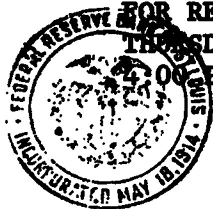

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ARE THERE ALTERNATIVE WAYS OF FIGHTING INFLATION?

Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

at

Cornell University

Ithaca, New York

Thursday, October 29, 1981

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SUMMARY

1. Monetary policy is carrying more of a burden in the struggle against inflation than would be necessary if other forms of inflation fighting were employed simultaneously.

2. A return to the gold standard is being recommended as a means of bringing down inflation, but examination of how it would work suggests that it is more likely to destabilize than stabilize money supply.

3. A gold-backed bond would not serve the purpose of bringing down interest rates in the absence of other effective measures against inflation.

4. A move toward better budget balance is essential to redistribute the burden of inflation fighting, preferably through further expenditure cuts.

5. In the absence of an incomes policy, it is still reasonable to expect labor and business to take into account the benefits of the tax cut in setting wages and prices.

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In the fight against inflation, I believe that we now can count on one important resource. This is the realization, clearly widespread, that inflation is a disease that must be conquered. It is neither a minor inconvenience nor, let alone, a means of stimulating the economy. For years now we have seen the consequences of inflation all around us: declining productivity, diminishing growth, inability to provide for one's future, mounting social and institutional tensions. The absolute need to deal with the problem is clear.

At the present time, the burden of the battle is carried by monetary policy. Monetary policy can do the job, given a free hand politically. But doing it alone would be a costly and protracted process. To speed up the process, reduce the pain, and make success more certain, monetary policy needs support.

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Is the Gold Standard a Workable Alternative?

It is of great interest, therefore, that at this critical juncture a new approach is being proposed that, if workable, would relieve monetary policy of much of the burden of bringing down inflation. This new approach is the return to the gold standard. Its proponents say "let us tie the dollar to gold." This will give people new confidence in their money. It will also prevent excessive creation of money, which is at the root of inflation. During periods when the gold standard prevailed, prices were roughly stable for decades and centuries. We can regain that stability without the stresses and pains of a restraining monetary policy by going back to gold.

Given the difficulties of the job ahead, every suggestion deserves careful examination. The proponents of the gold standard have in their favor their undoubted sincerity in the pursuit of stability. Unlike proposals made 10 and 15 years ago for a doubling or trebling of the price of gold, the present proposals, I believe, have little to do with speculative profit. They are oriented toward stable prices.

The gold standard proposal rests its case partly on the historical fact that under the gold standard secular price movements were relatively small. International exchange rates were stable. Particularly during the 19th century, the heyday of the gold standard, world trade and income rose rapidly. In many ways, the gold standard is a suitable theme for nostalgia. And, when one looks at the inflation and other financial disorders that have occurred since the United States formally terminated gold convertibility in 1971, one may well be tempted to try to return to the golden age. Unfortunately,

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I shall have to argue here that this is not workable, because of the difficulty of fixing a new price for gold, difficulties of extending a gold standard internationally, the instability likely to be encountered in operating a gold standard if a price were nevertheless fixed, and the long-run inadequacy of the supply of gold.

In making this case, and before looking at the problems of a future gold standard, we need to look at those of the old, which were very serious. It is true that the gold standard period of the 19th century was, in a sense, the golden age of capitalism. It is also true, however, that special conditions prevailed then that helped to make it work. Government economic policy was extremely limited in scope. Maintenance of the national currency at a parity with gold was regarded as the paramount objective. All other considerations, such as full employment, were subordinated to it. There were periods of prolonged depression that in some measure can be traced back to the gold standard. Moreover, the stability of prices that looks so attractive today was of a secular rather than a year-to-year order. Short-run fluctuations of prices were frequent. Indeed, this variability of prices, especially flexibility downward, played an essential role in making the system work.

Problems of a new gold standard. How would the gold standard -- I shall not dwell on the diverse variants that are available -- work if reintroduced now? The first problem, widely recognized, is the "reentry" price of gold. The official price of gold was $20.67 per fine ounce in 1929. It was raised to $35 an ounce in 1934 and to $42.42 in 1973. After World War II, however, free (or black) market prices appeared from time to time whenever gold was not freely supplied by official holders at the

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official price. Eventually the market price became the only effective price. It went from $35 in 1968 to as high as $850 very briefly in 1980 and is now around $450. Over this same period, since 1929, the United States consumer price index has risen about 380 percent. Since 1934, when the $35 price was fixed, the CPI has risen over 500 percent. Since 1971, when we went off gold with gold still officially valued at $35, the CPI has risen 100 percent.

Fixing the price. The first step in going back to gold today would require fixing a price for gold. What would be the right price? Past levels of the official price of gold and of the CPI give conflicting indications, although all point to a price far below the present market price. Using the wholesale price index instead would yield another set of conflicting indications also pointing to a price lower than the prevailing. The market price today is heavily influenced by the expectation of private (and probably official) gold holders that the price will rise. Many holders, to be sure, may own gold for diversification of portfolio and protection against risk rather than for appreciation. But the forward price for gold contracts, which reflects a premium of about 15 percent, suggests that the price is expected to appreciate, even though the premium may also have to do something with the cost of carrying. If the market came to believe that the United States soon would fix the price of gold and would do so in a credible manner so that no further price increase could be expected for the foreseeable future, many holders would sell, and the price would come down. If the price failed to come down in the face of a U.S. decision to go back to the gold standard, it would reflect doubt on the part of the market that a fixed price could long be maintained.

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All this makes the fixing of a price very difficult. Accepting whatever market price might prevail could be a mistake, because gold holders' actions are so dependent on expectations concerning price and the future success of the plan.

Yet the fixing of the "right" price is of great importance. If the price is fixed too high, gold will be sold by holders around the world. The U.S. Treasury would have to buy it at its fixed price. Dollars would have to be issued by the Federal Reserve, as required by the normal processes of the gold standard, against the incoming gold, posing a threat of inflation. The United States had an experience of this nature during the 1930's after the price of gold had been raised to $35. Large amounts of gold then flowed in from abroad, producing enormous excess reserves in the banks. Only the depressed conditions of the times prevented the use of these reserves by the banks for credit expansion that would have been inflationary. Some part of the inflow was "sterilized" by the Treasury which borrowed money in the market to pay for the gold instead of issuing gold certificates to the Federal Reserve against it. This was relatively cheap when the Treasury bill rate was below one percent, but would hardly be commendable today.

On the other hand, if the price were fixed too low, the Treasury would become a cheap source of gold to the rest of the world, and perhaps also to American holders. Our gold stock would drain away until the money supply had been reduced by the normal processes of the gold standard, and economic activity and prices had been deflated sufficiently to put an end to the drain, provided we were willing to stick by the rules. We experienced the effect of a low gold price during the 1960's, when we lost more than

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half of our high postwar gold stock. However, this outflow was not allowed to influence our domestic monetary policy, so that the money supply continued to expand.

Even if somehow the "right" price could be arrived at, this would not ensure that it would remain the right price. Inflation in the United States, or stability in the United States coupled with inflation abroad, would after a while make the price too low or too high. Occasional changes in the price of gold might remedy this situation. But that, of course, would destroy the stabilizing properties of the system and would make a mockery of the entire concept of the gold standard.

International implementation. Difficulties would arise also if the United States were to seek an extension of the gold standard to other countries. This would require, in effect, a return to the system of fixed exchange rates. In some countries there might exist a willingness to do so, particularly if they felt protected against the large payments deficits run by the United States in the final days of the Bretton Woods system. Such deficits and the corresponding surpluses in other countries with their inflationary impact would not easily be possible under a reasonably hard form of the gold standard.

Many other countries, however, might prefer to continue on a floating system. Extensive negotiations would probably be required to establish an internationally coordinated gold-based system. However, each country, and especially the United States, could, of course, establish a gold standard by itself to control its domestic monetary system if it is not concerned about the fixity or flexibility of exchange rates.

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Money-supply determination. Suppose that by skill or by luck all such initial problems were overcome and a gold standard had been put into operation at least in the United States. How would the money supply then be determined? Suppose the money supply is firmly tied to the gold stock, which seems to be what gold-standard proponents interested in discipline have in mind. Given such a firm link, a stable and moderate rise in the money supply would depend on there occurring a stable and moderate increase in the gold stock. Gold would have to flow into the Treasury, which would issue gold certificates to the Federal Reserve, in just sufficient volume to keep the money supply growing stably.

Presumably, in the absence of speculative disturbances, interest rates are the principal means of encouraging or discouraging such private flows of gold. One can visualize a system in which interest rates would be lowered and raised to maintain a stable inflow of gold into the Treasury. But interest rates set to determine gold flows would not be necessarily consistent with a stable growth of the money supply. The chances are that in such a system interest rates would be volatile and the growth of the money supply highly erratic.

The alternative would be to make the link between gold and the money supply quite loose, as it has historically been in the United States. That, however, would probably not serve the purposes of the proponents of the gold standard. Very likely it would lead to a repetition of the policies pursued in the past when restraints imposed by the gold standard upon monetary policy were frequently set aside when they began to bite. An important exception was the restrictive policy actions taken by the Federal Reserve during the early 1930's to counter international gold outflows and domestic withdrawals, with adverse effects on economic activity.

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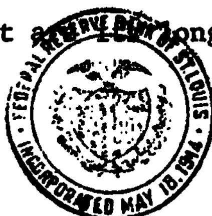
It may be comforting to conjure up a picture of citizens lining up at the gold window of their local bank to withdraw gold because they fear inflation and want to discipline their government. The history of bank runs in the early 1930's conveys a somewhat different flavor. In any event, the main flows of gold, even under a gold-coin standard, would probably be international rather than domestic. Economic expansion and contraction here and abroad, leading to varying interest-rate differentials and to international payments surpluses and deficits, would be the main determinants of gold flows and hence of the U.S. money supply. In today's environment, the picture that this conjures up is not that of the Bank of England, as in 1881, regulating gold flows by small changes in its discount rate and keeping the world monetary system in balance. More likely we ought to recall the picture of the early 1930's, with its bank closings, or the late 1930's, with its threat of inflation and ever-widening payments deficits breaking down the foundations of the international monetary system. Such things need not happen, but under a gold standard rigorously maintained they might. And I abstract here altogether from the additional dangers that might come from the dominant position in gold mining and new gold supplies held by South Africa and the Soviet Union. The wisdom of giving some degree of control over the U.S. money supply to the main gold-producing countries is questionable. The same applies to other countries that might decide to change substantially their existing gold stocks.

Long-run inadequacy of gold supply. Finally, suppose that a gold-standard system somehow had become operative and that the risks I have sketched had been held in check. What are its long-term prospects? The chief virtue



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of gold, as a monetary standard, is that its supply cannot be changed by additional production very much in any short period of time. Most of the gold mined throughout history is still in somebody's hands. Annual output historically has averaged less than two percent of the existing stock. That is what gives a gold standard its power to protect against excessive increases in the money supply, provided, of course, that there are no supplies of gold held outside the monetary system.

The trouble with gold is that this rate of increase is too slow. A system rigidly linking the growth of money to the growth of the gold stock would not generate a growth of the money supply commensurate with the real growth of the United States and even less of the world economy, which historically has been in the 3-5 percent range. This problem was recognized at various times during the gold-standard era. In 1930, the League of Nations published a study which concluded that the growth of the world's gold stock was too slow to finance world economic growth without deflationary pressure on prices. It recommended withdrawal of gold coins from circulation and the use by central banks of foreign exchange instead of gold reserves as a means of economizing gold. During the late 1950's, the International Monetary Fund conducted a similar study also focusing on insufficiencies of new gold supplies. Later this was followed by the creation of the special drawing right (SDR) as a means of eking out supposedly inadequate international reserve creation.

It could be argued that at today's incomparably higher prices, gold output should increase more rapidly. On the other side of that argument, however, is the fact that in South Africa, the world's principal producer,

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output has declined as price has gone up. The simple reason is that at higher gold prices it becomes profitable to employ the not unlimited capacity of the mining industry in processing lower grade ores which may never become processable again if the gold price should decline.

Some implications. From both short- and long-run points of view, therefore, the gold standard presents serious problems. Under existing conditions, it probably would not work at all as its proponents hope. Under conditions of stability of prices and exchange rates, such as prevailed during the 1950's, the matter might be different. But if those conditions prevailed, would we need a gold standard?

The simple fact seems to be that the gold standard and price and exchange-rate stability are mutually dependent on each other. The gold standard encourages stability if it exists to begin with. Stability in turn facilitates the working of the gold standard. But there can never be any assurance that this happy symbiosis will continue.

Some of these difficulties might be met by adopting a very loose form of the gold standard. If the money supply were linked to the gold stock only in the sense that some minimum or maximum ratio had to be respected and could not be exceeded, there could be leeway for the money supply to move without triggering these constraints, i.e., it would be expanded or contracted by the same monetary policy techniques now in use. In that case, however, the automatic control by the gold standard and its supposed effects on confidence would be missing. The gold standard of the 1930's and the subsequent Bretton Woods period was of that sort. In the early postwar period, the critical ratios were never approached and the gold standard

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did not prevent the United States from pursuing any kind of monetary policy. Later, whenever the restraints threatened to become binding, it was not monetary policy that gave way, but the restraining ratios. These were liberalized from time to time and finally removed altogether.

It is well to recall, at this point, that we already have a legislative ceiling designed to curb undue expansion. I am referring to the Federal debt ceiling. We know what happens whenever the ceiling is approached, which is almost every year. The Congress does not act to limit spending, but raises the ceiling. One must ask whether a gold ceiling on the money supply would fare any better, if as a nation we did not have the will to constrain the money supply to avoid inflation in the first place.

Ultimate disposition. Some people who are skeptical of the gold standard draw from that posture the further conclusion that the United States should sell its gold stock. If we are never going to use the gold, why keep it? I do not feel sufficiently sure about the future to recommend disposal of our gold stock. Conceivably, some day the rest of the world may want to go back to gold, and the United States then should not find itself handicapped by lack of gold. Conceivably, the gold stock may some day have a usefulness as a warchest. Conceivably, although I do not believe it, monetary conditions in our own country could some day be such as to make the case for the gold standard more persuasive. We have the means to prevent that from happening, by conducting sensible policies. But one should not let go of a potential lifesaver, however unlikely.

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Furthermore, the disposal of our gold stock would raise the question of what to do with the proceeds. All sorts of undesirable budgetary and public debt-management schemes immediately come to mind that should be firmly scotched before they gain currency. That is another reason for leaving the stock and the role of gold exactly where it is now.

Gold bonds. The present high level of interest rates has given rise to the suggestion that the gold standard would also serve as a means of bringing down interest rates. Like much of the gold standard proposal, the assumptions under which this would happen are not fully spelled out. I can see two ways in which the gold standard might reduce interest rates. One would be if it succeeded in bringing down inflation. There can be no quarrel with this view except, of course, that interest rates would also come down without the gold standard, if inflation is reduced. But it is also argued that the interest rate on bonds could be brought down by a tie to gold, apparently independently of the rate of inflation and independently of whether the gold standard is operating in other respects. It is important to be clear about what is supposed to be brought down here -- the interest rate on a gold-convertible bond, or the level of interest rates in general.

It is, of course, perfectly possible to design a bond tied to gold that could be sold at a very low interest rate. If the bond is made repayable in, or better still convertible into, a specified weight of gold equal, at today's gold price, to the value of the bond, the bond becomes in effect a warehouse certificate for gold. Someone willing to own gold should be willing to own the bond without any interest, considering that he would save the storage and insurance costs normally involved in gold ownership.

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He would presumably hold the bond on the assumption of getting a return on his investment from a rise in the price of gold, or else, for the purpose of risk diversification.

If the bond, instead of being based on today's gold price, were made payable in or convertible into gold at a price somewhat above the prevailing price, the bond would be like the familiar corporate convertible bond which is issued by a corporation trying to hold down its interest cost by making the bond exchangeable for its common stock at a price above the market. The bond would then have a "gold kicker" analogous to the equity kicker now often attached to loans made by institutional lenders. With a conversion price of gold close to the market price, the interest rate presumably could be very low. With a very high conversion price, unlikely to be reached during the lifetime of the bond, no improvement in the interest rate compared to nongold bonds would be attained. Quite conceivably, a private issuer could issue such a bond, if he could make a reliable forward contract for gold to cover his risk and if the combined cost of this contract and the interest rate turned out to be less than the straight interest cost of a nongold bond.

It should be noted that the viability of such a bond depends on an expectation, on the part of the buyer, that the price of gold will rise. That increase, or else risk diversification, is where the holder must expect to get part of his return. If the price of gold were credibly fixed, this expectation could not exist. The bond in that case would have to carry the same interest rate as gold bonds. If nevertheless it could be sold at a lower interest rate, this would be prima facie evidence that the market did not expect the fixed price to last.

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All this implies, of course, that gold bond holders expect their contracts to be fulfilled. That was not the case with respect to the many gold bonds outstanding in the United States, issued by corporations whose gold clause was invalidated in 1935 by the Supreme Court, thus depriving the owners of the benefit of the appreciation of gold from $20.67 to $35.

A contemporary precedent exists for a gold bond, in the form of the French government gold bonds now outstanding that were issued before the great rise in the price of gold. One of these bonds is gold-indexed both as to interest and principal, the other as to principal only, which has made the interest insignificant at the present price of the bond. Both bonds, of course, have appreciated enormously, and at present prices represent not far from one-half of the total debt of the French government. Far from reducing the cost to the government, they have increased it by a large multiple.

I have discussed at some length the possibilities of bringing down inflation and reducing interest rates by returning to the gold standard or issuing a gold-backed bond. As you will have noted, I do not believe that these devices, however well intentioned, would be workable or serve our purposes.

Matching Inflation Causes and Remedies

We are still left, therefore, with the question whether monetary policy alone should continue to carry the burden of bringing down inflation or whether an array of policies is needed. It may be easier to answer this question if we first ask how we arrived at the high inflation we are suffering

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today. Many contributing factors to inflation have been alleged: not only excessively easy monetary and fiscal policies, but also unanticipated shocks like the two rounds of oil-price hikes, occasional food shortages, the superior bargaining power of labor unions, monopoly power of corporations, and numerous government price-raising actions. Among the latter, I need mention only a few -- such as costly regulation, import restrictions, inadequate anti-trust policies, farm-price supports, and government wage-setting.

It is sometimes argued that with an adequately restraining monetary policy, none of the other sources of price increases could have brought about a general inflation. That is probably true, not in the sense that monetary policy could have prevented any of these things from occurring but in the sense that monetary policy could have produced a depression severe enough to overwhelm all upward pressures on prices.

If one were to take that analysis as a starting point, one could perhaps arrive at the conclusion that nothing needs to be done about fiscal policy, oil prices, food supply, union pressure, and government price-raising actions hereafter in order to bring down inflation. Monetary policy seemingly can do it all. Given the political realities, I do not find that analysis convincing. To the extent that they are subject to policy action, all sources of inflationary pressure must be regarded at least potentially as foci of policy. I am aware, of course, that some forms of action are not acceptable in our present environment. For instance, an incomes policy, such as the tax-based incomes policy (TIP) suggested by various economists including myself, does not rank high on the list of promising techniques. Even so, at a time when for several years we are all going to be the beneficiaries

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of very generous tax cuts, it does not seem amiss that the resultant improvement be taken account of by business and labor in their wage- and price-setting decisions.

If I am right in my belief that inflation must be attacked from all sides, there obviously is a wide range of possible actions. Many of these are already being moved ahead. Especially in the area of public spending, a historically unique move has been made to bring down expenditures. But more needs to be done to bring down the deficit to a level that can be financed without excessive pressure on financial markets. The Federal Reserve is trying to do its job in maintaining a moderate growth of the money supply. The interest rates to which this leads are in good measure determined, aside from the level of inflation itself, by demand for funds in the market, including those of the federal government. We shall get inflation under control more quickly, and at less cost, if we use not one of several alternative techniques, but a combined approach that attacks as many of its sources as possible.

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