A Sound Monetary Foundation

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As with investment and economic resource allocation more generally, fiscal prudence and national solvency must be built upon the foundation of sound money, i.e. money with predictably and reliably stable value. I will briefly explore the monetary policy options available and set out the arrangements that are most conducive to sound money?

Overview

When people discuss the concept of stable money they sometimes think of its purchasing power as measured by, for example, the Consumer Price Index. However, they sometimes think of its value relative to other currencies, i.e., its exchange rates. In fact, both are important for evaluating investment decisions and thus for economic growth. The classical gold standard of the late nineteenth and early twentieth centuries was the closest the world has come to such an ideal system.

When a currency was redeemable for gold at a fixed price, the supply of that currency was controlled and regulated by the market so that its purchasing power, its market value, was kept equal to the market value of gold. When other countries also fixed the gold price of their currencies, the exchange rates between those currencies were also fixed. The gold standard, to the extent that all or most countries adopted it, gave us a one-world currency and the enormous benefits of such a system from monetary stability.

Despite these very important virtues and benefits of the gold standard, gold or any other single commodity is not the best anchor for the value of money. "Between 1880 and 1914, the period when the United States was on the 'classical gold standard,' inflation averaged only 0.1 percent per year…. This compares with the post classical gold standard "period of 1946 to 1990 with an average inflation rate of 4.2 percent."[1] This was an impressive and important achievement of the gold standard. However, under the gold standard inflation has been quite volatile in the short run. "For the United States between 1879 and 1913, the coefficient [of

[1] Michael D Bordo, "Gold Standard" The Concise Encyclopedia of Economics

variation of inflation] was 17.0, which is quite high. Between 1946 and 1990 it was only 0.8.[2]

When Richard Nixon closed the U.S. gold window and ended the gold exchange standard in the early 1970s the major economies gradually adopted floating or market determined exchange rates for their currencies anchoring their monetary policies to domestic objectives. After an unhappy experience in the late 1970s, many large country central banks have settled on inflation targets to anchor and discipline monetary policy.

Like every other form of exchange, the value of money depends on its supply and demand. Monetary regimes and policy determine the behavior of money's supply. Without a hard anchor for the money supply, as was provided by the gold standard, central banks have chosen between policy rules such as a fixed rate of growth of the money supply (the Friedman rule), more flexible rules such as targeting the rate of inflation or the rate of growth of nominal income, or leaning against the wind of the business cycle or maximizing employment (sometimes misname "discretion").

But since most money today is created by banks, their behavior and central banks' control or influence over it must be taken into account as well. This introduces the policy issues of whether banks should be required to hold 100 percent of the money deposited with them as cash reserves (The Chicago Plan) or should be free to issue their own currency when depositors want to convert their deposits into cash (free banking) or something in between.

The great divide among monetary policy regimes is between those with floating exchange rates that anchor the central bank's supply of its money (so called base money) to domestic rules and objectives, such as a price level or inflation target, and those that fix the currency's exchange rate (such as the gold standard). Either can be combined with the full range of banking regimes.

The last thirty or so years with one form of inflation targeting or another gave us the great moderation until it all blew up with the great recession of 2008. After peaking in April 1980 at 14.6% change from a year earlier and a mini peak of 5.0% in May 1990, monetary policy rules were tightened and the CPI averaged close to 2.5% for the next 12 years. Following the bursting of the U.S. housing bubble and the great contraction, this measure of inflation has fluctuated between 5.5% in July 2008 to a minus 2.0% one year later, back up to 3.8% in September 2011 and near zero through all of 2015. Worse yet for international trade, exchange rates were very volatile in the post Bretton Woods period, i.e. after the collapse of the gold exchange standard. The U.S. dollar to Euro exchange rate has varied over 60% over the last

[2] *Ibid.* https://wcoats.wordpress.com/2008/07/11/should-the-u-s-adopt-a-gold-standard/

15 years. Despite their best intentions and improved data and forecasting models, central banks have not been capable of providing a stable currency or stable income.

This sad record has renewed interest in the fixed exchange rate or hard anchor alternatives. Attention has naturally turned to gold. But the gold standard suffered several weaknesses that led to its demise. The Federal Reserve was allowed to undertake limited expansions or contractions of its base money not fully backed with gold. Eventually the market (other central banks) lost confidence in the ability of the Fed to redeem its dollars for gold. In addition, as noted earlier, gold's value has not been stable over periods of a few years.[3] Anchoring the value of our currency to that of a single commodity, will never produce a currency with a value as stable as one anchored to a basket of commodities or goods. This is the well-known portfolio effect reflected in mutual funds.

Recommendations

I have long advocated replacing the discretion of the Federal Reserve to manipulate the money supply with a firm rule of issuing and redeeming its currency in response to market demand at a price fixed to a basket of goods that reflect an average household's consumption basket. This would be a strict form of a gold standard, but fixed to a broader basket of goods than just one.

Commodity baskets were recommended on many occasions earlier, including by Keynes. They failed to gain support largely because they were considered too costly to operate. It was incorrectly assumed that such a system required that the currency whose value was fixed to the value of a basket of goods had to be issued and redeemed against the same basket of goods, which then would have to be stored and guarded in some kind of Fort Knox. Some time ago Leland Yeager, a friend of this society, explained how a currency board rule would work to keep the market value of currency equal to that of its valuation basket with indirect rather than direct redeemability. Arbitrage would keep the market value of the two—the currency and its valuation basket—the same as long as the currency could be purchased (issued) or resold (redeemed) with any asset (such as U.S. treasury bills, e.g.) of current equivalent value. As with the earlier gold standard, if the value of the currency in the market (the price of gold, or of the goods in a goods basket) falls below its official value, there would be a financial incentive to redeem it for its higher official price thus reducing the supply of money in the market.

Currency boards cannot generally lend to anyone including banks. Central banks were first established largely to address the structural weakness of our fractional reserve banking system by acting as a lender of last resort when the public runs to their banks to withdraw their deposits as cash. Either the Chicago Plan of 100%

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[3] See: https://wcoats.wordpress.com/2013/07/31/a-hard-anchor-for-the-dollar/

required reserves, sometimes called narrow banking, or allowing banks to issue their own currency (redeemable for the central banks currency), sometimes called free banking, would remove this weakness and the need for a central bank lender of last resort facility.

Such a currency board system would provide a currency with a more reliably stable value than could a return to the gold standard. If all countries adopted such a monetary policy rule and used the same valuation basket, the world would again have currencies with fixed exchange rates as enjoyed under the gold standard. The most promising way to accomplish this would be to adopt the international reserve asset already established by the members of the International Monetary Fund—the so called Special Drawing Rights or SDRs—for pricing and settling internationally traded goods such as oil-and as the asset help by central banks as their international reserve.

I have described this proposal and the steps for implementing it in some detail in earlier articles.[4] [5] The United States or any other country can unilaterally adopt these proposals whenever they see fit. But the full benefit of a stable global currency would best be achieved by enhancing the IMF's SDR into this role. The first phase would consist of promoting the development of private SDRs by using the IMF's SDR valuation basket to price internationally traded commodities such as oil, extend loans from the World Bank and regional development banks in private SDRs (SDR denominated deposits at banks), and building up the private SDR denominated financial instruments to support these activities and related payments.[6] The second step would be to replace the current SDR valuation basket of five currencies (U.S. dollar, Euro, UK pound, Japanese yen, and Chinese yuan) with a valuation basket of representative goods). The final step would be to amend the IMF's Articles of Agreement to provide for issuing and redeeming these SDRs according to currency board rules and to replace via substitution the U.S. dollars and Euros in central bank reserves with these SDRs.

Conclusion

The implementation of monetary policy using inflation targets has improved monetary stability compared with the 1970s but has nonetheless failed to perform satisfactorily. No central bank determined monetary policy is likely to overcome the

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[4] Warren Coats, "Real SDR Currency Board", *Central Banking Journal* 2011, http://works.bepress.com/warren_coats/25/

[5] Warren Coats, "Implementing a Real SDR Currency Board," 2014 http://works.bepress.com/warren_coats/30/

[6] Warren Coats and Dongsheng Di, "The Asian Infrastructure Investment Bank and the SDR" January 20, 2016. https://wcoats.wordpress.com/2016/01/20/the-asian-infrastructure-investment-bank-and-the-sdr/

data and forecasting deficiencies needed to be fully successful. The world would benefit from a return to a hard anchor for the value of its currencies. Gold, the hard anchor used over a century ago with considerable success, would not be the best hard anchor. The United States and the world would be better served by issuing (and redeeming) currency whose value is fixed to that of a basket of commonly consumed goods under currency board rules. This would result in a supply of money determined completely by market demand and with a value fixed and known well into the future. Adopting the SDR globally for this purpose would eliminate exchange rate uncertainty and provide a solid and stable foundation on which to build and grow the world's economies.