, what potentially does that do in our inflation indexes?

And could we actually start from the right and go left?

Mr. SALERNO. I think the big danger is that if Japan needs extra imports and so on as their economy slows down in reaction to this disaster, and they begin to offload reserves of American currency which are actually government securities, there could be a cascading effect as it puts downward pressure on the U.S. dollar. And if China does the same thing, then we are at the situation where there—the only thing that the U.S. Government can do to finance this deficit is to borrow from the American people.

Mr. SCHWEIKERT. But that is also our bond prices functioning, start having to move up to be able to sell the product. That was actually going to be the second half of my question.

But even just—let us say there was just a national inflation step-up within Japan and China. What do you see from just that in the price of the products being imported and exported?

Mr. SALERNO. To the extent that China keeps its exchange rates with us, their prices would actually become higher in relation to us and we would actually have an increase in our exports and a decrease of imports from China. So for mercantilists, that would sort of be a good thing.

So given the system of exchange rates that we have today, there would not be a huge impact on the U.S. price level of those developments. Although, the problems in Japan if their economy slows down, that would put an upward tick on world prices and there would be some effects on consumer prices here in the United States.

Mr. GRANT. Agreed.

Mr. SCHWEIKERT. No, no I appreciate brevity.

Mr. LEHRMAN. Agreed, Congressman.

Mr. SCHWEIKERT. Okay, now going back in the other direction. What if we actually start to see the nation of China, which is the second biggest buyer of our debt, now they have to start to begin to finance their own reconstruction so they no longer are participating as much in the U.S. debt market so now we have lost one of our customers. So we start to tick up our own bond rates.

What do we face?

Mr. LEHRMAN. Do we go from right to left? There are at least two alternatives. One would be that despite Japan not absorbing U.S. dollars in exchange for exports and then adding them to their official reserves, that other emerging countries who have absorbed enormous amounts of dollars in their banking systems and then into their official reserves, which have risen even more dramatically than Japan, in the last 10 years, that they too would absorb whatever Japan no longer absorbs.

I might add that Japan had been out of the market for absorbing U.S. dollars and then investing them in U.S. Government securities in custody of the Fed for a good long while until recently, as the yen strengthened and they of course wanted to lower its value in order to maintain their valued export industries.

The other possibility is that there was no other emerging country or major country willing to absorb the residual of the securities and were the United States balance of payments to remain the same, all fairly large assumptions, the dollar would then fall on the foreign exchanges until there was intervention by countries who did not want the dollar to become increasingly competitive in the export markets or until the Federal Reserve reduced the volume of credit they were issuing talk in the market especially the subsidizing of banks and the U.S. Treasury and deficit.

For a concrete example of that, that is exactly what Paul Volcker did in 1981, 1982. He imposed the most Draconian credit contraction in American history since the Great Depression, or least comparatively with all other recessions. He put the Fed's fund rate up to 20 percent the prime rate hit 21 percent.

Unemployment in New York State that Jimmy referred to, in 1982, which was my year on the campaign, the unemployment rate in New York hit 11.2 percent. The unemployment nationally, in 1982, under the Volcker credit contraction policy hit almost 11 percent nationally, higher than at any time during the so-called Great Recession.

So that these two options, namely a great fall in the dollar with no residual buyer of excess foreign dollars in the foreign exchange markets, combined with Federal Reserve contractions, presents us with two unattractive alternatives.

Mr. SCHWEIKERT. Mr. Chairman, without objection, can I have another 60 seconds?

Mr. GRANT. Briefly, the more birthday candles I blow out, the less certain I am about cause and effect with bond prices and interest rates. Paradox seems to govern many of these markets. For example, the difficulties, the tragedy in Japan has forced the yen not downward but upward as the Japanese repatriate assets from abroad to finance the holes in their income statements and balance sheets. To attempt to suppress the rise in the yen the Japanese buy more dollars. They help to finance our deficit even in the midst of their travail and our interest rates have been going down since 1981. For 30 years, bond prices ostensibly have been rising and interest rates falling.

I think probably that no matter what happens with respect to the dollar, no matter what happens with regard to these hearings or with the congressional approach to monetary policy, the chances are that the next 30 years would see more likely interest rates rising and falling. Interest rates have tended to rise and fall in generation length intervals since the late 19th Century.

Mr. SALERNO. Foreign confidence in the dollar is precarious. So that if there is a drop in the dollar as the foreign demand for the dollar falls, I think what you are going to see is a cascading effect. There is already talk among China and Brazil and the president of the IMF of moving towards this sort of a gold-based reserve currency or a currency that has basket weight entities.

But at that point, I think then it could be a vicious circle in which it feeds on itself, the dollar drops, if the Fed doesn't contract the money supply what you will get is an explosion upward of import prices, no more cheap shopping at Wal-Mart. And it is so precarious, but a few years ago there is evidence that—now that drug dealers are beginning to offload their $100 bills, 80 percent of the $100 bills that are printed in the United States are not in the United States, they are financing drug deals they are hedging against inflation.

And they are beginning to stop using them and they are replacing them with EUR 500 notes. So that is just sort of the first step.

Mr. SCHWEIKERT. Mr. Chairman, forgive me, but should I be worried about that?

Chairman PAUL. I think we all should be, and we should have been a long time ago.

Mr. SCHWEIKERT. Something about when the drug dealers have attended their monetary economic classes I—we are in trouble. But please, I interrupted.

Mr. SALERNO. No, that is what I was going to say.

Mr. SCHWEIKERT. Thank you, Mr. Chairman.

Chairman PAUL. I would like to talk a little bit about the measurement of price inflation. The government depends on this CPI, there is an old CPI and a new CPI. John Williams has spent some time as a free market person, trying to keep us honest about what the CPI is really doing. And of course traditionally, when the government makes reports, they talk about core CPI and they drop off those unessential things like food and energy and it seems like the markets very frequently accept whatever they say.

"Oh, inflation is only 2 percent; prices are only going up at the rate of 2 percent." Of course, eventually, I think the numbers catch up, even with the government. In the 1970s, he did admit that prices were going up at a 15 percent rate.

But my question is, talk a little bit about the difference about the CPI, how good is it, how accurate is it? Is it—does John Williams have a good point there, saying that the revamping of it—what do you all look at if you want to know how prices are going up? I know we all look at the CPI and the PBI and it seems to have the immediate effect, but where do you put your most importance, what price measurement do you use?

All three of you, could you give me your comment?

Mr. SALERNO. Varese's once said that the housewife who just checks a few prices in the supermarket and keeps track of them is much more scientific than the arbitrary price indexes that are used by economists and statisticians. But I tend to look at something called median CPI which is calculated by the Cleveland Fed. It is not perfect and it shares some of the same problems as the CPI itself. But also I like to look at the raw prices of goods and what has happened over time, to them.

I do want to mention that these adjustments are just ridiculous. We have a substitution bias adjustment which, if the price of prime beef goes up, they don't include that increase; they reduce that and they say, "Well, people can eat chicken at a lower price." So the full increase is not reflected.

They have hedonic adjustments, if a car gets two-side airbags, "The increase in the price of the car has to be reduced by the fact that it is a higher quality now." And new technology adjustments, the iPad as someone talked about, when that comes into play, that is a deflating force. Despite the fact that other prices are going up at a certain rate, that rate is reduced for that reason.

Chairman PAUL. Are there any other comments?

Mr. LEHRMAN. I think it may be Mr. Williams' research, Mr. Chairman, I am not sure, I cannot quote the author for certain, but in his research on the CPI, he used the methodology that was in force in 1980. And if one were to use the methodology in force in 1980 without the hedonic adjustments, without the substitution effects and so much of the changes which have occurred, that the price level is increasing at approximately 8 percent by that methodology as opposed to the methodology presently adopted by the Bureau of Labor.

And for purposes in our investment business, we pay no attention whatsoever to these fictitious Ph.D.-created mechanisms otherwise known as the CPI. Even the PPI leaves much to be desired up until—for the longest period of time, up until the Second World War, which was a period, certainly before the Great Depression, of the greatest economic growth the world had ever experienced, it was the Industrial Revolution. It was the Wholesale Price Index, which was used to measure the level of prices.

The CPI and the PPI themselves aren't innovations. So looking at commodity prices, looking at equity prices which themselves are articles of wealth in the market and are excluded from the CPI, means to anybody who is involved in business, corporate capital allocations, or if you will, in long-term investing, one has to ignore the publication on a monthly basis of the CPI and PPI and look at the actual prices in the market which serve as indicators of the cost of production of producing another article of wealth to the market.

Chairman PAUL. Would it not be true that if they would use the CPI, wouldn't some groups of people suffer more by rising prices, and other groups be more protected? Everybody is not going to be penalized the same way, even if we did look at those numbers. The average person might spend their money differently. If your income is $25,000 a year, the inflation rate might be much more painful than if you were making a couple of hundred thousand a year.

Mr. GRANT. Or depending on your age, it—a younger person spends a great deal of his or her money on consumer electronics, that personal CPI is plummeting. He or she is in clover. It seems to me, and Professor Salerno will know whereas I am surmising, but it seems to me that the ancients posited that inflation is not too much money chasing too few goods, inflation is too much money, that which the money chases is variable. In one cycle, it might chase skirts at retail, and in another cycle, it might chase the Russell 2000 Stock Index.

And I think the complacency of our masters, the Fed, with respect to inflation, has to do with their overlooking this most basic concept about inflation.

Mr. LEHRMAN. Conversely, if I may, with the—with respect to the younger generation and the amount of money they spend on technology, with ever falling prices, you have the entire world of emerging markets, not to mention middle-income families and poorer families in the United States driven from subsistence level to starvation by basic food prices. The milk price has doubled in the past year and a half. Food prices, we know, have risen, depending upon the supermarket, anywhere from 15 percent to 20 percent in basic foods.

So, I believe that the political turmoil for example in North Africa, indeed all around the world, and some of the protests, the intensive protests about issues which in the past, in the United States have been received without quite the kind of ferocious protests, I think are related to the frustration that middle-income and poorer families all around the world are feeling.

As the political class is indifferent to what the effect of the commodity price is, the basic food and food prices have done to those on subsistence or near subsistence level, as they feel ever more the threat of starvation.

Chairman PAUL. Mr. Schweikert.

Mr. SCHWEIKERT. Mr. Chairman, actually—is it pronounced "Lehrman?"

Mr. LEHRMAN. Yes, sir.

Mr. SCHWEIKERT. Actually, heading in that same direction, just—and I know this is a bit of a lark, and there are other components that go into that food price. While our farm policies in this country subsidize certain commodities crops—or make them more expensive around the world. I once sat down with some agricultural economists who basically said U.S. agricultural policy kills people in Sub-Saharan Africa. So when you talk about the food prices, particularly what we see around the world, and some of the protests breaking out, what is a combination of just purely organic inflation and also government policy.

Mr. LEHRMAN. Government subsidies in the agricultural sector, as you suggest Congressman, are themselves very controversial. In the end, if I can make it brief, it is a question of, compared to what?

The common agricultural policy of the European Union causes, for example, corn prices and wheat prices and they too are great producers and exporters, to be about twice or more the level of basic agricultural prices in the United States because the United States farmer is the most efficient producer of all basic food goods and high-protein goods such as meat products, in the world.

So, that the elimination of subsidies in the United States, it is true, might make the production, the total output of farm goods sometimes—in some areas in which we export 50 percent of our own output to the world at very cheap prices relative to the rest of the world, those subsidies might reduce the prices, but it is also true I think that the profitability of the industry would change and the supply therefore would contract in the U.S. market in general and thus make less of our output in the farm sector available for export to countries: (A) which do not product sufficient food to feed their population; or (B) have to buy much more expensive goods subsidized at much higher rates of subsidy from the European Union.

Mr. SCHWEIKERT. Mr. Lehrman, I know we are not doing agriculture, but isn't there also, the flip side of that domestic agriculture in these foreign countries is also suppressed because we import a cheaper product than they can actually produce it domestically?

Mr. LEHRMAN. If I understand the question, are they able to import U.S.—

Mr. SCHWEIKERT. No, no, yes, often our commodity hits the country often at a price that is sometimes below what they would domestically produce. And so therefore all—

Mr. LEHRMAN. That is correct and that is because we produce it so cheaply in this country relative to the rest of the world.

Mr. SCHWEIKERT. And therefore, if we hit any price bumps or those things there they have no domestic agricultural safety net?

Mr. LEHRMAN. They do not, in some countries, most countries have a—most countries that are well advised have a food sufficiency strategy, the Chinese being a particular and a good example of this. Whereby believing that they always have to be prepared for a war, that—and this used to be the United States' policy, that food sufficiency in time of war, total war, was absolutely indispensable since only a blue water navy could fully protect the sea lanes in order to import food in the event it was blockaded by the enemy.

Mr. SCHWEIKERT. Mr. Chairman, may I ask unanimous consent for another minute or 2 minutes?

Chairman PAUL. Granted, yes.

Mr. SCHWEIKERT. Now, back to what I was actually really hoping to ask. Okay, if I was a market observer and I have a fixation of watching bonds and bond futures, but I think one of those over there said as his birthdays move along he sometimes isn't sure what those numbers really mean. If you were me and you are trying to watch the financial markets, where do I go to see a tell of both my future on interest rates and a tell of my future in inflation? Let us start from the far side and come back.

Mr. SALERNO. I think the tell on inflation is the long-term bond markets which will crystalize inflationary expectations in the longer-term bonds. And I think contrary to what Chairman Bernanke and the Fed believed when they engaged, when they undertook QE2, long-term bond rates did not fall they went up. And that because of the expectations that were stimulated, of an inflation in the future.

Mr. GRANT. With respect, I think that there is no long-term tell on anything, especially inflation, especially interest rates. Two examples from history, one in 1946, April, the long-dated U.S. trades at an astonishingly low 2.2 percent, 2.2 percent. At that time, the CPI was running in double-digits when General Marshall delivered his famous Marshall address at Harvard the next year, the CPI was even higher, close to 20 percent, bond yields rather lower, but Marshall was looking backwards. He was looking at the Depression and not forward to the prospects of a full generation of inflation and rising interest rates, observation number one.

Observation number two is, in the spring of 1984, bond yields are quoted at 14 percent, 14 percent and the CPI is at 4 percent, the market was looking backward to the experience of the tumultuous and wholly profitless period, 35 years of a bear market in bonds, rising interest rates, 1946 to 1981.

So the bond market to me is like an—it is like a badly trained waiter, looking at his shoes, looking left, not meeting your eye. He is—the bond market is an arbitrage market, that is it is priced, principally, I submit, off of the cost of financing a portfolio of bonds and not with regard to a possible scenario for the future.

The stock market is meant to look forward, the bond market I think is rather present minded.

Mr. LEHRMAN. Observation three, agreed on all the propositions that Mr. Grant just put forward. The one exception, I believe, on forecasting, would be that when an economy is fully employed, all resources—labor, capital, savings—are fully mobilized, the banking system is fully committed to full output and we are the authorities then because prices were advancing to establish wage and price controls then I think as the—as you the observer or the bond investor or speculator, you could bet on a rising level of interest rates and thus a falling bond market in the future.

And the example I would cite would be the infamous example of President Nixon deploying the Federal Reserve to pump up the money supply in 1971 on the verge of the 1972 elections. Having—on August 15, 1971, declared the dollar no longer convertible to gold. And in 1972 with the effects of the vast inflation which were developing as a result of the Fed policy, imposing wage and price control.

We know what happens after that.

Mr. SCHWEIKERT. Mr. Chairman, can I ask that there be no more cursing like that. Those are dirty words.

Chairman PAUL. Which words?

Mr. SCHWEIKERT. Wage and price controls.

Chairman PAUL. Oh.

Mr. SCHWEIKERT. Mr. Chairman, would you allow me just because there is one. In the whole sort of discussion of tells and inflation and my fear of a classic sort of cascading event, it is sort of the miniature version of a black swan; we float much of our U.S. debt, very short term. Our WAM is, I think, actually somewhat dangerously short. If we start to hit some ticks on the short end of the curve, what—does that create a ratcheting affect both on interest rates and therefore inflation or should I just stop worrying about it?

Mr. GRANT. No, you should really worry.

Mr. LEHRMAN. You should worry substantially. The average maturity of the U.S. Treasury debt is approximately 4 years which is very short for a country which is approaching a level of direct debt equal to total national output. We are at the level of interest rates now subsidized by the Federal Reserve, despite their marginal rise, as Professor Salerno suggested, we are at the level of interest rates to rise close to market rates which are typical of full employment.

The level of debt service payments would rise by an order of magnitude, consume that part of the Federal budget, the total Federal budget which today is almost unthinkable and could be only as little as 4 or 5 years away.

And all of the talk about cutting $100 billion of spending would be consumed by the fact that the level of interest rates had risen from several hundred billion to as much as $700 billion, $800 billion. So the political leaders of our country, the Congress, need to worry very much about a rise in the level of interest rates from their present subsidized level to market interest rates associated with a more fully employed economy.

Mr. GRANT. Think about how this might just look in retrospect. We are sitting here in 2011, we have a Federal Reserve that is suppressing money market interest rates, it is funds rate notoriously is zero. We are running $1.5 trillion a year, public deficit we are running deficit on current account of 3 percent to 4 percent, 5 percent, depending on the fiscal quarter, of GDP. We are enjoying generation low market interest rates and the measured rate of inflation as they measure it is comfortable.

That is the moment—and one can imagine looking back on this moment saying, couldn't we see that this was Nirvana that nothing better was going to be coming down the pike. In fact, as Mr. Lehrman has suggested, market interest rates were going to revert to something like normal. So if the long-dated Treasury bond goes from 3.25 percent to 6 percent, and if money market interest rates go from zero to 3 percent, or 4 percent that presupposes an immense increase, as has been suggested, in the cost of financing these debts, these are the good old days with respect to interest cost.

Mr. SCHWEIKERT. Anything else to be shared?

Mr. SALERNO. I agree with both Mr. Grant and Mr. Lehrman.

Mr. SCHWEIKERT. All right. Thank you for your tolerance, Mr. Chairman.

Chairman PAUL. You are welcome. Thank you.

I have a couple more additional questions that I want to touch on before we adjourn. The opposition, those people who believe in a monetary system quite different than you describe, the people who believe in Fiat money and the creation of money out of thin air, do they deliberately have a purpose for dealing with the debt? We know that the debt won't be paid, do they actually believe that it is a proper policy to liquidate the debt by just reducing the debt by devaluing the money because real debt goes down?

If you have a $14 trillion debt and you can get inflation going again, because I sense when I talk to individuals at the Federal Reserve that they would sort of like inflation to come back.

Do they ever actually in their writings describe that this is one way you can handle the debt? And likewise, is there ever an argument by those who believe in that system that this is one way you can lower real wages without lowering nominal wages? If there is a correction it is necessary, wages, maybe they should go down.

But nobody can quite accept the idea of, we are going to lower your wages, but we will lower the real wage by inflating the currency. Do we have evidence that they actually use that as a policy? Would anybody care to answer that?

Mr. SALERNO. In academic writings, increasingly they are talking about adjusting wages through the device of inflation. As far as the debt is concerned, it is hard to know people's motives but the standard argument is that we owe much of it to ourselves and increasingly more to the rest of the world but that we would still, as a reserve currency, we can pay the rest of the world off by simply printing money to pay those debts.

They don't go on and say that in fact what we are really doing is repudiating the debt over time.

Chairman PAUL. I have trouble, politically, as others would, to describe our position about what to do when a bubble forms. Those of us who believe in sound money don't create the bubbles; they come from the excessive amount of credit that is created.

But when the crisis hits and the bubble bursts, we can do a lot of things like we have done in the last 2 years—we just turn off the printing presses and the spending and hope that is going to take care of it. Others would argue that we just do nothing like we did in 1921. How do we handle this politically, because right now it is virtually impossible to talk to—people are saying, let us just not do anything. Any suggestions on how you present this to people who want to and feel compelled to do something?

Mr. GRANT. I have a modest suggestion speaking as a non-politician. I would suggest, as an interim step before the promulgation of a new gold standard, let us say as an interim step to that, I would suggest to the Congress, respectively, that the Congress admonishes the Federal Reserve to speak in plain language, in plain English. For example, "quantitative easing" should be called money printing. "Quantitative easing" should not be allowed in the official discourse.

Similarly, the chairman used the phrase "portfolio balance channel" to convey the Fed's intentions to manipulate stock prices higher. In place of "portfolio balanced channel," I would suggest the Congress admonish the Fed to use the term "thimble rigging," an ancient Wall Street term, or a little more clinically, "manipulation." So if we talk about money printing and manipulation, the public will understand what is afoot. These three-dollar words signify nothing, and I think that Congress should outlaw them.

Mr. LEHRMAN. I wish not to assail the motives of any man. But I would say, directly, in answer to your question, Dr. Paul, that it is not, I think, correct to blame or to assign motives to those who are manipulating the monetary system. We live in America, in a world of institutions that were created over time and created a set of facts and circumstances in which men and women find themselves operating.

The academics believe that the Federal Reserve System should be a form of the GOSS plan; it should be sort of general manager of the national economy if not the world economy. But they have been trained to think that way. In the economics department of almost every graduate school, this is the way they are trained to think. They are either neo-Keynesians or they are members of, if you will permit me to say it, the discredit moniterus school.

So that it is sufficient to say that the system is flawed, it is imperfect that the Federal Reserve manipulates interest rates as well as the money supply. That foreign officials, the governments are financing the Treasury, creating inflation, without attributing base motives to the individuals who are operating in a set of institutions which were bequeathed to them sort of by chance or by historical developments rather than by any satanic design.

Mr. SALERNO. From an academic perspective, Keynesian economics and even the moniterus have no place for bubbles in their theories. They deal with the effect of the money supply on current production and employment, and so on. So that when Chairman Greenspan made a statement that—in the early part of the last decade, there is no bubble, you wouldn't know if there was one and if there was one we wouldn't do anything about it because it would cause recession.

Most macroeconomists agreed with him. Now, that is starting to change and they are starting to cast around for some sort of an explanation of bubbles. But what they have seized on now is irrationalities in the markets which certainly from the off stream perspective, it is not true. What we look at is the manipulation of the interest rate by the Fed, there is a ready explanation for the creation of bubbles.

Chairman PAUL. I had a Federal Reserve Board Chairman testify before the committee that the gold standard had some merits but it was unnecessary because central bankers have now learned how to manage a Fiat currency in a manner in which it would mimic the gold standard. Would anybody care to comment about where the flaw is in that thinking?

Mr. LEHRMAN. I am anxious to comment on that, Dr. Paul. Under—and I must say Mr. Greenspan made the same insipid remark. Mr. Greenspan and Mr. Bernanke will have to then explain why it was that two of the greatest booms in American history, and two of the greatest panics and busts in American financial history, occurred under their 25-year watch.

We have the just unparalleled boom in the U.S. equity market focused on the Internet stocks of the late 1990s and a collapse under Mr. Greenspan's tutelage of not only the stock market but a fall in the economy and a rise in unemployment. This is not what Mr. Greenspan, I think, believes would be the characteristics of an economy regulated with a stable price level, under the gold standard.

And equally, Mr. Bernanke himself, who was the Vice Chairman of the Fed under Mr. Greenspan, would have to explain the near catastrophic boom generated by the Federal Reserve in the real estate market in the United States among other markets. The great panic and the bust which have then led to Mr. Grant's quantitative easing one, two and—

Mr. GRANT. Money printing.

Mr. LEHRMAN. —money printing, one, two, one and two. So that this is just an—it is incredible that a responsible academic economist from Princeton or one preceding him, from NYU, could have the temerity to suggest.

All of their 25 years presiding over the U.S. monetary system is a witness to the contrary.

Mr. GRANT. I would say something a little bit different, and I would echo Mr. Lehrman's earlier observation that gold standard is the least imperfect system, but it is not people-proof. Long before the Federal Reserve was conceived, let alone enacted, we saw plenty of booms and busts. We got rich we got poor, there was a terrific boom in Great Plains farm land in the 1880s, Moody's hadn't even been invented.

For a really fouled-up economy, you don't need anything except people; that goes without saying. But what the gold standard did was to introduce an element of reciprocal movement in money from one country to the next, in one country that participated in the gold standard to the next.

So I think the telltale feature of our present day landscape that shows you how far we have come from the gold standard is the existence of the 3 trillion and counting dollar bills on the balance sheets of our mercantilist counterparts, counterparties, in Asia.

That never happened, it couldn't have happened in the gold standard because creditors and debtors exchanged cash to clear trades.

The failure of AIG is so instructive in this respect. AIG, this immense insurance company with this ever so brilliant financial products group, didn't do one thing. It didn't mark its positions to market. Finally came the day of judgment and it argued with Goldman Sachs about what these things were worth, AIG said 100 cents on the dollar, Goldman Sachs said not close, Goldman Sachs won that debate and AIG failed.

As with AIG and Goldman Sachs, so it is today with the United States and its Asian trading partners. We never clear our trades. Our dollars go there, and they come right back here. We run 25 consecutive years of debts on a current account and there will be for us, as there was for AIG, a moment in truth in which we must settle.

Mr. SALERNO. I just want to add that the statement that you quoted by the Fed Chairman shows a complete innocence of any familiarity with the history of monopolies. The Federal Reserve has a legal monopoly of printing money. In history, every monopolist that has been granted a legal monopoly has used it.

Now, they could use it for motives they believe are altruistic. You can use it to cure unemployment or think you can use it for that. Or to keep interest rates low. But the point is, even if Mother Teresa was reincarnated and was given this monopoly, she would use it to print money to feed poor people, but the effects would be exactly the same: bubbles; manipulated interest rates; and inflation.

Mr. LEHRMAN. I want to demur. I think Mother Teresa would be a sound money lady.

Chairman PAUL. I want to thank our very excellent panel for participating in this very important hearing.

I have a couple of announcements before we adjourn. Without objection, all members' opening statements will be made a part of the record. The Chair notes that some members may have additional questions for these witnesses which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses in the record.

This hearing is adjourned.

[Whereupon, at 11:55 a.m., the hearing was adjourned.]

APPENDIX

March 17, 2011

United States House of Representatives
Committee on Financial Services
Monetary Policy and Rising Prices
March 17, 2011

Congressman Ron Paul
Statement for the Record

There is perhaps no topic as important to the average American today as rising prices. Whether we consider food, gasoline, or clothing, the cost of living is increasing significantly. At a time of high unemployment, rising prices trap American families between a rock and a hard place. While rising prices colloquially are referred to as "inflation", true inflation is defined as an increase in the money supply, and all other things being equal, an increase in the money supply leads to a rise in prices. Inflation is and always has been throughout history a monetary phenomenon, and its destructive effects have ruined societies from the Roman Empire to Weimar Germany to modern-day Zimbabwe.

Blame for the most recent round of price increases has been laid at the feet of the Federal Reserve's program of quantitative easing, and rightly so in my opinion. This program, known as QE2, sought to purchase a total of $900 billion in US Treasury debt over a period of 8 months. Roughly $110 billion of newly created money is flooding into markets each month, markets which still have not fully recovered from the financial crisis of the last few years. Banks still hold billions of dollars in underperforming mortgage-backed securities on their books, securities which would render numerous major banks insolvent if they were "marked to market." These nervous banks are hesitant to loan out further money, instead holding well over a trillion dollars on reserve with the Fed. Is it any wonder, then, that the Fed's new hot money is flowing into commodity markets?

The price of cotton is up more than 170% over the past year, oil is up over 40%, and many categories of food staples are seeing double-digit price growth. This means that food, clothing, and gasoline will become increasingly expensive over the coming year. American families, many of whom already lve paycheck to paycheck, increasingly will be forced by these rising prices into unwilling tradeoffs. Rising prices lead to consumers purchasing ground beef rather than steak, drinking water rather than milk, and choosing canned vegetables over fresh. Clothes are worn until they are threadbare, in order to conserve money that keeps food on the table and pays the heating bill. While some might argue that this new frugality is a good thing, frugality is virtuous only when it results from free choice, not when it is forced upon the citizenry by the Fed's ruinous monetary policy.

While the Fed takes credit for the increase in the stock markets, it claims no responsibility for the increases in food and commodity prices. Even most economists fail to understand that inflation is at root a monetary phenomenon. As the supply of money increases, more money chases the same amount of goods, and prices rise. There may be other factors that contribute to price rises, such as famine, flooding, or global unrest, but these effects on prices are always short-term, not long-term. Consistently citing rising demand, bad weather, or energy supply uncertainty while never acknowledging the effects of monetary policy is a cop-out. Governments throughout history have sought to blame price increases on bad weather, speculators, and a whole host of other factors, rather than acknowledging the effects of their inflationary monetary policies. Indeed, tyrants of many stripes have debased their nations' currencies while denying responsibility for the suffering that results.

The unelected policymakers at the Fed are also the last to feel the effects of inflation, in fact, they benefit from it, as does the government as a whole. Inflation results in a rise in prices, but those who receive this new money first, such as government employees, contractors, and bankers are able to use it before prices begin to increase, while those further down the totem pole suffer price increases before they see any of this new money. By reducing the purchasing power of the dollar, the Fed's monetary policy also harms savers, encouraging reckless indebtedness and a more present-oriented pattern of consumption. Hard work and thrift are punished, so economic actors naturally respond by spending more, borrowing more, and saving less. After all, why save rapidly depreciating dollars?

We must also remember that those policymakers who exercise the most power over the economy are also the least likely to understand the effects of their policies. Chairman Bernanke and other members of the Federal Open Market Committee were convinced in mid-2008 that the economy would rebound and continue to grow through 2009, even though it was clear to many observers that we were in the midst of a severe economic crisis. Chairman Greenspan before him was known for downplaying the importance of the growing housing bubble, even while it was reaching its zenith. It remains impossible for even the brilliant minds at the Fed to achieve both the depth and breadth of knowledge necessary to enable centralized economic planning. As Friedrich von Hayek stated in his Nobel Prize address:

> "The recognition of the insuperable limits to his knowledge ought indeed to teach the student of society a lesson of humility which should guard him against becoming an accomplice in men's fatal striving to control society - a striving which makes him not only a tyrant over his fellows, but which may well make him the destroyer of a civilization which no brain has designed but which has grown from the free efforts of millions of individuals."

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Over to you, H. Parker Willis
(GRANT'S Interest Rate Observer -9/17/10)

"What Should the Federal Reserve Do Next?" was the headline over the roundup of expert monetary opinion on the op-ed page of the Sept. 9 *Wall Street Journal.* The experts couldn't seem to agree. Buy Treasurys by the boatload, one counseled. Do nothing of the sort, urged another. Hew fast to the Taylor Rule, John B. Taylor, himself the author of the very rule, modestly proposed (i.e., fix the federal funds rate at one-and-a-half times the inflation rate plus one-half times the shortfall of GDP from potential, plus one). The half-dozen authorities shared not much common ground except to ignore the principles on which the dollar was defined in 1792 and those on which the Federal Reserve was enacted in 1913. The burden of this essay is that they thereby missed the point.

The trouble with living authorities on money and banking is the ideas they absorbed in school. For instance, that a central bank can calibrate the rate of debasement of the currency it prints by adjusting the speed of the digital press. Or that the Federal Open Market Committee can pick the interest rate that will cause the GDP to grow and payrolls to swell and prices to levitate by 2% per annum, give or take a basis point. Such things are impossible.

Say that the Fed built bridges rather than manipulated interest rates, and that, in 2008, its bridges fell down. The world would want to know why. Maybe we aren't engineers, the people would say, but we know a heap of rubble when we see it. And if an inquest determined that the Fed had built its bridges with plywood instead of reinforced concrete--a clever updating of the fusty old operations manual, some bright light on the board staff had determined--even a layman would see that "progress" is sometimes retrogression.

So it is in money and banking. With a little help from our friends, we are about to make the case that there has been no net progress in doctrine and policy since 1914, when the lights went out on the true-blue gold standard. Some will smile. The pure paper dollar, these scoffers say, is but a lighter, sleeker, more intelligent variant on the old, gold-backed model. But you could only issue so many gold-backed dollars, the supply being constrained by the scarcity of the collateral. There now being no check on the volume of issuance, dollars pile up in the vaults of America's creditors. It falls to them to say "uncle," and say it they will one day, we are certain. They will then be queueing up to exchange intrinsically worthless paper for tangible value. May the readers of *Grant's* beat them to the punch.

In the theory and practice of interest-rate manipulation, too, we have fallen off the shoulders of giants. Under classical doctrine, developed in

England and deemed best practice in this country into the administration of William Howard Taft, commercial banks existed not to "create credit" but to facilitate and liquefy the credit that two parties to a business transaction created when one said to the other, "I'll pay you in 30 days." There was an exquisite economy of motion in the old methods--no central authority deemed it necessary to buy up $1 trillion or so of public securities or to scoop up every available residential mortgage to stave off disaster in the housing market. Somehow, the economy functioned without econometricians.

Though the Fed's monetary and credit bridges collapsed two years ago, few have demanded a fundamental accounting of the ideas that undergird Chairman Bernanke's $2.2 trillion balance sheet and inform his interest-rate policy. Maybe it's as simple as the fact that the living authorities don't know, and the dead ones can't talk. Then, again, some of the ancients wrote books. Henry Parker Willis (1874-1937) is one such posthumous expert, and it's him we call on now.

Present at the monetary creation, Willis consulted for the authors of the Federal Reserve Act. He was first secretary of the Federal Reserve Board and right-hand man to Sen. Carter Glass of Virginia, the so-called father of the Fed and co-author of the Glass-Steagall Act of 1933. "The Theory and Practice of Central Banking," published in 1936 and long out of print, was his swan song. Possibly, he died of a broken heart.

The Fed--*his* Fed--had gone off the rails almost as soon as it opened its doors for business in 1914, Willis lamented. The central bank he envisioned was a kind of balance wheel in the engine of the American money market. The Reserve Banks would turn commercial IOUs into cash according to the demands of the season and the cycle, in that fashion making the currency elastic. Critically, the Fed itself would not create credit. It would, rather, liquefy the bills that a vendor would extend to his customer--the self-liquidating kind of commercial credit that allows the economic wheels to turn. In the founders' conception, the Fed would operate passively through the discount window, not actively through open-market operations. That is, it would accommodate the needs of the community, not determine what those needs should be. It would no more intervene to rescue the American residential real estate market than it would to steer the GDP or manipulate the rate of rise of the core Personal Consumption Expenditures index (as if anyone could reliably calculate it, which Willis doubted).

Alan Greenspan was 10 years old the year Willis published; Ben S. Bernanke was minus 17. Still, the lineaments of the modern command-and-control approach to monetary management were all too much in evidence. The Mark I gold standard had died in World War I, and with it had gone the classical English central banking technique of discounting commercial bills.

Discretionary open-market operations--buying and selling government securities in the open market--were the new, new thing. "Central banks. . . ," wrote Willis, wagging a finger at the young fellows, "will do wisely to lay aside their inexpert ventures in half-baked monetary theory, meretricious statistical measures of trade, and hasty grinding of the axes of speculative interests with their suggestion that by so doing they are achieving some sort of vague 'stabilization' that will, in the long run, be for the greater good." It may interest Willis's ghost to learn that, although "inflation targeting" became the darling of the monetary-policy intellectuals in the years leading up to the 2008 crisis, the "stability" it thereby seemed to achieve turned out to be singularly unstable.

To the *Journal*'s timely question, "What Should the Federal Reserve Do Next?" numerous economists have proposed myriad nostrums. Among the scariest of these brain waves was one proffered last week by the chief economist of Citigroup. Writing in the *Journal*'s European edition, Willem Buiter suggested that the Fed explore techniques to impose a federal funds rate of less than zero percent. "To restore monetary policy effectiveness in a lower interest rate environment when confronted with deflationary or contractionary shocks, it is necessary to get rid of the zlb [i.e., zero lower bound, meaning a zero-percent funds rate] completely," Buiter wrote. "This can be done in three ways: abolishing currency, taxing currency and ending the fixed exchange rate between currency and bank reserves with the Fed. All three are unorthodox. The third is unorthodox and innovative. All three are conceptually simple."

Still simpler is the old doctrine that the moderns have pushed aside or never learned in the first place, and to which if the Citigroup front office had adhered, might have spared the bank the indignity of a $4 stock price. Thus, commanded the ancients: Anchor the dollar to the precious metals, raise liquidity to the top of the list of banking virtues and understand the process by which commercial credit comes into the world (hint: not by bankers' pens). The first of these rules to live by was, to Willis and his contemporaries, as clear as the law itself. Under the Constitution, the 1792 Coinage Act and the 1900 Gold Standard Act, the dollar was defined as a weight of silver and gold. The verdict of monetary history resoundingly seconded the wisdom of the lawmakers: Paper currencies unbacked by anything except the issuing politicians' good intentions invariably lost their value. Regrettably, that was not the end of the discussion. The economists were busily chipping away at the semiautomatic workings of the pre-1914 gold standard. Better, they contended, a managed system of their own devising. Willis mocked the eggheads: "The 'new era' in central banking theory," he wrote, "may thus be said to have taken form as a view that it was possible for central banks to 'manage' the level of prices and, incidentally, the business situation by issuing more or less currency (or credit). . . ." Hopefully more than analytically, Willis predicted that these demonstrably false notions were on their way out. In fact, they were on their way in.

The idea of liquidity, too, had had a hard time of it in the 1920s. A liquid asset, as Willis and his peers defined it, was a short-dated commercial IOU--a money-good industrial purchase order, for example. Banks had no business owning any asset that did not, upon its maturity, generate a cash payment. Leave bonds, mortgages and other long-lived capital instruments to the savings banks and insurance companies, Willis preached. Commercial banks were put on this earth to facilitate the exchange of goods, not to "create" credit or finance speculation. But in the Harding and Coolidge years, a new theory came to the fore. Banks need not confine themselves to the gospel of so-called real bills, the theorists held. It was not strictly necessary that a banking asset be "liquid" (as defined). All would be well if an asset were "shiftable," i.e., salable in the continually functioning, deep and liquid capital markets of the day. Willis cringed at the heresy but had the sour pleasure of seeing it exploded in the Great Depression. Though bankers and economists had endlessly debated the matter, hard experience finally told the tale: "In this case, as in so many other economic disputes, however," Willis wrote, "the test is furnished not by the usual or 'normal' experience, but is afforded by the action or experience with regard to bank portfolios during special trial or difficulty. Particularly is such a test applied in times of panic followed by depreciation when the security markets suffer most from long-period fluctuations and when unemployment and business derangements give large scope to fluctuation in volume of trade."

Holders of frozen assets in the long, hard financial winter of 2008-09 will warm to the words that followed: "[D]uring the depression following the panic of 1929, banks have lost relatively little through the 'freezing' of their bona-fide commercial paper, while they have suffered heavily through inability to dispose of their long-term capital obligations or from deterioration of such obligations when sold at a sacrifice," Willis recorded. "In a word, recent experience is positively against the acceptance of the doctrine of shiftability in place of that of liquidity as a canon of banking soundness." Reading Willis, one is led to wonder how often the same lesson must be absorbed. Evidently, once a generation.

And, in a panic, what duty did a central bank owe to the institutions that chose shiftability over liquidity? "There is no more reason for violating the canons of conduct of central banking in a time of 'panic' than there is at any other time," Willis answered. "No central bank can, by the mere exercise of its credit-granting power, make something out of nothing, or save other banks from the disastrous consequences of their past policy. When a central bank does so it merely tends to make a bad matter worse."

The story of the evolution of American finance since the publication of "The Theory and Practice of Central Banking" has been the comprehensive rejection of every theory and practice Willis advocated. Commercial banks have seemed to apply themselves to the pursuit of illiquidity while the Federal Reserve has devoted itself to the black arts of central planning. As for the dollar, it is a claim on nothing except the competence of the public servants who somehow failed to anticipate--having so signally helped to cause--the greatest credit calamity of the past 70 years.

"What Should the Federal Reserve Do Next?" Less, we say. Withdraw from the business of macroeconomic management. Acknowledge the essential error of the doctrine of interest-rate manipulation. Confess to the obvious flaws in the paper-currency system. Renounce debasement under the pseudo-scientific name of "quantitative easing."

"What Should We the People Do Next?" is another question. Inflation usually proceeds by stealth--in the 1950s and 1960s, "creeping inflation" was the phrase. There is, however, nothing stealthy about Chairman Bernanke. He could not be more forthright. Inflation is his policy, and money printing, a.k.a. quantitative easing, is his method. Gold is one refuge from this design, though there is safe harbor in cheap stocks and undervalued real estate, too. As for bonds, they are promises to pay dollars, the definition of which the bondholder entrusts to the man who intends to cheapen them.

David A. Stockman, paid-up subscriber and former director of the Office of Management and Budget, points out that Willis's name does not even appear in the index of Bernanke's "Essays on the Great Depression." Monetarists like the late Milton Friedman brushed aside Willis's quaint (to them) attachment to the doctrine that credit has its origins not with a bank loan officer, but with the businesspeople who anticipate each other's cash in the process of production.

"The ironic point," Stockman observes, "is that H. Parker Willis and the English banking tradition did not believe in macro-management of the aggregate economy. They thought that the free market would take care of itself as long as trade bills were not artificially and precipitously liquidated in a money panic. Stated differently, they thought that the job of the central bank was to liquefy the commercial banking system, not to levitate the GDP. So in embracing the quantity theory of money, Mr. Capitalism and Freedom ["Capitalism and Freedom" was a Friedman best seller] laid the planking for central planning by the Fed. Yes, Friedman said that such macro-management of the aggregate economy should proceed not from discretionary tinkering by the Open Market Committee, but based on a fixed rule. As we can see, his wayward disciple, Professor Bernanke, has done just that. He is running the U.S. economy based on *his* rule."

HEARING OF THE SUBCOMMITTEE ON DOMESTIC MONETARY POLICY & TECHNOLOGY

Statement and Testimony of Lewis E. Lehrman

Chairman, The Lehrman Institute

Prepared for March 17, 2011 Hearing

I. Monetary policy, the Federal Reserve, the Budget Deficit, and Inflation

Since the expansive Federal Reserve program of Quantitative Easing began in late 2008, oil prices have almost tripled, gasoline prices have almost doubled. Basic world food prices, such as sugar, corn, soybean, and wheat, have almost doubled. Commodity and equity inflation, financed in part by the Fed's flood of excess dollars going abroad, has profound effects on the emerging markets. But in many emerging countries, food and fuel make up 25-50% of disposable income. Families in these countries can go from subsistence to starvation during such a Fed-fueled commodity boom.

The Fed credit expansion, from late 2008 through March 2011 -- creating almost two trillion new dollars on the Fed balance sheet -- triggered the commodity and stock boom, because the new credit could not at first be fully absorbed by the U.S. economy in recession. Indeed, Chairman Bernanke recently wrote that Quantitative Easing aimed to inflate U.S. equities and bonds directly, thus commodities indirectly. But some of the excess dollars sought foreign markets, causing a fall in the dollar on foreign exchanges. With Quantitative Easing the Fed seems to aim at depreciating the dollar. In foreign countries, such as China, financial authorities frantically purchase the depreciating dollars, adding to their official reserves, issuing in exchange their undervalued currencies. The new money is promptly put to work creating speculative bull markets and booming economies.

The emerging market equity and economic boom of 2009 and 2010 was the counterpart of sluggish growth in the U.S. economy during the same period. But the years 2011 and 2012 will witness a Fed- fueled economic expansion in the United States. Growth for 2011, in the United States, will, I believe, be above the new consensus of 3.5% -- unless there is an oil spike, combined with even greater catastrophe in Japan. The Consumer Price Index (CPI) will be suppressed because unemployment keeps wage rates from rising rapidly; the underutilization of industrial capacity keeps finished prices from rising rapidly. Inflation has shown up first in commodity and stock rises.

For Congress the irony could be that euphoria -- always caused by renewed, gradual inflation -- may set in once again, disarming potential budget and monetary reforms.

But commodity and stock inflation inevitably engenders social effects, not only financial effects. Inflationary monetary and fiscal policies have been a primary cause of the increasing inequality of wealth in American society. Bankers and speculators have been, and still are, the first in line, along with the Treasury, to get the zero interest credit of the Fed. They were also the first to get bailed out. Then, with new money, the banks financed stocks, bonds, and commodities, anticipating, as in the past, a Fed-created boom. The near zero interest rates of the Fed continue to subsidize the large banks and their speculator clients. A nimble financial class, in possession of cheap credit is able, at the same time, to enrich themselves, and to protect their wealth against inflation.

But middle income professionals and workers, on salaries and wages, and those on fixed income and pensions, are impoverished by the very same inflation that subsidizes speculators and bankers. Those on fixed incomes earn little, or negative returns, on their savings. Thus, they save less. New investment then depends increasingly on bank debt, leverage, and speculation. Unequal access to Fed credit was everywhere apparent during the government bailout of favored brokers and bankers in 2008 and 2009, while millions of not so nimble citizens were forced to the wall, and then into bankruptcy. This ugly chapter is only the most recent chapter in the book of sixty years of financial disorder.

Inequality of wealth and privilege in American society is intensified by the Fed-induced inflationary process. The subsidized banking and financial community, combined with an overvalued dollar -- underwritten by China -- have also submerged the manufacturing sector, dependent as it is on goods traded in a competitive world market. In a word, the government deficit and the Federal Reserve work hand in hand, perhaps unintentionally, to undermine the essential equity and comity necessary in a constitutional republic. Equal opportunity and the harmony of the American community cannot survive perennial inflation.

If the defect is inflation and an unstable dollar, what is the remedy?

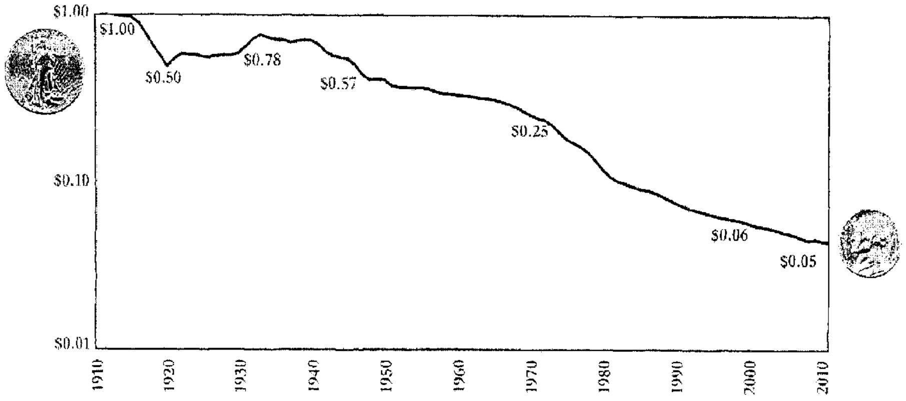
A dollar convertible to gold would provide the necessary Federal Reserve discipline to secure the long term value of middle income savings, to backstop the drive for a balanced budget. The gold standard would terminate the world dollar standard, by prohibiting official dollar reserves, and the special access of the government and the financial class to limitless cheap Fed and foreign credit.

The world trading community would benefit from such a common currency -- a non-national, neutral, monetary standard -- that cannot be manipulated and created at will by the government of any one country. Thus, dollar convertibility to gold must be restored. But dollar convertibility to gold must also become a cooperative project of the major powers. Gold, the historic common currency of civilization, was during the Industrial Revolution and until recent times, the indispensable guarantor of stable purchasing power, necessary for both long-term savings and long-term investment, not to mention its utility for preserving the long-term purchasing power of working people and pensioners. The gold standard puts control of the supply of money into the hands of the American people, as it should in a constitutional republic. Because excess creation of credit and paper money can be redeemed by the people for gold at the fixed statutory price, the monetary authorities are thus required to limit the creation of new credit in order to preserve the legally guaranteed value of the currency. As President Reagan said: "Trust the people."

To accomplish this monetary reform, the U.S. can lead, first, by announcing future convertibility, on a date certain, of the U.S. dollar, the dollar itself to be defined in statute as a weight unit of gold, as the Constitution suggests; second, by convening a new Bretton Woods conference to establish mutual gold convertibility of the currencies of the major powers -- at a level which would not pressure nominal wages; third to prohibit by treaty the use of any currency but gold as official reserves.

A dollar as good as gold is the way out. It is the way to restore American savings and competitiveness. It is the way to restore economic growth and full employment without inflation. Gold convertibility is the way to restore America's financial self-respect, and to regain its needful role as the equitable leader of the world.

A Century of Decline in the Dollar's Value



March 15, 1910
One ounce gold = $20.00

March 15, 2011
One ounce gold = $1,396.60

II: The Monetary Problem and its Solution in Historical Perspective

As a soldier of France, no one knew better than Professor Jacques Rueff, the famous French central banker and economist, that World War I had brought to an end the preeminence of the classical European states system; that it had decimated the flower of European youth; that it had destroyed the European continent's industrial primacy. No less ominously, on the eve of the Great War, the gold standard -- the gyroscope of the Industrial Revolution, the proven guarantor of one hundred years of price stability, the common currency of the world trading system -- the monetary standard of commercial civilization -- was suspended by the belligerents.

The Age of Inflation was upon us.

The overthrow of the historic gold standard, led, during the next decade, to the great inflations in France, Germany, and Russia. The ensuing inflationary convulsions of the social order, the rise of the speculator class, the obliteration of the savings of the laboring and middle classes led directly to the rise of Bolshevism, Fascism, and Nazism -- linked, as they were, to floating European currencies, perennial budgetary and balance of payments deficits, central bank money printing, currency wars and the neo-mercantilism they engendered.

Today, one observes -- at home and abroad -- the fluctuations of the floating dollar, the unpredictable effects of its variations, the new mercantilism it has engendered, and the abject failure to rehabilitate the dollar's declining reputation. Strange it is that an unhinged token, the paper dollar, is now the monetary standard of the most scientifically advanced global economy the world has ever known.

The insidious destruction of the historic gold dollar -- born with the American republic -- got underway gradually, in the 1920s, during the inter-war experiment with the gold-exchange standard and the dollar's new official reserve currency role. It must be remembered that World War I had caused the price level almost to double. But after the war, Britain and America tried to maintain the pre-war dollar-gold, sterling-gold parities. Designed at the Genoa Convention of 1922, the official reserve currency roles of the convertible pound and dollar collapsed after 1929 in the Great Depression -- a collapse which helped to cause and to intensify the worldwide deflation and depression. Then, Franklin Roosevelt in 1934 reduced the value of the dollar by raising the price of gold from $20 to $35 per ounce.

But it must be emphasized that it was in 1922, at the little known but pivotal Monetary Conference of Genoa, that the unstable gold-exchange standard had been officially embraced by the academic and political elites of Europe. It was here that the dollar and the pound were confirmed as official reserve currencies to supplement what was said to be a scarcity of gold. But there was no true scarcity, only overvalued currencies after World War I. Professor Rueff warned in the 1920s of the dangers of this flawed gold-exchange system designed "to economize gold." He predicted again in 1960-61 that the Bretton Woods system, a post-World War II gold-exchange standard, flawed as it was by the same official reserve currency contagion of the 1920s, would soon groan under the flood weight of excess American dollars going abroad. Rueff in the 1950s and 1960s forecast permanent U.S. balance of payments deficits and the tendency to constant budget deficits, and ultimately the suspension of dollar convertibility to gold. His prescience was borne out by the facts.

After World War II, Professor Rueff saw that because the United States was the undisputed hegemonic military and economic power of the free world, foreign governments and central banks, in exchange for these military services and other subsidies rendered, would for a while continue to purchase, (sometimes to protect their export industries,) excess dollars on the foreign exchanges against the creation of their own monies. But these foreign official dollars, originating in the U.S. balance of payments and budget deficits, were then redeposited by foreign governments in the New York dollar market which led to inflation and excess consumption in the United States. This same process engendered inflation in its European and Asian protectorates which purchased excess dollars against the issuance of their own currencies. In a word, official reserve currencies jam the indispensable, international settlements and adjustment mechanism. Moreover, these purchases of dollars by foreign central banks have the simultaneous effect of creating inflation in these foreign countries and undervaluing their currencies relative to the dollar. Incipient mercantilism was only one pernicious result of the dollar's overvalued, official reserve currency status. The decline of the great U.S. manufacturing center was another.

Incredibly, during this same period of the 1960s, the International Monetary Fund authorities had the audacity to advocate the creation of Special Drawing Rights (SDRs), so-called "paper gold," invented, as International Monetary Fund officials said, to avoid a "potential liquidity shortage." At that very moment, the world was awash in dollars, in the midst of perennial dollar and exchange rate crises. Professor Rueff remarked that the fabrication of these SDRs by the International Monetary Fund would be "irrigation plans implemented during the flood."

The post-World War II gold-exchange standard (Bretton Woods) came to an end on the Ides of March, in 1968, when President Johnson suspended the London Gold Pool. After a few more crippled years, Bretton Woods expired on August 15, 1971. The truth is that Monetarists and Keynesians sought not to reform Bretton Woods, as the true gold standard reform of Jacques Rueff intended, but rather to demolish it. The true gold standard had become passé among the intellectual, economic, and political elites because of their confusion over the difference between the gold standard and the gold-exchange standard -- the collapse of the latter, not the former -- having intensified the depression. I shall give you just one example of the obtuseness of the political class of the 1960s and 1970s, which happened at the height of one major dollar crisis. A friend of Professor Rueff, the American banker and policy intellectual, Henry Reuss, Chairman of the Banking and Currency Committee of the United States House of Representatives, went so far as to predict, with great confidence and even greater fanfare, that when gold was demonetized, it would fall from $35 to $6 per ounce. (I am not sure whether Congressman Reuss ever covered his short at $800 per ounce in 1980.)

President Nixon, a self-described conservative, succeeded President Johnson and was gradually converted to Keynesian economics by so-called conservative academic advisers, led by Professor Herbert Stein. Mr. Nixon had also absorbed some of the teachings of the Monetarist School from his friend Milton Friedman -- who embraced the expediency of floating exchange rates and central bank manipulation and the targeting of the money stock to create a stable inflation rate. Thus, it was no accident that the exchange rate crises continued because the underlying cause, inflation, continued. On August 15, 1971, after one more violent dollar crisis, Nixon defaulted at the gold window of the western world, declaring that "we are all Keynesians now." In 1972, Nixon, a Republican, a so-called free market President, imposed the first peacetime wage and price controls in American history -- encouraged by some of the famous "conservative" advisers of the era.

In President Nixon's decision of August 1971, the last vestige of dollar convertibility to gold, the final trace of an international common currency, binding together the civilized trading nations of the West, had been unilaterally abrogated by the military leader of the free world.

Ten years later at the peak of a double digit inflation crisis, the gold price touched $850. At the time, Paul Volcker, Chairman of the Federal Reserve declared that the gold market was going its own way and had little to do with the Fed's monetary policies. Volcker then engineered a draconian credit contraction leading to near 11% unemployment and a decline in inflation. At that time, Professor Wallich declared that the gold market is but "a side show." Secretary of the Treasury William Miller, and a short-lived Fed Chairman, who had been selling United States gold at about $200 in 1978, announced solemnly that the Treasury would now no longer sell American gold. Presumably Secretary Miller, an aerospace executive, meant that whereas, more than one-half the vast American gold stock had been a clever sale, liquidated at prices ranging between $35 and $250 per ounce -- now, in the manner of the trend follower, Secretary of the Treasury Miller earnestly suggested that gold was a "strong hold" at $800 per ounce.

On January 18, 1980, Fed Governor Henry Wallich, a former Yale Economics professor, explained Federal Reserve monetarist policies in an article appearing in the Journal of Commerce:

> "The core of Federal Reserve...measures," basing "control upon the supply of bank reserves," he said, "gives the Federal Reserve a firmer grip on the growth of monetary aggregates..."

As subsequent events showed, the Federal Reserve promptly lost control of the monetary aggregates. The bank prime rate rose to 21%, inflation to double digits.

Professor Rueff's experience as a central banker had taught him from hard experience what his five volumes of monetary theory and econometrics demonstrated. That is, no central bank, not even the mighty Federal Reserve, can determine the quantity of bank reserves or the quantity of money in circulation -- all conceits to the contrary notwithstanding. The central bank may influence indirectly the money stock; but the central bank cannot determine its amount. In a free society, only the money users -- consumers and producers in the market -- will determine the money they desire to hold. In a reasonably free society, it is consumers and producers in the market who desire and decide to hold cash balances, and also to change the currency and bank deposits they wish to keep; it is central banks and commercial banks which can supply them.

During the past forty years, the important links between central bank policies, the rate of inflation, and the variations in the money stock have caused much debate among the experts. It is still generally thought by neo-Keynesian, and some monetarist economists and central bankers, that the quantity of money in circulation, and economic growth, and the rate of inflation can be directly coordinated by central bank credit policy. May I now firmly say that, to the best of my knowledge, no one who believes this hypothesis, and, as an investor, has systemically acted on it in the market, is any longer solvent. But I do confess, that the neo-Keynesian and monetarist quantity theories of money still hang on -- even if its practitioners in the market cannot. In the end neo-Keynesian and monetarist economists at the Federal Reserve were ultimately required to accommodate to a reality in which, for example, during 1978, the quantity of money in Switzerland grew approximately 30% while the price level rose only 1%. The quantity of money, M-1, grew in 1979 about 5% in the

United States while the inflation rate rose 13%. The Fed learned that the CPI inflation rate cannot be precisely associated with the quantity of money in circulation.

If then, a central bank cannot determine the quantity of money in circulation, what, in Rueffian monetary policy, can a central bank realistically do? To conduct operations of the central bank, there must be a target. If the target is both price stability and the quantity of money in circulation, one must know, among other things, not only the magnitude of the desired supply of money, but also the precise volume of the future demand for money in the market -- such that the twain shall meet. It is true that commercial banks supply cash balances, but individuals and businesses -- the users of money -- generate the decisions to hold and spend these cash balances. Thus, the Federal Reserve must have providential omniscience to calculate correctly, on a daily or weekly basis, the total demand for money -- assuming the Fed could gather totally reliable statistical information -- which it cannot; and even if the Fed's definitions of the monetary aggregates were constant -- which they are not.

Jacques Rueff, himself the Deputy Governor of the Bank of France, clarified this fundamental problem in the form of an axiom: Because the money stock cannot be determined by the Federal Reserve Bank, nor can it determine a constant rate of inflation, the monetary policy of the central bank must not be to target the money supply or the rate of inflation. The Federal Reserve Bank simply cannot determine accurately the manifold decisions of the public to hold money, for individual and corporate purposes, in order to make necessary payments and to carry precautionary balances. Therefore, the leaders of the European central bank and the Federal Reserve System, all central banks cannot and should not try to determine the quantity of money in circulation.

But, if the true goal of the central bank were long run stability of the general price level, the operating target of monetary policy at the central bank must be simply to influence the supply of cash balances in the market, such that they tend to equal the level of desired cash balances in the market. To attain this goal, the central bank must abandon open market operations and simply hold the discount rate, or the rediscount rate, above the market rate -- when, for example, the price level is rising -- providing money and credit only at an interest rate which is not an incentive to create new credit and money. Indeed, if the target of monetary policy is long run price stability, the central bank must supply bank reserves and currency only in the amount which is approximately equal to the desire to hold them in the market. For if the supply of cash balances is approximately equal to the desire to hold them, the price level must tend toward stability. If there are no excess cash balances, there can be no excess demand, and, thus, there can be no sustained inflation. There also can be no sustained deflation, caused by scarcity of cash balances, because the target of monetary policy is a stable price level and, in these circumstances, the central bank supplies the desired cash balances.

An effective central bank policy, therefore, must reject open market operations. Professor Rueff shows further that, in order to rule out inflation, and unlimited government spending, the government treasury must be required by law to finance its cash needs in the market for savings, away from the banks. That is, a government treasury, in deficit, must be denied the privilege of access to new money and credit at the central bank and commercial banks, in order also to deny the government the pernicious privilege of making a demand in the market without making a supply -- the ultimate cause of inflation. That is, since the Federal Reserve creates new money and credit to finance the Treasury deficit, but the Treasury creates no new goods and services, total money demand will exceed supply at prevailing prices. Prices must rise. At first, commodity and equity prices advance. Then the general price level rises gradually. This exorbitant U.S. government financing privilege, a function of total Fed discretion and of the dollar's reserve currency status, is a necessary cause of the balance of payments deficit and persistent inflation. It is also a fundamental cause of unlimited budget deficits and bloated big government. So long as new bank credit is available to the government, so long will the budget deficit persist and grow.

One can see that the monetary theory and policy of Jacques Rueff finally does come to grips with, indeed it modifies, the famous Law of Markets of Jean Baptiste Say, building of course on Say's insights, but perfecting the flawed Quantity Theory of Money. Jacques Rueff reformulated the quantity theory of money, definitively, in the following proposition: aggregate demand is equal to the value of aggregate supply, augmented (+/-) by the difference between the variations, during the same market period, in the quantity of money in circulation and the aggregate cash balances desired. This is a central theorem of Rueffian monetary economics. Rueff demonstrated that Say's law does work, namely, that supply tends to equal demand, provided, however, that the market for cash balances must tend toward equilibrium. Any monetary system, any central bank, which does not reinforce this tendency toward equilibrium in the market for cash balances destroys the first law of stable markets, namely, overall balance between supply and demand -- a necessary condition for limiting inflation and deflation.

It is conventional wisdom that Milton Friedman and the Monetarists try to regulate the growth of the total quantity of money and inflation through a so-called money stock rule designed to constrain the central bank monopoly over the currency issue. In practice, the Federal Reserve has failed, and will fail, to succeed with such a flawed, academic, and impractical rule. Professor Friedman, himself, humbly admitted failure in a remarkable 2003 interview. The much simpler, more reliable, market-biased technique -- proven in the laboratory of history -- as Professor Rueff demonstrated, would be to make the value of a unit of money equal to a weight unit of gold, in order to regulate, according to market rules, the same central bank monopoly. But academics have argued for a century that a monetary "regulator," such as gold money, absorbs too much real resources -- by virtue of the process of gold production -- and is therefore, in economic terms, too costly.

Whatever the minor incremental mining cost of a gold-convertible currency, it is a superior currency stabilizer, as history shows. The empirical data also show that it is a more efficient regulator of price stability in the long run. The gold standard was no mere symbol. It was an elegantly designed monetary mechanism -- carefully orchestrated over centuries by wise men of great purpose -- who developed convertibility into a supple and subtle set of integrated financial and credit institutions organized to facilitate rapid growth, quality job creation, a stable price level, above all, social stability amidst free economic institutions. Thus did the free price mechanism and the international gold standard become the balance wheel of rapid economic growth during the long-lasting Industrial Revolution. Who can deny that two generations of floating exchange rates, pegged undervalued currencies like the Chinese Yuan, and discretionary central banking, have burdened the world with booms, panics, and busts, producing immense inflation and uncertainty costs, much greater than the comparatively modest cost of mining gold?

Therefore, in order to bring about international price stability and long run stability in the global market for cash balances, the dollar and other key currencies must be defined in law as equal to a weight unit of gold -- at a statutory convertibility rate which insures that nominal wage rates do not fall. Indeed, nothing but gold convertibility, without official reserve currencies, will yield a real fiduciary monetary standard for the integrated world economy.

At the end of the first decade of the new millennium, the world requires, a real monetary standard, a common non-national monetary standard, to deal with the monetary disorder of undervalued, pegged, currencies and manipulated floating exchange rates -- the diabolical agents of an invisible, predatory mercantilism. Despite all denials, the currency depreciations of today are, without a doubt, designed to transfer unemployment to one's neighbor and, by means of an undervalued currency, to gain share of market in manufactured, labor intensive, value-added, world traded goods. If these depreciations and undervaluations are sustained, floating exchange rates combined with the twin budget and trade deficits will, at regular intervals, blow up the world trading system. Great booms and busts, inflation and deflation, social instability must ensue.

To head off the mercantilism of present floating exchange rates, and the consequences of exchange rate disorders caused by official dollar reserves, an international monetary conference is indispensable. The present high rates of unemployment and perverse trade effects, associated with floating exchange rates, require an efficient and stable international monetary reform. Not least because floating exchange rates re-price entire national production systems at unpredictable intervals. Such monetary perversity cannot be sustained. A European Monetary Union may be necessary; but it is not sufficient.

Now we see clearly, what before we saw in a glass darkly -- the dollar's official reserve-currency status still gives an exorbitant credit privilege to the United States. Professor Rueff spoke of American "deficits without tears," because the American budget deficit and balance-of-payments deficits were -- they still are -- almost automatically financed by the Federal Reserve and the world-dollar reserve-currency system -- through the voluntary (or coerced) buildup of dollar balances in the official reserves of foreign governments. These official dollar reserves were, and still are, immediately invested by foreign authorities, directly or indirectly, in the dollar market for United States securities, thus giving back to the United States, at subsidized rates, the dollars previously sent abroad as a result of the persistent United States balance-of-payments deficit and budget deficits. This is the subtle mechanism by which excess American domestic consumption and budget deficits are financed. To describe this awesome absurdity, Professor Rueff invoked the metaphor of the King's overworked tailor, yoked permanently to fictitious credit payments by His Majesty's unrequited promissory notes. Despite his purchases, His Majesty's cash balances and euphoria kept rising, blinded as he was to his ultimate, debt-induced insolvency.

There is not sufficient time to dwell on all the intricacies of the superior efficacy of the balance-of-payments adjustment mechanism grounded in domestic and international convertibility to gold. But it can, I think, be shown that, in all cases, currency convertibility to gold, without official reserve currencies, is the least imperfect monetary mechanism, both in theory and in practice, by which to rule out currency wars, to maintain global trade and financial balance, a reasonably stable price level, and economic growth -- while ensuring budgetary equilibrium. This proposition has been proven in the only laboratory by which to test monetary theory -- namely, the general history of monetary policy under paper and metallic regimes, and, in particular, the history of the international gold standard. (See chart in appendix.)

Whereas, by contrast, when one country's currency -- the dollar reserve currency of today -- is used to settle international payments, the international settlement and adjustment mechanism is jammed -- for that country -- and for the world. This is no abstract notion. An example from the past: during the twelve months of 1995, one hundred billion dollars of foreign exchange reserves were accumulated by foreign governments which were directly invested in U.S. Treasury securities held in custody at the New York Federal Reserve Bank -- thus financing the more modest U.S. current account and U.S. budget deficits of the time. Between March 10, 2010 and March 9, 2011, foreign governments monetized $415 billion dollars in the form of U.S. securities held in custody at the Fed. This is only a fraction of the $3.5 trillion of official dollar reserves, held in custody at the Fed, accumulated by March, 2011, over two generations. This accumulation of foreign dollar reserves is a gigantic mortgage on America. It is the infernal mechanism by which the government budget deficit and balance of payments deficits are financed. Along with the Fed, foreign dollar reserves are sufficient today to finance domestic over-consumption in the United States at below market interest rates.

It is essential to understand the nature of this ongoing process of currency degradation -- because the dollar's reserve-currency role in financing the U.S budget and balance of payments deficits certainly did not end with the breakdown of Bretton Woods in 1971. The perennial and extraordinary U.S. budget and balance of payments deficits still persist because there is, today, no efficient international monetary mechanism to forestall the American deficits. Indeed, Professor Rueff argued that if the official reserve role of the dollar -- i.e., the world dollar standard -- were abolished, and convertibility restored, the immense U.S. budget and current account deficits must end -- a blessing not only for the United States, but for the whole world. This is so because the Fed and the Treasury would be bound by statute and treaty to maintain the gold convertibility of the dollar. It is true that both law and international treaty may be violated, but they do create the only barriers to the license of rogues.

The reality behind the "twin deficits" is simply this: the greater and more permanent the Federal Reserve and foreign reserve facilities for financing the United States budget and trade deficits, the greater will be the twin deficits and the growth of the U.S. Federal government. All congressional, administrative, and statutory attempts to end the United States deficits have proved futile, and will prove futile, until the crucial underlying flaw -- namely the absence of an efficient international settlements and adjustment mechanism -- is remedied by international monetary reform inaugurating a new international gold standard and the prohibition of official reserve currencies.

Broadly speaking, at least three essential steps toward convertibility could be taken by America and other great powers.

(1) The U.S. president should request the Federal Reserve System to cooperate with, say, a Group of Ten to stabilize the value of key currencies at levels consistent with balanced international trade among national currency areas. That is to say, exchange rates should be stabilized at approximately their purchasing power parities, based largely upon comparative unit labor costs of standardized world traded goods. To do this, indexes of purchasing power can be agreed upon within the Group of Ten and, thus, an optimum and fair value determined for mutual convertibility of national currencies. But how should the value of the gold monetary standard be determined? The optimum value of the gold parity should reflect a gold price correctly positioned within the hierarchy of all prices; that is, a price proportional to its underlying cost of production. This dollar price of gold, or more properly, the defined gold weight of the monetary standard, must be set above the average of the marginal costs of production of gold mines operating throughout the world. This price would provide for steady output of the gold monetary base (about an average of 1.5% to 2% increase per year over a long run, as centuries of available monetary statistics show). Such a

gold price would also prevent any decline in the average level of nominal wages -- avoiding, for example, the British problem of underemployment in the 1920's caused by an overvalued pound. Under existing conditions, during the present market period, I have estimated, based on empirical data, that the optimum convertibility price of gold is not less than $2,000 per ounce. (March, 2011)

(2) The President should recommend to the Group of Ten, that convertibility regimes take effect at a fixed date in the future, subsequent to the international monetary conferences and agreements made there, perhaps an interval of three to four years. Gold-convertible currencies should become the monetary standards of Europe, of the United States, of the world, just as the gold standard should become the common money of world trade and finance in Asia and elsewhere.

To simplify, if the United States government, or any other key country, then creates excess money and credit, under conditions of gold convertibility, it will be forced in a relatively short period to change, because market participants will exchange paper currencies for gold, or gold for paper, to bring the quantity of money in circulation into balance with the desire of the public to hold these cash balances.

In a constitutional republic such as the United States the sovereign people should control the supply of money through the limiting mechanism of gold convertibility of the dollar. As President Reagan said, "Trust the people." Moreover, domestic monetary reform in the United States, and elsewhere, would also mean that only gold and domestic, non-government, secured, self-liquidating securities, convertible at maturity to gold, could serve as collateral, or backing for new currency issues such as, for example, Federal Reserve Notes. Standard gold coins, minted according to the statutory standard, should be generally circulated in the market to be held by all working people, so as to guarantee that neither the monetary standard, nor the wages and savings of working people, will be arbitrarily abridged by inflationary governments. Such a regime, among other purposes, eliminates the advantage of nimble speculators over middle income people and those on fixed incomes.

(3) The new international monetary system would rule out, by enforceable treaty obligations, official reserve currencies which so plagued the entire financial history of the twentieth century and the first decade of the twenty-first. Existing official dollar-reserves could be consolidated and refunded and then gradually amortized over the long term (even to a certain extent refunded through the rise of the official value of gold above the last official revaluation ($42.22 per ounce). This is not unlike the consolidation plan deployed by the first United States Secretary of the Treasury, Alexander Hamilton, to refund the national and state debts after the revolutionary war.

This was and is the Rueff plan, brought up to date to deal with the exigencies of the present facts and circumstances. May I say, it is an intellectual scandal that such a solution is today regarded as impractical. For if we and our former adversary, Russia, can share capsules in space, why can the United States and its trading partners not agree to restore monetary convertibility, the indispensable condition for stable currencies, world economic growth, and free trade?

By pinning down the future price level by gold convertibility, the immediate effect of international monetary reform will be to end currency speculation in floating currencies, and terminate the immense costs of inflation hedging. Gold convertibility eliminates the very costly exchange of currencies at the profit-seeking banks. Thus, new savings will be channeled out of financial arbitrage and speculation, into long-term financial markets.

Increased long-term investment and improvements in world productivity will surely follow, as investment capital moves out of unproductive hedges and speculation -- made necessary by floating exchange rates -- seeking new and productive investments, leading to more quality jobs. Naturally, the investment capital available at long term will mushroom, inspired by restored confidence in convertibility, because the long run stability of the price level will be pinned down by gold convertibility -- as history shows to be the case in previous, well-executed monetary reforms of the past two hundred years. Along with increased capital investment will come sustained demand for unemployed labor, at quality wages, to work the new plant and equipment.

The world now awaits a far-seeing leader to carry out the international monetary reform proposed by the great monetary statesman of the twentieth century, Professor Jacques Rueff.

Lewis E. Lehrman
March 15, 2011

America needs: *A dollar that is, once again, an honest dollar, a dollar as good as gold.*[1]

Both American and world history show that only proper monetary reform -- specifically, restoring the international gold standard without official reserve currencies -- will end chronic episodes of inflation (or deflation), U.S. international payments deficits, and endless Federal deficit spending.

A brief monetary history of the United States. The stability of the U.S. dollar has varied widely in its history. This variation is explained by two factors: the monetary standard chosen for the dollar, and whether other countries have simultaneously used securities payable in dollars as their own monetary standard.

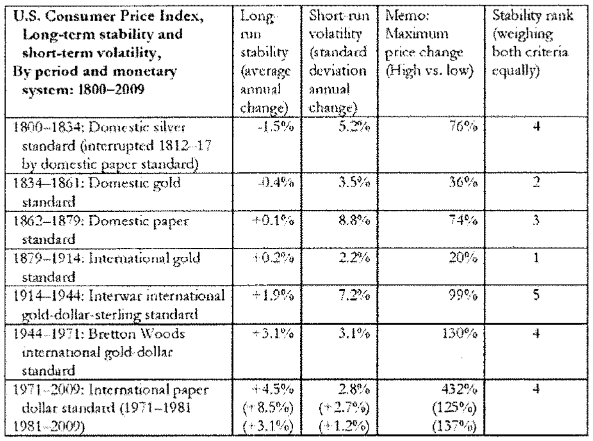
The United States has alternated between two kinds of standard money: inconvertible paper money and some precious metal (first silver, then gold). The dollar was an inconvertible paper money during and after the Revolutionary War (1776–92), the War of 1812 (1812–17), the Civil War (1862–79), and again from 1971 to the present. The dollar was effectively defined as a weight of silver in 1792–1812 and 1817–34, and as a weight of gold in 1834–61 and 1879–1971. The dollar was not used by foreign monetary authorities as a monetary reserve asset before 1913, but has been an official "reserve currency" for many since 1913, and for most since 1944.

Applying these two criteria divides the monetary history of the United States into distinct phases. We can compare the stability of these monetary regimes by examining the variation in the Consumer Price Index (as reconstructed back to 1800) by two simple measures: long-term CPI stability (measured by the annual average change from beginning to end of each monetary standard) and short-term CPI volatility (measured by the standard deviation of annual CPI changes during the period). Weighting these criteria equally, the classical gold standard from 1879-1914 was the most stable of all U.S. monetary regimes (as the table below shows).

The first chart shows why ending the dollar's official reserve currency role would end chronic U.S. payments deficits. In 1980 U.S. residents owned net investments in the rest of the world equal to about 10 percent, but by 2009 had become net debtors equal to about 20 per cent, of U.S. GDP. Meanwhile U.S. net official monetary assets -- official monetary assets minus foreign liabilities -- declined by almost exactly the same amount, while the books of the rest of American residents remained in balance or slight surplus.
This comparison proves that the entire decline in the U.S. net investment position has been due to Federal borrowing from foreign monetary authorities.

As the second chart shows, the same process caused the commodity-led inflations that triggered each of the recessions of 1974-75, 1979-80, 1990-91, and 2007-9. The chart compares the annual rate of inflation of CPI nondurable goods -- mostly food and energy prices -- with a ratio of the main factors affecting them: the lagged "World Dollar Base," or total supply of "high-powered" dollars, divided by a proxy for the current demand for high-powered dollars: U.S. currency and commercial bank reserves times current world oil production.

In each case, voters blamed the President: Richard Nixon, Gerald Ford, Jimmy Carter, George H.W. Bush, George W. Bush, or Barack Obama. Thus, any presidential candidate who does not wish to become a by-word must restore the first principle of successful presidential economic policy, by defining the dollar again as a weight of gold and ending by treaty the dollar's role as chief official reserve currency.



U.S. Consumer Price Index, Long-term stability and short-term volatility, By period and monetary system: 1800–2009	Long-run stability (average annual change)	Short-run volatility (standard deviation annual change)	Memo: Maximum price change (High vs. low)	Stability rank (weighing both criteria equally)
1800–1834: Domestic silver standard (interrupted 1812–17 by domestic paper standard)	-1.5%	5.2%	76%	4
1834–1861: Domestic gold standard	-0.4%	3.5%	36%	2
1862–1879: Domestic paper standard	+0.1%	8.8%	74%	3
1879–1914: International gold standard	+0.2%	2.2%	20%	1
1914–1944: Interwar international gold-dollar-sterling standard	+1.9%	7.2%	99%	5
1944–1971: Bretton Woods international gold-dollar standard	+3.1%	3.1%	130%	4
1971–2009: International paper dollar standard (1971–1981 1981–2009)	+4.5% (+8.5%) (+3.1%)	2.8% (+2.7%) (+1.2%)	432% (125%) (137%)	4

[1] John D. Mueller, *Redeeming Economics: Rediscovering the Missing Element* (ISI Books, 2010) Table 16-1

TESTIMONY BEFORE

THE U.S. HOUSE COMMITTEE ON FINANCIAL SERVICES

March 17, 2011

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Joseph T. Salerno received his Ph.D. in economics from Rutgers University. He is currently a professor of economics in the Finance and Economics Department in the Lubin School of Business of Pace University in New York. He is Academic Vice President of the Ludwig von Mises Institute and the editor of the *Quarterly Journal of Austrian Economics.* He is a research associate of the Foundations of the Market Economy in the economics department at New York University and a policy expert for the Heritage Foundation in Washington, D.C. Dr. Salerno has published numerous essays and articles in scholarly books and popular and academic journals. He has authored or co-authored three books and edited several others. His most recent book, *Money: Sound and Unsound*, was published in 2010. He lectures frequently in both the U.S. and internationally and more than fifty of his lectures are available online. He is also frequently interviewed on broadcast and online radio shows and has appeared on CSPAN and Fox News television programs.

Since it began operations in 1914 the Federal Reserve System ("the Fed") has presided over a relentless decline in the value of the U.S. dollar. Prices increased in 83 of the 97 years of the Fed's existence. Over the last 60 years, beginning in 1950, prices rose in 58 of them. As a result the cumulative loss of the dollar's buying power during the Fed's existence has been staggering. For example, today a consumer pays $22.13 to purchase a basket of goods comparable to a basket that a consumer in 1913 would have paid $1.00 for. This means that since 1913 the dollar has lost 95 percent of its purchasing power and that today's dollar is worth roughly a nickel in terms of the pre-Fed dollar of 1913. The Fed's performance in safeguarding the value of the dollar has been particularly abysmal since 1971, when President Nixon closed the "gold window" and completely unshackled the Fed from the remaining restraints of the gold standard. Since then the price level has more than quintupled, so that today's dollar retains only 19 cents of the purchasing power of the 1971 dollar.

Now the view held by Chairman Bernanke and other mainstream macroeconomists is that the Fed was chastened and enlightened by the disastrous consequences of the inflationary monetary policy that it pursued in the 1970s. According to this view the enlightened monetary policy that the Fed began to follow in the 1980s was responsible for the so-called "Great Moderation" from

1984 to 2004. During this period, price inflation was stabilized at moderate levels and the economy grew more steadily while unemployment remained low. But this story conveniently ignores the October stock market crash of 1987, the sudden collapse of the S&L industry in 1989-1990, and the high-tech bubble of the late 1990s that culminated in the stock market collapse and the recession of 2001. But even the claim that inflation remained moderate during this period is dubious when viewed from a longer run perspective. For if we take 1984 as the beginning of the "The Great Moderation," average consumer prices have more than doubled and the dollar has lost 52 percent of its purchasing power since then. And this is accepting at face value the dubious method of calculating official CPI indexes.

Now, some economists have responded to this criticism of the Fed's performance by arguing that "money is neutral in the long run." Their point is that average wages and salaries, which are the prices of labor services, rise roughly in proportion to inflation *in the long run*. So, if prices are 20 times higher now than they were in 1913, well then so are incomes twenty times higher, and therefore, no one is really worse off in terms of their real standard of living. There are serious problems with this argument but I will mention only one here.

The key point is that prices and wages do not all increase at the same time during inflation. When the Fed initially expands the money supply, not everyone receives a share of the new money immediately. There is no Friedman-Bernanke helicopter that spreads the money evenly throughout the country. New money and credit is always injected into the economy at specific points through bank loans and government purchases and subsidies. Some firms, financial institutions, and households necessarily receive the new money before others in the economy. The money incomes of these groups rise before prices go up, enhancing their ability to purchase real goods and services and increasing their standard of living. As these first recipients of the new money increase spending on investment and consumption, prices begin to rise and inflation sets in. The rest of the entrepreneurs and laborers, who did not initially receive the newly created money, suffer a decline in their living standards because they must pay rising prices for the goods they purchase while their selling prices and wages remain unchanged. Eventually, as the new money works its way through the economy—and this may take months or even years—their product prices and wages finally adjust to the depreciation of the dollar. In the meantime, they suffer an arbitrary and unseen inflation tax that redistributes part of their real income and wealth to those who have privileged access to the new money created by the Fed—for example, subsidized agribusiness, defense contractors, the creditors of financial institutions bailed out by the Fed and so on.

Furthermore, if inflation is a continuous process as it has been in the U.S. since World War Two, then many wage-earners and entrepreneurs find their living standards permanently depressed as their wages and sale prices persistently lag behind the rising prices they must pay. And of course, those living on fixed incomes such as pensions and life insurance annuities suffer a cruel and relentless decline of their living standards that is never reversed.

So, it is indeed true that in the long run inflation results in average wages and other productive incomes rising in rough proportion to average prices. But this statistical correlation conceals the true devastation wreaked by inflation. The rapid decline of the purchasing power of the dollar, especially since 1971, has involved a massive and surreptitious transfer of real income and wealth from productive laborers, entrepreneurs and investors to those privileged corporations and financial institutions that are the recipients of government largesse and bailouts. Additionally, in orchestrating this inflationary process, the Fed has repeatedly driven the interest rate below its natural market level, misleading investors and entrepreneurs and causing disastrous asset market bubbles, unsustainable business investments and the creation of jobs that are not consistent with consumer preferences. It is the arbitrary manipulation of the interest rate by the Fed that has caused the financial meltdowns and recessions that the U.S. economy has suffered over the last four decades.

One of the arguments in favor of inflation that has recently come into vogue again is that moderate inflation is desirable to prevent the far greater evil of deflation. In the past decade, this view has been promoted by many mainstream economists, most notably former Fed Chairman Greesnpan and current Fed chairman Bernanke. But this view is based on a fundamental confusion. It confuses deflation with depression, which are two very different phenomena. Falling prices or deflation is, under most circumstances, absolutely benign and the natural outcome of a prosperous and growing economic. The fear of falling prices is thus a phobia, a "deflation-phobia," which has no rational basis in economic theory or history.

Let me explain. As technology advances and saving increases in a progressing economy, entrepreneurs and business firms are given the means and the incentive to invest in new methods of production, which in turn enables them to lower their costs and expand their profit margins. In a given market, the natural result is an increase in the supply of the good and more intense competition among its suppliers. Assuming no change in the money supply and continuing technological innovation, this competitive process will drive the production costs and price of the good ever downward. Consumers will benefit from the falling price because their real wages will continually increase as each dollar of income commands an increasing quantity of the good in exchange.

This is not merely abstract theoretical speculation but is precisely the process that occurred in the past four decades with respect to the products of the consumer electronics and high-tech industries, such as hand calculators, video game systems, personal computers, HDTVs, and medical lasers. Thus, for example, a mainframe computer sold for $4.7 million in 1970, while today one can purchase a PC that is 20 times faster for less than $1,000. The first hand calculator was introduced in 1971 and was priced at $240, which is $1,400 in terms of today's inflated dollar. By 1980, similar hand calculators were selling for $10 despite the fact that the 1970s was the most inflationary decade in U.S. history. The first HDTV was introduced in 1990 and sold for $36,000. When HDTVs began to be sold widely in the United States in 2003 their prices ranged between $3,000 and $5000. Today you can purchase one of much higher quality for as little as $500. In the medical field, the price of Lasik eye surgery dropped from $4000 per eye in 1998, when it was first approved by the FDA, to as little as $300 per eye today.

Now no one, not even a Keynesian economist, would claim that the spectacular price deflation in these industries has been a bad thing for the U.S. economy. Indeed the falling prices reflect a greater abundance of goods which enhances the welfare of American consumers. Nor has price deflation in these or other industries diminished profits, production and employment. In fact, their growth has been just as spectacular as decline in the prices of their products and has been caused by it. But if deflation is a benign development for both consumers and businesses in individual markets and industries than why should we fear a fall in the general price level, which of course is nothing but an average of the prices of individual goods? The answer given by theory and history is that a falling price level is the natural outcome of a dynamic market economy operating with a sound money like gold.

Under a gold standard, prices naturally tend to decline as ongoing technological advances and investment in additional capital rapidly improve labor productivity and increase the supplies of consumer goods while the money supply grows very gradually. For instance, throughout the nineteenth century and up until World War I, the heyday of the classical gold standard, a mild deflationary trend prevailed in the U.S. As a result, an American consumer in the year **1913** needed only $**0.79** to purchase the same basket of goods that required **$1.00** to purchase in **1800.** In other words, due to the gentle fall in prices during the nineteenth century, a dollar could purchase 27 percent more in terms of goods in 1913 than it could in 1800.

Contrary to our contemporary deflation-phobes, the secular fall in prices under the classical gold standard did not inhibit economic growth in the U.S. In fact deflation coincided with spectacular transformation of the United States from an agrarian economy in 1800 to the greatest industrial power on earth by the eve of World War One. If we examine the data more closely, we find that the years from

1880 to 1896 included the decade of the most rapid growth in U.S. history. Yet, during this period, prices fell by almost 30 percent, or by 1.75 percent per year, while real income rose by about 85 percent, or roughly 5 percent per year. More generally, a 2004 study of 73 episodes of deflation from sixteen different countries dating back to 1820 indicates that only 8 of the 73 episodes of deflation involved recession or depression. It also indicates that 21 of the 29 depression episodes involved no deflation. The authors of this study, Andrew Atkeson and Patrick J. Kehoe conclude, "In a broader historical context, beyond the Great Depression, the notion that deflation and depression are linked virtually disappears." Even when the Great Depression is included in the data, they find that link between falling prices and negative economic growth is economically insignificant.[1]

Ironically, while Chairman Bernanke just affirmed again a few days ago that the Fed will persist in its inflationary policy of quantitative easing to ward off the imaginary threat of falling prices, signs of inflation abound. The prices of consumer food staples have risen by 6 percent over the past year, with the prices of beef, bacon, butter and lamb rising by 10 percent or more. The U.N. index of grain export prices has risen by 70 percent in the past year and stands at its highest level in 21 years. Gasoline prices have surged 49 percent in the last six months. According to IMF statistics, commodity prices are up by 33 percent in the past

[1] Andrew Atkeson and Patrick J. Kehoe, ""Deflation and Depression: Is There an Empirical Link," *American Economic Review* Papers and Proceedings 94 (May 2004): 99–103.

year; metals prices by 40 percent; energy prices by 30 percent; crude oil prices by 31 percent; and commodity industrial inputs by 40 percent.[2] As a result of skyrocketing prices of agricultural products such as corn, wheat, soybeans and other crops, the price of farmland in the U.S. has been soaring, particularly in the Midwest where land prices increased at double-digit rates last year and regulators fear that a bubble is forming.

Not only does Chairman Bernanke seem unfazed by these inflationary developments, but, what is more astounding, he appears to welcome the rapid increase in stock prices as evidence that QE2 is working to right the economy. When it became apparent that the Fed's $600 billion buying program for treasury bonds had failed to reduce long-term interest rates as intended but caused them to rise instead, Mr. Bernanke desperately sought another sign that QE2 was working. While he denied that the Fed was responsible for rapidly rising commodity prices, he credited Fed with re-igniting the stock market boom. Oddly, he seized on the Russell 2000 index of small cap stocks, which has increased 25 percent in the last six months, stating "A stronger economy helps smaller businesses." In other words, despite the stagnant job creation and sluggish growth of real output, Mr. Bernanke has declared Fed policy a success on the basis of yet another financial asset bubble that threatens again to devastate the global economy. This would be

[2] Commodity data is from Index Mundi available at http://www.indexmundi.com/commodities/

farcical were it not so tragic. But what else can be expected from the leader of an institution whose very rationale is to manipulate interest rates and print money.