Research Department
Federal Reserve
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San Francisco

May 18, 1979

FRBSF Weekly Letter

The Multiple-Currency Defense

Remember the gold clause

During the half-century ending in 1914, "greenbacks" and "free silver" were the favorite instruments of American inflationism. William Jennings Bryan became the mouthpiece of what we call today "reflation" and "economic stimulation" thinking. As insurance against greenbackery and "Bryanism," and later against any revival of "cheap money," bondholders and other long-term creditors accepted lower nominal interest rates in exchange for "gold clauses" in the securities they held. (If you held a $1000 bond with a gold clause, you could claim both interest and eventually principal in gold. Were the price of gold to double over the life of the bonds, for example, you could claim $2000 in U.S. currency when the bond matured.)

The gold clause is a simple example of "choice in currency." It harks back to the disinflation which took place from the end of the Civil War until the resumption of specie payments in 1879 — "the only period in which two kinds of money exchanging at a fluctuating rate — greenbacks and gold — were used domestically side by side to any considerable extent."

In 1933, the first New Deal administration raised the U.S. price of gold from $20.67 to $35.00 per ounce. This was done to reflate the price level to a pre-depression figure. (The price theory which prompted this action was simply wrong.)

An issue of Baltimore and Ohio Railroad (B&O) bonds, with gold clauses, matured in 1933, with the price of gold $35 per ounce but the general price level still close to its depression lows. Some B&O bondholders demanded $1693 (1000 × 35.00/20.67) for each $1000 bond as per the gold clause, although gold clauses had been abrogated by Congress. B&O refused to pay more than $1000. The bondholders sued, calling the Congressional abrogation of existing gold clauses unconstitutional. The resulting lawsuit was decided 5-4 in B&O's favor by the U.S. Supreme Court in 1935 (B&O *v* Francis). *Query:* Were the case to come up today, would the learned Justices decide the same way despite altered "equities?"

Generalized currency choice

The "choice in currency" movement proposes, by legislation, to reverse the gold-clause decision in the U.S. and similar decisions in other countries, and to re-establish on broader geographic and other bases the situation prevailing in the U.S. between the Civil War and the 1879 "resumption." Currently, private parties can of course specify in advance the currency — or other commodity — in which interest and principal of debts should be payable. Such stipulations, however, are not legally binding or enforceable unless "legal tender" currency is specified. "Choice in currency" advocates propose to abolish this

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distinction by broadening the "legal tender" concept.

This change would permit U.S. creditors who distrust U.S. economic policy to stipulate payment in gold, German marks, or anything else they (and their debtors!) can agree upon. If a U.S. contract were written in marks, and the marks rose during the life of the contract, the creditor under a "mark clause" could demand either marks or the current dollar equivalent. The courts would enforce his claim as though the contract had been drawn up in U.S. dollars. Before agreeing to a mark clause, a gold clause, or a yen clause in a long-term contract, the rational American debtor in 1979 should insist upon a relatively low nominal interest rate.

Debtors might go even further, and persuade creditors to accept payment in currencies depreciating faster than the U.S. dollar in exchange for higher nominal interest rates. Once agreed upon by creditors, such stipulations would also be binding.

With media of payment negotiable between contracting parties, each contract or security might conceivably specify its own idiosyncratic legal tender. Absence of any contrary stipulation would surely be interpreted in the U.S. to imply mutual acceptability of the U.S. dollar. The various U.S. governments (national, state, and local) would also continue to require payment of tax and similar liabilities in U.S. dollars. In earlier days some Southern states permitted deer and coon skins to be used for payment of taxes.

The revival of interest in currency choice reflects desires by prospective creditors for a defense against inflation, and by prospective debtors for a defense against high nominal interest rates. The revival is largely the work of one man, Friedrich von Hayek of Austria, a 1974 Nobel laureate in economics. Hayek would even permit private parties (from David Rockefeller to Robert Vesco, from General Motors to Penn Central) to issue certificates of indebtedness which would compete freely for public acceptance as money. The conventional reading of U.S. financial history in the "wildcat banking" generation which preceded the Civil War renders most economists skeptical about this extension of the free market.

Impact problems

The availability of alternatives to the dollar would doubtless have kept American money managers and legislators more sensitive to inflationary dangers in the past than they actually were. Market participants would have deserted the dollar in favor of gold and foreign currencies in a more massive and more rapid fashion, bringing more and earlier pressure on the dollar exchange rate in international finance. A wider nominal interest spread between contracts denominated in dollars and in more stable media would have provided early warning to the government of developing distrust of the American currency.

There might also have been an earlier and faster migration of the world financial community from Wall Street to rival centers. The U.S. government might then have acted sooner, and more consistently, against inflation. This change of public policy would have been an added bonus of the Hayek proposals, which Hayek duly stresses.

Introduction of currency-choice in mid-inflation, however, exerts unhappy impact effects. With gold clauses suddenly made legal and enforceable, we can forecast a shift in the demand for money — Keynesian "liquidity preference" — from dollars to gold. This would raise the price of gold and weaken the dollar internationally. On the domestic scene people would hold fewer dollars for shorter periods, raising the velocity of dollar circulation; at the same time, the volume of transactions carried on by exchange of goods for dollars would fall. All these reactions could accelerate the American inflation, not only until our money managers "learned their lesson" but quite possibly until short-term resumption of inflation became as unlikely as it seemed 50 years ago.

Now consider the reactions of currency choice upon an economy in a period of at least relative deflation. To make this scenario more concrete, consider a two-country world and neglect gold and other commodities. Our two countries are North America or N.A. (a dollar country in which we live) and Latin America or L.A. (a peso country with more rapid inflation). With currency choice in both countries, total demand for N.A. dollar-denominated assets would rise as Latin Americans shifted to the dollar from the peso. This would slow N.A. inflation (or accelerate N.A. deflation). It would probably raise real N.A. interest rates on balance. The deceleration of inflation we should instinctively consider stabilizing, while acceleration of deflation would be destabilizing. These changes would also handicap N.A. export and import-competing industries in international competition.

This analysis ignores the effects of currency choice in N.A. itself, i.e., the preference of N.A. debtors to borrow in pesos, paying higher nominal interest rates as an offset. Such borrowings would presumably be rare. But why, one wonders, would they be rare? My personal belief is that most of us develop early in life a certain stability preference with regard to general price levels. This stability preference would be an aspect of the same risk aversion which makes so many of us pay premiums for insurance and which generates ulcers when circumstances force us to become large-scale risk-bearers (gamblers). I also believe that this stability preference is overlooked in theoretical-economic discourses about the "welfare cost of inflation" — but that is a subject for another sermon.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 5/2/79	Change from 4/25/79	Change from year ago @ Dollar	Change from year ago @ Percent
Loans (gross, adjusted) and investments*	124,975	549	+ 17,324	+ 16.09
Loans (gross, adjusted) — total#	102,205	798	+ 16,616	+ 19.41
Commercial and industrial	30,172	192	+ 3,693	+ 13.95
Real estate	36,466	176	+ 7,871	+ 27.53
Loans to individuals	21,247	114	NA	NA
Securities loans	1,644	154	NA	NA
U.S. Treasury securities*	7,707	− 217	− 354	− 4.39
Other securities*	15,063	− 32	+ 1,062	+ 7.59
Demand deposits — total#	42,597	26	+ 3,373	+ 8.60
Demand deposits — adjusted	30,534	− 857	+ 2,892	+ 10.46
Savings deposits — total	29,632	− 31	− 591	− 1.96
Time deposits — total#	49,680	− 64	+ 6,661	+ 15.48
Individuals, part. & corp.	40,387	− 5	+ 7,138	+ 21.47
(Large negotiable CD's)	17,061	− 106	+ 1,458	+ 9.34

Weekly Averages of Daily Figures	Week ended 5/2/79	Week ended 4/25/79	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (−)	10	67	25
Borrowings	224	122	66
Net free reserves (+)/Net borrowed(−)	− 214	− 55	− 41
Federal Funds — Seven Large Banks			
Net interbank transactions [Purchases (+)/Sales (−)]	+ 967	+ 1,365	+ 1,695
Net, U.S. Securities dealer transactions [Loans (+)/Borrowings (−)]	+ 220	+ 84	− 63

*** Excludes trading account securities.**

 # Includes items not shown separately.

@ Historical data are not strictly comparable due to changes in the reporting panel; however, adjustments have been applied to 1978 data to remove as much as possible the effects of the changes in coverage. In addition, for some items, historical data are not available due to definitional changes.

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