There is little new in this latest cycle of economic boom, panic, and bust. All of these cycles are linked to the life and death of the unstable post–World War II Bretton Woods monetary system. First came the crisis-ridden gold-dollar system from 1944 to 1971. Then came the rise of floating exchange rates and the world paper dollar standard from 1971 to the present—associated with regular booms, panics, and busts—bringing us down to this very day.

Between 2009 and 2011, the world experienced a major emerging market equity and economic boom—but at the very same time, sluggish growth in the United States. Foreign authorities now react to inflation by raising interest rates. Why such a sluggish sequence in the U.S.? Because the Federal Reserve’s vast credit creation of 2008–2010 could not be fully absorbed by the U.S. economy, coming as it did after a wild panic and a deep recession. The unprecedented Fed credit expansion flooded into U.S. stocks, bonds, and commodities. Excess Federal Reserve credit and money also went abroad, causing not only a fall in the dollar but also the emerging market financial boom. What is the mechanism which links Fed credit expansion to the emerging market boom? It is simply this: financial authorities abroad purchase the incoming flood of excess dollars against the creation of their local currencies. There, the new local money is put to work promptly, creating a boom in all financial assets, and then a boom in the local economy as well.

In truth, the Federal Reserve is the de facto central bank of the world monetary system, because the paper dollar is the monetary standard of the world banking system. Expansive Fed credit policy—especially Federal Reserve and foreign financing of the U.S. balance of payments deficit and the government budget deficit—has been behind almost every boom and bust cycle since 1914. The cycle is engineered by the purchase of dollar-denominated securities by the Fed and foreign central banks, a process enabled by the opaque workings of the official world reserve currency system, based on the dollar.

For example, after World War II the dollar-based Bretton Woods gold-exchange system, followed by the disorder of floating-pegged exchange rates, led to an overvalued dollar and to the diminution of our dominant manufacturing sector. Floating exchange rates cause huge upward and downward currency moves, which abruptly reprice the entire

Lewis E. Lehrman is chairman of the Lehrman Institute. For additional information about the gold standard, please visit [www.thegoldstandardnow.org](http://www.thegoldstandardnow.org).
productive machinery of nations subject to floating currencies. Thus, whole national economic sectors become unprofitable, making steady long-term investment and output very difficult. Subsequent underinvestment leads unavoidably to scarcity booms, fueled from cycle to cycle by Fed-subsidized credit to the banking system and to the deficit-ridden Treasury. Thus, the natural business cycle is intensified rather than moderated.

To mitigate the perverse effects of floating exchange rates, many countries have pegged their undervalued currencies to an overvalued dollar in order to subsidize and sustain their export production machines. This is an ancient practice of predatory mercantilism.

It is obvious that the current Fed credit cycle, coming out of the 2008 economic bust, did finance a major equity and commodity boom from 2009 to 2011. The ultimate source of the equity and commodity inflation was the Fed’s monetization of insolvent U.S. mortgage-backed securities and the Treasury deficit. But this outpouring of Federal Reserve credit to bail out the banks at home then leaks abroad. There it is to be absorbed by foreign governments, and monetized by central banks in the form of official foreign exchange reserves. Invisible to the general population, these foreign official dollar reserves are then recycled back into the market for U.S. Treasury securities, whereby they finance both the perennial U.S. balance of payments deficit and the rising budget deficit. Abroad, the United States is, in effect, enabled to buy without paying. So is the U.S. Treasury.

For example, in addition to the recent Fed purchases of $600 billion of U.S. government securities in order to finance the government budget deficit, foreign financial authorities have to date purchased in total at least $3.5 trillion of U.S. government and agency securities, against which these foreign central banks created new domestic money and credit—the penultimate trigger of past booms and busts in their home countries. Foreign credit financing of the U.S. Treasury deficit comes in addition to the more than $1 trillion of U.S. government securities purchased by the Fed, and much more by the U.S. banking system. With such limitless bank credit financing available, the Treasury deficit will continue. The Treasury owns a unique credit card with no requirement to settle its debts. So long as there is unrestrained Fed and foreign credit available, the U.S. deficit will go on and on—Jacques Rueff’s infamous “deficit without tears.”

However, U.S. fiscal and monetary policy causes not only perverse financial effects, but also—and especially—unstable and inequitable social effects. In other words, the dollar-based world monetary system has been a leading cause of the increasing inequality of wealth in American society.

To see how this is so, let us first consider the mechanism by which the Federal Reserve open market operations are at the epicenter of this economic disorder characterized by inflation, speculation, boom, and bust. Simplified, and focusing on today only, the sequence is as follows: In order to finance the government deficit, the Treasury now sells bills and bonds at a rate of about $120 billion per month—or $1.5 trillion per year, an amount about equal to the present annual budget deficit. The Federal Reserve, the banking system, and foreign central banks purchase these Treasury bills and bonds against the issue of new money, or newly created credit. But during this same market period, the new money created to finance the U.S. government deficit is not associated with the production of any new goods, new services, new equities. Thus, during the market period in which the Treasury spends the newly issued money, total spending, or purchasing power, must exceed, in the same market period, the total value of goods
and services at prevailing prices. Of course, prices must rise when demand exceeds supply. During the Fed credit expansion of 2009–2011, equities and commodities—and food and fuel prices—boomed in the U.S. market. Some of the Fed-created excess dollars went abroad, also creating a boom in financial assets in emerging economies. However, with so much unemployed labor in the United States, prices rose faster than wages. Thus, profits also rose. U.S. corporations are now awash in cash, but real wages of working people have declined even as corporate profit margins expand.

In this U.S. inflationary process, bankers and speculators are the first in line, along with the Treasury, to receive the near-zero-interest credit from the Federal Reserve. They are also first to get bailed out with new Fed money. Then, with the new money, the banks and brokers finance depressed stocks, bonds, and commodities—front running, as in the past, an advertised Fed-created financial boom. (Quantitative Easing 2, the Fed’s most recent marketing plan to raise equity prices, was “advertised” by its chairman, Ben Bernanke, late last year in the Washington Post.) In each boom cycle, prices rise first for scarce and volatile goods. In the current cycle those goods are stocks, commodities, and financial claims because they are relatively liquid vehicles for speculators, brokers, and banks. The bulls congratulate themselves. The lost tribe of the bears capitulates. But in other credit cycles, the excess Fed-created money will move into real estate, as in 2004–2007, or Internet stocks, as in the late 1990s, or emerging market equities, as in 2009–2010, or wherever romance and relative prices entice investors and speculators with cheap, new Fed credit.

The gradual and insidious process of inflation is hidden at first from the vast majority of working people. For example, inflation today is muted in the United States at the consumer price level because of high unemployment and unused production facilities. These were both inherited from the last panic and bust—a panic and a bust ultimately caused, of course, by belated, tight Federal Reserve credit policy in 2006–2007. Over many inflation cycles the social effects of financial disorder and the overvalued dollar have intensified inequality. The overvalued dollar subsidizes Chinese exports and the workers who produce them. The near-zero interest rates maintained by the Fed subsidize the bankers and their financial clients. A nimble financial class in possession of cheap credit can maneuver to protect itself against inflation, but the vast population of middle-income professionals and workers, on salaries and wages, as well as those on fixed incomes and pensions, are impoverished by this very same volatile, inflationary process. Worse yet, average American savers will earn a negative real return on their savings. Thus, they save less. And thus, new investment will once again come to depend increasingly on bank debt, leverage, and speculation. Inequitable access to cheap Fed credit was everywhere apparent during the government bailout of favored brokers and bankers in 2008 and 2009, while millions of not-so-nimble average citizens were forced into bankruptcy. This is the latest ugly chapter in a century of financial disorder.

So when did this story begin? The age of inflation was inaugurated in 1914 by the onset of World War I. The Great War had brought to an end the preeminence of the classical European states system. It had decimated the flower of European youth. It had destroyed the European continent’s industrial primacy. On the eve of the Great War the international gold standard was destroyed. The gold standard had been the monetary gyroscope of the Industrial Revolution and its extraordinary economic growth, marked by one hundred years of general price sta-
bility. The general price level, almost literally, wound up at the same level in 1914 as it had almost one century before. Compare this with the forty-year period from 1971, the year President Nixon suspended dollar convertibility to gold. Adjusted for the Consumer Price Index (CPI), the dollar has in fact lost over 80 percent of its purchasing power since 1971. (See graph below.)

Decline in the Dollar Since the End of Convertibility

Graph 1: The Dollar Deflated by the CPI. See Testimony, Lewis E. Lehrman, March 17, 2011, before Congress.

It is certainly strange that an unhinged token, the paper dollar, is now the monetary standard of the most scientifically advanced global economy the world has ever known. How did we get here?

In 1922, at the little-known post–World War I Monetary Conference of Genoa, the gold-exchange standard was officially embraced by academic and political elites. It was there that the dollar and the pound were confirmed as official reserve currencies, so that these national currencies might substitute for what was said to be a “scarcity” of gold. But there was no true scarcity—only overvalued national currencies caused by the inflation of World War I. The overvaluation, relative to the gold monetary standard, was maintained after World War I despite a doubling and tripling of the general price level in national currencies during the war. The greatest economist of the twentieth century, Jacques Rueff, warned in the 1920s of the dangers of this flawed official reserve currency system, designed “in camera” by the experts. Rueff predicted a collapse of this newly rigged official reserve currency system. And it did collapse, in 1929–1931, with catastrophic effects.

Rueff then predicted in 1960–1961 that the Bretton Woods jerry-rigged dollar system, a post–World War II form of the official reserve currency system, would collapse. Rueff warned that the world would groan under the flood-weight of excess American dollars going abroad. Throughout the 1960s,
he wrote that Federal Reserve credit policy, combined with the official reserve currency status of the dollar, would cause permanent U.S. balance of payments deficits and a tendency to constant federal budget deficits. Underwritten by the “exorbitant privilege” of the world dollar standard, the twin deficits of the U.S. would be continually financed, at home and abroad, by expanding Federal Reserve and foreign central bank money and credit. In the April 1961 issue of Fortune magazine, Rueff foretold the end of gold convertibility for the dollar unless the monetary system was reformed. His prescience was confirmed when President Nixon suspended dollar convertibility to gold in August 1971.

Now, let us turn for a moment to the booms and busts that occurred after the 1971 suspension of gold convertibility. It is in this period that we can see our own future, as in a glass darkly. In 1980, at the peak of a double-digit inflation crisis, the price of gold touched $850 per ounce. Remember, the dollar had been pegged to gold at $35 as recently as 1971. Paul Volcker, chairman of the Federal Reserve, in words similar to those of present Fed chairman Ben Bernanke, declared in 1980 that the gold market had little to do with the Fed's monetary policies. But unlike his predecessors, Volcker acted. He engineered a draconian credit contraction, a 20 percent federal funds rate and 15 percent long-term U.S. Treasury bond rates, which led to more than 10 percent national unemployment in 1982.

During the entire post–World War II period, the important links between central bank policies, the rate of inflation, the variations in the money stock, and economic growth caused much debate among economists and experts. It is still generally thought by central bankers, neo-Keynesian and monetarist economists that the quantity of money in circulation, the economic growth rate, the level of employment, and a stable price level can be centrally controlled by the commissars of central bank credit policy. To the best of my knowledge, however, no one who believes this hypothesis, and as an investor has systematically acted on it, is solvent any longer.

Nevertheless, the neo-Keynesian credit theories and monetarist quantity theories of money live on at the Fed and in the academy. Still, neo-Keynesian and monetarist economists at the Federal Reserve were required long ago to accommodate to a reality in which, for example, during 1978, the quantity of money in Switzerland grew approximately 30 percent, while the price level was stable. Conversely, in the United States, the quantity of money, M-1, grew in 1979 about 5 percent while the inflation rate rose 13 percent. The empirical evidence shows that the inflation rate, the rate of economic growth, and the growth of the money stock cannot be centrally controlled by central bank manipulation of the money supply. What a central bank is not able to do, it must not try to do—or the people suffer the consequences.

So, if the problem of the postwar monetary system has been extreme booms and busts—marked by an unstable world reserve currency, inflation and deflation, mercantilism, and incipient currency wars—what is the solution? The historical and empirical data show that gold convertibility, without reserve currencies, is the least imperfect regulator of general price stability in the long run. In monetary and economic policy, there is only one laboratory for experiment, the laboratory of empirical evidence in human economic history. Perfect stability is, of course, unattainable in human affairs—except in a university classroom, but blackboards at the University of Chicago and at Cambridge University will not do. The classical gold standard was no blackboard
exercise, no mere mathematical symbol in a university monograph. The international gold standard was an elegantly designed institutional set of monetary mechanisms. Carefully orchestrated during centuries of experience, merchants and bankers of great purpose developed monetary convertibility into a supple and subtle set of integrated financial and credit institutions. Those were institutions organized to facilitate economic growth, job creation for an increasing population, a rising standard of living, and a stable long-term price level. Above all, in order to maintain a certain social stability amidst the hurly burly of free economic institutions, the gold standard insured a stable currency over the long run.

The historical evidence shows that 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 cash and securities payable in dollars as their own reserves, or even as their monetary standard itself (i.e., official reserve currencies in place of gold.) The United States has alternated between two kinds of standard money: inconvertible paper money, on the one hand, and precious metal (first silver, then gold), on the other. The dollar was an inconvertible paper money during and after the Revolutionary War (1776–1792), the War of 1812 (1812–1817), the Civil War and Reconstruction (1862–1879), and again from 1971 to the present. The dollar was effectively defined as a weight of silver (and gold) from 1792 to 1812 and 1817 to 1834, and as a weight of gold from 1834 to 1861 and 1879 to 1971. The minted gold eagle, set equal to ten dollars, was provided for in the Coinage Act of 1792. The dollar was not used by foreign monetary authorities as an official monetary reserve asset before 1913, but the dollar has been an official “reserve currency” for many countries since 1913 (along with the pound sterling). The dollar has been the primary official reserve currency for most countries since 1944.

Applying 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 the period 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 to 1914 was the most stable of all U.S. monetary regimes (as the table on page 9 shows).

Free market institutions, grounded on the gold standard, were designed to mobilize the free price mechanism in order to act as the balance wheels of rapid economic growth for an increasingly integrated world economy. International trade among different cultures, various national currencies, and competitive nations was firmly based, despite cultural and language differences, on a common monetary standard defined in law as a weight unit of gold. All countries traded according to one objective yardstick of value. Under the rules, no one would have the power arbitrarily to deprecate the thirty-six-inch yardstick to twenty-nine inches one year, nor to manipulate it to thirty-nine inches the year after. Who today can reasonably deny that the world needs a defined, objective, monetary yardstick?

To restore long-term price stability and to sustain an equitable market for growing world trade, the dollar, a monetary yardstick, must again be defined in law as a precise weight unit of gold—at a statutory convertibility rate which ensures that nominal wage rates do not fall. This stipula-
tion is necessary in order to avoid unwitting deflations like those that ensued after World War I. Indeed, nothing but gold convertibility, a true gold standard without official reserve currencies, will yield a real monetary standard for the integrated world economy of today. Such a true and proven monetary standard provides simultaneously all the necessary functions of money, both domestic and international: that is to say, a long-term store of value for saving, a stable means of exchange for trading, and a stable unit of measure for comparing all other articles of wealth in the market. Moreover, the true gold standard is a proven integrator of the modern credit and banking system.

Like every standard of measurement—the yardstick, the meter, the liter—the monetary standard must be constant in order to maintain trust and confidence in an equitable and growing economic order. Further, only a common, non-national monetary standard can rule out manipulated floating exchange rates and unconstrained central banks—themselves, the aggressive agents of predatory mercantilism. Despite all political denials, undervalued currencies and currency depreciations are today, without a doubt, designed to subsidize exports and to transfer unemployment to other nations, to beggar thy neighbor, and, by means of an undervalued currency, to gain market share in manufactured, labor-intensive, value-added, world-traded goods. If competitive depreciations and undervaluations continue, floating exchange rates combined with the United States’ twin budget and trade deficits will at regular intervals blow up the world trading system.

Table commentary from John D. Mueller, Redeeming Economics (ISI Books, 2010)
Edited and shortened by Lewis E. Lehrman from the original

<table>
<thead>
<tr>
<th>Period</th>
<th>Stability Rank</th>
<th>Long-Run Stability (Average Annual Change)</th>
<th>Short-Run Volatility (Std. Deviation of Annual Change)</th>
<th>Maximum Price Change (High vs. Low)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1800-1834</td>
<td>4</td>
<td>-1.5%</td>
<td>5.2%</td>
<td>76%</td>
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<tr>
<td>Domestic Silver</td>
<td></td>
<td>(Interpreted 1812-17 by domestic paper standard)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1834-1861</td>
<td>2</td>
<td>-0.4%</td>
<td>3.5%</td>
<td>36%</td>
</tr>
<tr>
<td>Domestic Gold</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1862-1879</td>
<td>3</td>
<td>+0.1%</td>
<td>8.8%</td>
<td>74%</td>
</tr>
<tr>
<td>Domestic Paper</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1879-1914</td>
<td>1</td>
<td>+0.2%</td>
<td>2.2%</td>
<td>20%</td>
</tr>
<tr>
<td>International</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1914-1944</td>
<td>5</td>
<td>+1.9%</td>
<td>7.2%</td>
<td>99%</td>
</tr>
<tr>
<td>International Gold-Dollar Sterling Standard</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1944-1971</td>
<td>4</td>
<td>+3.1%</td>
<td>3.1%</td>
<td>130%</td>
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<tr>
<td>Bretton Woods International Gold-Dollar Standard</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1971-2009</td>
<td>4</td>
<td>+4.5% (18.5%, 3.1%)</td>
<td>2.8% (2.7%, 1.2%)</td>
<td>432% (125%, 137%)</td>
</tr>
</tbody>
</table>

U.S. Consumer Price Index
(Long-term stability and short-term volatility, by period and monetary system: 1800-2009)
If the reestablishment of dollar convertibility to gold is to happen, the project must become a cooperative effort of the major powers. To accomplish this reform, the U.S. must lead: first, to announce 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. Second, a new Bretton Woods conference must be convened to establish mutual gold convertibility of the currencies of the major powers. Third, the curse of official reserve currencies must be ruled out, while at the same time a consolidation of official dollar reserves must be organized into long-term debt—to be funded in the way Secretary of the Treasury Alexander Hamilton funded the volatile national and state debts at the birth of the American republic.

A dollar as good as gold is the way out of the monetary maze in which we are currently lost. The American Founders agree. Article I, Section 8, of the U.S. Constitution ordained that Congress had the power “to coin money” and to define uniform weights and measures. The U.S. Constitution in Article I, Section 10, further ordained that the states should make nothing but gold and silver coin a legal tender. The constitutional American monetary standard, therefore, should be a uniform weight and measure of gold (or silver), gold having proved itself the superior monetary standard for over a century.

It is a great lesson of American history that the classical gold standard is in fact the constitutional American monetary system. With it, we can inaugurate a new industrial revolution—to rebuild America’s financial self-respect, to end inflation, and to restore American leadership in the world.