

## THE U.S. DOLLAR AND PROSPERITY: ACCIDENTS WAITING TO HAPPEN

*Reuven Brenner*

Development in the rest of the world depends on the United States because America continues to be the engine of the world economy and the U.S. dollar is the main reserve currency. In this article, I examine the prospects of America remaining an economic superpower and the dollar maintaining its status as a reserve currency. I also show that unless the United States succeeds financial markets and development around the world will suffer.

During the last decade, the U.S. dollar has experienced wide fluctuations. The dollar's real effective exchange rate relative to the seven major currencies varied from about 80 in 1995 to 120 in 2001, and back to 90 in 2005 (BIS 2005: 91). The dollar was up roughly 30 percent relative to commodity prices between 1997 and 2001. Then, between 2002 and the end of 2004, the dollar fell by about 30 percent relative to gold and commodities. During the first 10 months of 2005, all hard currencies (except the Canadian and Australian dollar) were down by another 15 percent relative to gold.

Nevertheless, the bond market still expects a stable dollar over the long haul, as reflected in long-term interest rates. The relative stability of the long-term interest rates offers comfort because the world depends on a predictable value of the dollar. The havoc its demise as reserve currency would provoke is hardly imaginable.

The significant upward movement in the U.S. dollar during the late 1990s brought financial, political, and social havoc in countries that either pegged their currencies to the dollar or had currency boards, Argentina's case being the most prominent. Later, the decline in the

---

*Cato Journal*, Vol. 26, No. 2 (Spring/Summer 2006). Copyright © Cato Institute. All rights reserved.

Reuven Brenner holds the REPAP Chair in Economics at McGill University's Desautels School of Management, is an Adjunct Scholar at the Cato Institute, and a partner at March Strategic Partners. He thanks Stephen Shipman for helpful comments on an earlier version of this article.

dollar between 2002 and 2004 has brought about much antagonism in trade relations around the world and cries for protectionism.

Even with the dollar's volatility around a downward trend since 2002, the euro did not displace the U.S. dollar as the world's main reserve currency—and will not do so unless drastic events happen, which I do not foresee.<sup>1</sup> One such drastic event would be an utter mismanagement of the U.S. dollar. Another would be the European Central Bank (ECB) announcing that it was moving toward targeting the price of gold to manage the euro. The ECB would then become a supranational monetary institution independent of all political pressures. Anchoring the euro to the price of gold would reflect changes in global demands for euro liquidity, functioning as a reserve currency.

The reason I do not expect the euro to replace the U.S. dollar as the main reserve currency, unless either of these two events happens, is that the euro is the very first paper currency not backed either by a strong government or by gold. It is a unique experiment. For the euro to become a reserve currency, the eurozone would have to run persistent trade deficits, allowing surplus countries to build up their euro reserves. To achieve that outcome, however, the eurozone countries would have to radically reform their fiscal and regulatory policies, to encourage far more domestic entrepreneurship and consumption than they presently do. This scenario does not seem to be in the cards. Indeed, as Europe's population gets older, meaningful reform becomes less likely, and I do not see any chance for a strong European government to emerge and tackle the situation. Aging baby boomers, who dominate Europe's voters, prefer the status quo.

In sum, the chances of the euro becoming a serious alternative to the U.S. dollar as a reserve currency are slim, or nonexistent. The Federal Reserve would have to seriously mishandle monetary affairs for this to happen.

## Separating Money from Domestic Politics

Besides anchoring monetary policy to the price of gold, there are other ways to make central banks credible, by separating monetary policy from domestic politics. At first sight it would appear that monetary rules such as a quantity rule or inflation targeting could achieve that objective—but monetary rules cannot guide a reserve currency (see Brenner 1994, 2002).

<sup>1</sup>Chinn and Frankel (2005) argue that the euro may surpass the dollar as the leading international reserve currency by 2022.

Obviously quantity rules are better than unrestrained printing. But as Milton Friedman himself admitted in an interview with the *Financial Times* (June 6, 2003), he was wrong in pushing the quantity theory “too much,” conceding that the use of the quantity of money as a target has not been successful. Already in 1997, discussing Japan’s revival in the *Wall Street Journal* (December 17), he wrote: “The surest road to a healthy economic recovery is to increase the rate of monetary growth, to shift from tight money to easier money—to a rate of monetary growth closer to that which prevailed in the golden ’80s, but without again overdoing it.” But the broad money supply (M2 + CDs) was growing at 8.2 percent during those golden 1980s. What is then the criterion for not “overdoing it”? Is 8.2 percent monetary growth a universally applicable golden rule?

Limiting the increase in the quantity of money prevents runaway inflation, and preventing the supply of money from diminishing drastically prevents serious deflation. But those policies do not offer anchors when one has “middle of the range” variations in the *global* demand for liquidity (recall that Friedman’s policy implication was based on the view that velocity is rather stable). Friedman’s quantity rule was the proper one for the time when irresponsible or incompetent central bankers either printed money with abandon or failed to grasp the implications of restoring their currencies to the gold standard at the wrong level. However, today a market-priced based anchor is a better alternative to achieve monetary stability.

Likewise, inflation targeting, although better than no constraint on central bank behavior, has its shortcomings. In particular, as Alan Greenspan (1997–2005) often testified (see, for example, his November 7, 1997, testimony), in the short and medium run, the link between money and prices is unclear, which means that inflation targeting cannot have the desired effects. Price indexes are also not reliable guides because they are backward-looking rather than forward-looking and subject to severe measurement problems.<sup>2</sup>

A third way to separate money from national politics—currency boards—is not subject to either of the problems that targeting monetary aggregates or price levels are subject to. Currency boards may be the proper institution for developing countries, but only if the currency to which they are linked is managed properly. Alternatively, such countries could fix their currencies to another credible one, once they brought their domestic inflation down. However, these countries

<sup>2</sup>Greenspan (1997–2005) often testified along the lines that price indexes are unreliable, and that is one reason he did not adopt inflation targeting (see Brenner 2003).

can go through much turbulence if capital markets do not trust their governments and central banks.

Lacking credibility, the central banks cannot announce that they suspend the board or delink their currencies because the reserve currency is being mismanaged. Argentina and Asian countries are a case in point, when the U.S. dollar suddenly appreciated by 30 percent relative to most currencies in the late 1990s (Brenner 1998b). Argentina's long history of high inflation prevented its central bank from standing up and saying that this time abolishing its currency board is a response to the U.S. dollar having gone up by 30 percent relative to most currencies and commodities and would not signal future monetary mischief in Argentina.

In spite of the focus on U.S. trade and government deficits, bond markets do not expect the dollar to be mismanaged in the long run, since long-term interest rates are staying low. This does not mean, however, that the United States and the global economy may not face severe upheavals in the near future.

Although the lack of a firm monetary anchor is the source of many of the exchange and international trade-related problems the world faces today, the symptoms—"trade deficits" and "trade imbalances"—can continue to be managed for quite a while. True, such management, focusing on attempts to separate solving the "trade deficit" and "twin deficit" problem from long-range reform of the international monetary system, will bring with it much continued exchange rate volatility. However, they will be "managed"—as they have been managed during most of the 20th—bringing about serious political upheavals around the world.

The main problem of monetary policy, whether that facing a central bank managing a reserve currency or one managing a national one, is that of maintaining the supply of liquidity at the level matching the demand for it. What is missing today are both agreements on an indicator that would be the best approximation to offer such a signal for the reserve currency, and institutions to enforce the discipline to adhere to it. For non-reserve currencies, the solution is for the central bank first to eliminate inflation and then lock in the exchange rate to that of the trusted reserve currency. By so doing the country has a "fixed exchange rate" and a precise monetary policy based on the reserve currency country.

A lasting solution would be to recognize explicitly that market prices, reflected in the yield curve and gold price have been the most reliable signals of the global demand for dollar liquidity. The daily correlation between gold and the dollar has been in the  $-0.9$  range over extended periods, whereas the correlation coefficient for the

euro and gold over the last year has been in the +0.7 range. The negative correlation does not suggest that increases in gold prices signal U.S. inflationary upticks. Rather, it signals decreased global demand for dollar liquidity. The Fed can react to this signal and take a counteractive measure absorbing the unwanted liquidity. Thus, finding no correlation between changes in gold prices and changes in U.S. inflation should not be surprising.

Gold's role in a monetary system has never been mere convertibility. Instead, it has been to signal both control and alarm—it's a "put" on the dollar and other paper currencies. The rest of this article is less about making forecasts and more about shedding light on what happens when monetary anchors either are being abandoned or there is no firm monetary anchor, which is presently the case.

## Monetary Mismanagement, Financial Markets, and Development

Robert Mundell's main point in his Nobel Memorial lecture was "to bring out the role of the monetary factor as a determinant of political events" (Mundell 1999).

He argued that "many of the political changes in the century have been caused by little understood perturbations in the international monetary system, while these in turn have been a consequence of the rise of the United States and mistakes of its financial arm, the Federal Reserve." He first explains how central banks mismanaged the gold standard, bringing about a fluctuating gold price. He then reaches the conclusion that "had the major central banks pursued policies of price stability instead of adhering to the gold standard, there would have been no Great Depression, no Nazi revolution, and no World War II." This sentence is somewhat misleading since Mundell makes it immediately clear in his speech that the mistake was not the principle of using gold as an anchor in the international monetary system, but something else. After World War I, during which price levels rose, Mundell explains, "a return to the gold standard is only consistent with price stability if the price of gold is increased." However, most central bankers at the time did not do that, and brought about the disastrous political upheavals, with whose consequences we still live today. An exception was France.

When Raymond Poincaré became French premier in 1926, he commissioned Jacques Rueff to determine the level at which the French franc should be stabilized. Though Poincaré thought initially to return to the prewar gold parity of the currency, as Britain had done, Charles Rist and Pierre Quesnay, the deputy governors of the

Bank of France persuaded him not to do that. France reentered the gold anchor fixing the franc at only one-fifth the pre-World War I parity. Rueff chose this level so as to prevent deflation and unemployment, and Emile Moreau, the governor of the Bank, approved. The currency was stabilized and the economy boomed, without inflation or unemployment, as capital flowed back to France (see Mueller 2000).

The effects of monetary disturbances on price levels, trade, government deficits, and unemployment receive most of the attention in the economics literature relative to the political upheavals that Mundell associates with monetary mismanagement.<sup>3</sup> In the next section, which draws on Brenner (2002, 2004), I briefly summarize my views regarding the link between monetary mismanagement, financial markets, sociopolitical order, and prosperity. After the brief summary, I return to present-day monetary issues and the role of the dollar as a reserve currency. The arguments for urgency in dealing with the dollar are then better understood.

## Five Sources of Capital

Prosperity is the result of matching people with capital, holding both sides accountable. This is easy to say, but hard to realize. In every society there are five sources of capital: (1) inheritance/nature, (2) savings, (3) access to financial markets, (4) government, and (5) crime. If access to the first three sources of capital is hindered, there are only two others left: government and crime. Often, the distinction between these two is not sharp, as we see daily in the rampant corruption characterizing many countries around the world, including some in the West.

What happens when societies either do not have or, inadvertently, destroy their financial markets? The facts are that even today very few societies have developed the institutions that could enable the development of deep financial markets—in particular, a solid legal infrastructure and a free press. When this is the case, most people wanting access to capital have no other option but to turn to government to raise the money, whether through taxes or borrowing.

During the 1920s and 1930s, a series of monetary blunders—such as England returning to the gold standard at the wrong price (thus bringing about deflation) and Germany, Austria, Hungary, Poland, and Russia printing money with abandon (thus bringing about hyperinflation)—weakened or destroyed these countries' capital markets.

<sup>3</sup>Economists such as von Mises (1944) and Canetti (1978) have discussed the broad impacts of monetary disturbances on economic, social, and political life.

Banks failed, markets crashed, unemployment rose, and the middle classes lost their lifetime savings. The first three sources of capital evaporated. What could be done?

People live first, and philosophize later. With their savings gone, they turned to the two other ways of accessing capital: government and crime. But people also need comforting rationalizations for their actions, and intellectuals offered them. Words are cheap, and are produced promptly, rehashing ideas sitting on shelves. Predictably, following the monetary mismanagement and destruction of capital markets during the 1920s and 1930s, socialism rationalized governments' increased roles in some countries. In other countries, theories about public works and, eventually, the Keynesian jargon of manipulating aggregate demands offered a "scientific" approach for increasing the scope of government in raising and allocating capital. These ideas sowed confusion and have ever since slowed down development around the world.<sup>4</sup>

During the same time, "crime" took ominous "national and racist" meanings in some countries—Germany being the most prominent—to "justify" access to capital, be it from "foreigners," or groups made "foreigners" by other types of novel theorizing. Throughout history intellectuals have been very good at turning real issues into so-called moral ones with religious, racist, and nationalist undertones, rationalizing immediate access to capital and confiscating it.

People's betting on such new ideologies did not happen randomly. The reactions were often the consequence of monetary mismanagement that destroyed the countries' capital markets and people's savings, destabilizing the middle classes (e.g., see von Mises 1944 and Canetti 1978, who link Nazism and the Holocaust to Germany's hyperinflation in the 1920s). When severe monetary mismanagement makes people desperate and hopeless, they bet on absurd ideas (Brenner 1983, 1985). Such ideas have long lives. We still live today with the consequences of the 1920s and 1930s, not only in the realm of laws and regulations, but, more fundamentally perhaps, in the way in which people relying on "accepted wisdom" look at monetary issues, capital markets, and development.

With governments getting into the void to access capital, the accepted wisdom is still that governments must be a major source of capital (raising money through taxes, borrowing, or nationalization of natural resources, then spending), and that together with central

<sup>4</sup>The persistence of the Keynesian view should not be surprising; it promised prosperity, with no regard to custom, tradition, and political institutions. The trivial algebra of the Keynesian model promised to work under any political system.



banks, they are a stabilizing force. According to this view, unstable capital markets are the problem, be it due to sudden bursts of pessimism, the famous “animal spirits” in Keynes’s view, or due to the equally famous “irrational exuberance” in Greenspan’s view.

These two terms have one thing in common: They convey the message that capital markets are excessively volatile unless clever bureaucrats and smart central bankers mitigate them. They also convey the message that the increased volatility is random and unpredictable, rather than due to the policy errors of governments and central banks. I am not saying that crowds are always wise, and that there is no occasional disastrous herd behavior. One can just consider how Keynesians dominated both the academic and the policy landscapes for decades, never mind lesser-known academic fads. But the facts are that such “herd” behavior is more often than not brought about by mistakes made by governments and central banks.

Many use the famous Amsterdam-driven tulip folly of the 17th century to suggest random herd folly. What few discuss, however, is that the folly disappeared quickly, and there were no significant consequences for the new Dutch Republic at the time. The reason for the folly was that the suddenly emerging Dutch middle class wanted to display their new status somehow. They needed a symbol, which had to be scarce—like a Picasso or Matisse today. But the middle classes turned out to be wrong, since tulips turned out not to be scarce after all. The mistake was quickly corrected as soon as the ships bringing the tulips from Turkey found ways to prevent the rats from eating most of the bulbs during the voyage.

In sum, monetary mismanagement can destroy capital markets and bring about a chain of reactions that have disastrous effects. These effects are long lasting because of the ideologies people bet on during upheavals and the institutions that come into existence, which sustain false ideas, including what type of monetary policy to pursue. As a result, in most countries around the world capital markets are still closed, and these countries lack the institutions necessary to induce that long-term trust without which deep capital markets cannot develop. And without such markets, prosperity is fleeting. Governments remain the main source of capital and individual freedom suffers.

## International Monetary Problems and the Balance of Payments

The preceding analysis helps explain why the world’s steady road to development depends on the relative stability of the dollar, which, in



turn, is necessary for deepening and democratizing capital markets around the world. The potential for a sequence of crises that the demise of the U.S. dollar as a reserve currency might unleash in many countries may be as great, if not greater now than in the past. This is so because not only China but many other countries too, with trade much expanded, link their currencies to the dollar, and a large fraction of contracts in the world—debt in particular—are made in terms of dollars. Many of these countries are at a fragile point in the development of their financial markets.

It is true that today's trillion dollar per year market in currency and interest rate derivatives helps spread currency risks. But a large part of this market itself exists only because of monetary mismanagement, the cost of which shows up in both direct and indirect ways (never mind how aggregates mismeasure these costs). The cost of capital is increased relative to a situation where international monetary policy would have been more stable, and, indirectly, talent is reallocated (in particular, within the United States) to the banking, hedging, and derivative sector. Companies in this business do not favor stable currencies.

The instability in international monetary affairs—with the dollar as its floating core—imposes large costs and brings about dangers and uncertainties that, as shown earlier, one cannot always capture with numbers. Let us then consider more closely what is happening today, and why formally guiding U.S. monetary policy by relying on gold prices and the yield curve (combined with institutional changes that I shall not get into in this article) would offer a return to a more stable solution. The signal that has been emanating from gold prices provides information on the state of global liquidity for the reserve currency at any moment of time. The alternatives to this signal are second bests. Some argue that linking the dollar to gold may diminish the power of U.S. seignorage (the profit from printing a fiat money). But, by taking into account the aforementioned serious upheavals, a well-managed reserve currency would generate benefits that far exceed the forgone opportunity of petty—though measurable—seignorage.

## The Twin Deficits and the Dollar as a Reserve Currency

The consequences of relying on a reserve currency that does not have a built-in control or alarm signal are well known. Unless one looks at gold and commodity prices, financing a reserve currency

country's deficits by other countries' central banks would suggest that domestic purchasing power is unaffected. Money leaves the reserve currency country, and comes back promptly—regardless of the level of U.S. interest rates.

A long-lasting deficit can develop in the U.S. balance of payments because foreign settlements no longer automatically reduce the amount of credit available at home. It is true that the central bank could itself restrain money and credit, but experience suggests that politics can often prevent such discipline. Greenspan did carry out such policy, though in spurts and stops, bringing about exchange rate volatility.

The United States has thus been in the privileged position of being able to buy foreign goods, invest and lend abroad, or provide foreign aid without its money markets feeling any effects for a while. It is easy to get accustomed to having a “deficit without tears” in the U.S. balance of payments, and it will require much commitment and credibility to reverse this custom.

At present the Federal Reserve has no obligation to look at price signals emanating from gold and commodity prices. Such neglect can lead to illusions that the twin deficits can continue without paying a price for them. Inflation in the United States seems contained (though I have serious doubts about the reliability of price indexes). Inflation did not develop in the surplus countries either, in spite of the substantial increase of dollar reserves held by their central banks. True, such inflation can be—and was—offset by sterilization in the creditor countries, restricting domestic credit. But at least in China, which has been accumulating dollar reserves rapidly, one cannot infer from official statistics what the inflation is. China is still pretty much a communist country as far as the allocation of capital is concerned, and the government still practices price control. What type of markets would China have, and what would be either the domestic or global “market prices” if private financial markets in China allocated capital rather than the central government—I do not know.

Some experts suggest that the solution to the twin deficits problem is higher growth rates in Europe, Japan, and the United States—thereby absorbing the dollar liquidity. Others suggest that liberalization in China and revaluation of its currency would help. Based on the analyses I offered here, these remedies are at best partial, at worse wrongheaded. They do not consider the status of the dollar as a reserve currency; and they do not answer the question of when the twin deficits will bring about severe monetary mismanagement. It would be much better if the United States decided the future role of

the dollar as a reserve currency, rather than wait for drastic policy changes in other countries.

European, Japanese, and Chinese domestic policies are not under U.S. control, and we do not know at what speed they would change. To expect that the demand for dollar liquidity can be absorbed quickly by a more entrepreneurial Western Europe or Japan does not seem to be in the cards. Expecting revolutionary fiscal changes from aging voters in Europe and Japan is wishful thinking. Neither do I expect the Chinese Communist Party to give up power and offer greater freedoms—increasing, perhaps, Chinese citizens' demand for the U.S. dollar. Asking China to revalue its currency is far more than a simple monetary matter. It is about allowing domestic decentralization and liberalizing its financial markets, which implies dispersion of power. At present these changes are not in the cards.

In sum, the increase in the U.S. twin deficits is a symptom of a “floating reserve currency.” One can manage the symptoms, but such management should not be confused with a lasting cure of the disease. Meanwhile, the accumulation of dollar reserves has the effect of greatly increasing the leverage of the world financial system.

It is not the first time that such a “dollar glut” has occurred. At the end of the 1950s the reserve-currency problem became urgent, only then the “glut” resulted in draining U.S. gold reserves. Many economists viewed the Bretton Woods system as the cause of creeping international inflation and accurately predicted its breakdown. They disagreed about the solution. Some, like Jacques Rueff, sought a return to an international gold standard and advocated doubling the price of gold. Such a reform would have probably prevented the worldwide inflation of the 1970s and 1980s, and set the United States and the world on far more sounder footing. In the end, the United States chose floating exchange rates and inflation followed, as Mundell and others had predicted.

By the end of the 20th century, all major industrial countries and most emerging ones had rejected the Keynesian approach of inflationary finance of budget deficits, and Europe adopted a single currency. But the problems caused by a floating reserve currency, disciplined mainly by central banks' soft commitments and inappropriate statutes (such as confusions arising from the 1978 Humphrey-Hawkins Act) are still with us.

The fluctuations in exchange rates and gold prices in 2005 suggest that investors expect that the inflationary risks that Greenspan alluded to in his departing speech at the symposium sponsored by the Federal Reserve Bank of Kansas City at Jackson Hole, August 27, 2005, are not sufficiently contained at present. In his closing remarks he said,

Monetary policy . . . cannot ignore the potential inflationary pressures inherent in our current fiscal outlook, especially those that could arise in meeting commitments to future retirees. However, I assume that these imbalances will be resolved before stark choices again confront us and that, if they are not, the Fed would resist any temptation to monetize future fiscal deficits. We had too much experience with the dangers of inflation in the 1970s to tolerate going through another bout of dispiriting stagflation. The consequences for both future workers and retirees could be daunting [Greenspan 2005].

But Greenspan far underestimates the dangers. The consequences would be far more broadly spread than just to these two groups, and far more dangerous.

## What Now?

Since I am not an “alarmist” by nature, but rather looking for solutions, let me clarify why only when one puts the monetary part of the equation in order, can one properly evaluate the twin deficit issue.

Once the monetary issue is solved, maintaining the dollar as a firmly anchored reserve currency, it is not obvious how much of the U.S. external deficit the world would absorb. Young, entrepreneurial people from around the world are still lining up to get into the United States, because it has a high degree of personal and economic freedom. There are no such line-ups for most other countries. Capital follows—or anticipates—places where critical masses of talent move and where they are expected to leverage their skills. The value of such migration of talent is not captured in official statistics, and one cannot say just how much capital should flow to the United States to finance either domestic or international entrepreneurship and innovations there.

The United States has plenty of internal slack that, if remedied, would make a significant step toward solving the government deficit problem (and contribute to the solution of the trade deficit as well). I am not talking about the usual policies that have been put forward (e.g., staying longer in the labor force and tax simplification), but something else. My proposal is to have youngsters graduate one year earlier from college, say in three years rather than four (Brenner 2005). Consider a “Fermi” calculation about the consequences of this change and combine it with the effect of facilitating the migration of talented people to the United States (see Brenner 1998a, 2002: chap. 3). There are about 16 million youngsters enrolled in post-secondary education in the United States, say 4 million for every year. Assume

that from now on 4 million join the labor force a year earlier. Each subsequent generation could then stay one year longer in the labor force. How much annual income would this generate? Assume that after graduation the average salary would be \$20,000 and stay there. This adds \$80 billion to the national income. At an average income of \$40,000, it would be \$160 billion. At a discount rate of 8 percent, and a worst-case scenario of average salary never going up, this three-year option alone represents one to two trillion dollars of added wealth per cohort. With each future generation studying more intensely, and finishing their studies a year earlier, such benefits would accrue for years. Thus, although large unfunded liabilities in Social Security and other entitlement programs loom on the horizon, they can be resolved.

The major immediate issue is the currency problem, and it too can be resolved. The source of the problem is not trade imbalances. Rather, it is the Federal Reserve's freedom to make erratic changes in the supply of the reserve currency with no immediate alarm system. Gold has only one monetary function: it acts as such an alarm, disciplining the monetary authorities and reigning in excess liquidity. Greenspan leaves a legacy tending toward a weaker dollar, which does not bode well either for continued global prosperity or for deepening global financial markets.<sup>5</sup>

## Back to Fundamentals

Changes in relative prices signal consumers, producers, and investors on how to reallocate resources. But what are these changes relative to? Say there are 1,000 goods and services to be delivered now and in the future. In the absence of choosing one yardstick, there would be 499,500 possible relative prices, as each commodity and service would be priced in relation to every other one. With one common yardstick, there would be 999 prices and that's it. Similar calculations hold true for exchange rates. The fact that we live today in a world without a solid yardstick explains the vast derivative business, most of these derivatives representing trading for price ranges.

This reasoning also shows that debates about the domestic purchasing power and the foreign exchange value of a reserve currency become redundant once the central bank chooses gold and market prices as anchors. Then, all prices, domestic and foreign, would be priced relative to the reserve currency, and relative to the market-based

<sup>5</sup>Before he became chairman of the Federal Reserve, Greenspan (1967) was an ardent advocate of returning to the gold standard.

price anchor. Although the various backward-looking statistical artifacts called “price indexes” would still measure variations in price levels, those variations would be due to mismeasurement, which can be serious (see Brenner 1994: chap. 5).<sup>6</sup> The foreign exchange value of the reserve currency would still fluctuate if other countries do not pursue monetary discipline. A central bank that anchored its policy in gold and the yield curve would not pay attention to these fluctuations.

The above calculation also explains why since time immemorial, societies have agreed on a monetary yardstick. In ancient Rome it was salt, which is where the word “salary” comes from. Others have used pepper, rocks, and, in prisons and communist countries (which were large prisons), cigarettes. Even relatively large fluctuations in their value did not lead immediately to their substitution, which shows just how important such relatively stable yardsticks are. Eventually people settled on gold and silver.

In his book *Money Mischief*, Milton Friedman (1992) reports the well-known story of the monetary system of a small island in Micronesia. At the end of the 19th century, the inhabitants used stone wheels as a medium of exchange and as a store of wealth. The colonial government imposed “fees” on disobedient district chiefs by painting black crosses on these stone wheels thus “confiscating” them. This induced the locals to change their ways and work harder in order to have these marks erased. Friedman concludes that this example illustrates how important appearance, belief, or myth become in monetary matters.

My interpretation is different. What this story shows is just how important it is to sustain a monetary standard to price goods and services—even in a relatively “primitive economy.” People are willing to incur costs to sustain the standard, just as they do today when inflation and devaluation do not immediately lead people to abandon fiat money (though hyperinflation had that effect). But the fact that people do not entirely abandon a currency that is being debased does not imply that the instability is without consequences. Signals emanating from gold prices and yield curves offer information about the pending dangers and, if properly taken into account by the Federal Reserve, could set the dollar on far more solid ground than it is today.

<sup>6</sup>The last few years illustrate why the consumer price index is not a good measure of price stability. Energy prices are taken out, assuming that they are cyclical. But what if those prices vary around an upward trend? What if the cycle lasts longer than in the past? Innovations in technology and politics (the fall of communism) kept price indexes relatively low. But have there been adjustments for the documented deterioration in the quality of schools, highways, and the infrastructure?

There is far more at stake by weakening a currency, a reserve currency in particular, than a change of a few percentage points in measured inflation. Jacques Rueff (1967: 79–80) did not exaggerate when he wrote,

Depending whether or not you move toward convertibility, you will or will not tend to restore what we used to call “civilization.” Ethics, the binding nature of commitments entered into, justice, individual responsibility—all these are notions that have no meaning in a system which, by denying you the necessary foreign exchange, makes it impossible for you to settle your debts. Under foreign exchange controls, there can be no such thing as individual responsibility. There can be no individual responsibility for an industrialist whose fate depends on the coal quota allocated to him. The entire future of our civilization depends on what decisions we shall take in the field of monetary policy. The situation is serious because the evil is deep-rooted.

## Conclusion

Stable money is a necessary condition for developing capital markets. Unless countries open and democratize their capital markets, one cannot talk about either prosperity or freedom. Freedom means having options, having alternatives. But alternatives come only from having access to capital, from being able to borrow against various imagined futures. If government is the sole source of capital, there is only one official future.

Pursuing prosperity requires that people abandon old ways of doing things, old industries, and sometimes one’s country. To make the transition, the move must be financed: money and people must move from yesterday’s industries to those of the future, whether in the same country, or across borders. Someone must decide how much money to bet, on whom, on what ideas, and where. When capital markets are open, venture capital firms, commercial and investment banks, leveraged-buyout firms, and asset management firms price the risk and bet on entrepreneurs and managers, holding them accountable. When capital markets are closed, governments, families, and criminals make the key decisions about the allocation of capital. Countries with closed capital markets will fall behind as investors and talented people move to countries with more open capital markets.

Monetary mismanagement—weakening the U.S. dollar and delaying finding a stable solution for managing it as a reserve currency—can cause unemployment and inflation, or far worse symptoms of instability, both in the United States and abroad. Moreover, monetary instability hinders the development of global capital markets. It is



time to move toward a stable anchor for the dollar by reforming the international monetary system using the gold price and other forward-looking market prices. The benefits would be significant, increasing both prosperity and freedom around the globe.

## References

- BIS (2005) Bank for International Settlements, *75th Annual Report*. Geneva, Switzerland: BIS ([www.bis.org/publ/index.htm](http://www.bis.org/publ/index.htm)).
- Brenner, R. (1983) *History: The Human Gamble*. Chicago: University of Chicago Press.
- \_\_\_\_\_ (1985) *Betting on Ideas: Wars, Invention, Inflation*. Chicago: University of Chicago Press.
- \_\_\_\_\_ (1994) *Labyrinths of Prosperity*. Ann Arbor: University of Michigan Press.
- \_\_\_\_\_ (1998a) "The Causes of Economic Growth." *Cato Policy Report* 20 (3): 1, 12–14.
- \_\_\_\_\_ (1998b) "The Asian Currency Crisis." *Jobs and Capital* 7 (2): 1–9.
- \_\_\_\_\_ (2002) *Force of Finance*. New York: Thomson/Texere.
- \_\_\_\_\_ (2003) "Fed's Greenspan Hints at Return to Gold Standard?" *Financial Post* (21 January).
- \_\_\_\_\_ (2005) "Unsettling Civilizations." *Asia Times* (23 June).
- Canetti, E. (1978) *Crowds and Power*. New York: Seabury.
- Chinn, M., and Frankel, J. (2005) "Will the Euro Eventually Surpass the Dollar as the Leading International Reserve Currency?" Paper presented at the NBER conference on "G7 Current Account Imbalances: Sustainability and Adjustment," June 1–2.
- Friedman, M. (1992) *Money Mischief: Episodes in Monetary History*. New York: Harcourt.
- \_\_\_\_\_ (1997) "Rx for Japan: Back to the Future." *Wall Street Journal* (17 December).
- Greenspan, A. (1967) "Gold and Economic Freedom." In A. Rand et al., *Capitalism: The Unknown Ideal*. New York: Signet. ([www.usagold.com/gildedopinion/Greenspan.html](http://www.usagold.com/gildedopinion/Greenspan.html)).
- \_\_\_\_\_ (1997–2005) "The Greenspan-Paul Congressional Exchanges, 1997–2005." In Hearings before the U.S. House of Representatives' Committee on Financial Services during the Questions and Answers sessions ([www.usagold.com/gildedopinion/greenspan-gold.html](http://www.usagold.com/gildedopinion/greenspan-gold.html)).
- \_\_\_\_\_ (2005) Speech at Symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, August 27 ([www.federalreserve.gov/Boarddocs/Speeches/2005/20050826/default.htm](http://www.federalreserve.gov/Boarddocs/Speeches/2005/20050826/default.htm)).
- Mises, L. von (1944) *Omnipotent Government: The Rise of the Total State and Total War*. New Haven: Yale University Press.
- Mueller, J. D. (2000) "Jacques Rueff: Political Economist of the 21st Century?" Ethics and Public Policy Center, *The LBMC Report* (January).
- Mundell, R. (1999) "A Reconsideration of the Twentieth Century." *Nobel Prize Lecture*, December 8 (<http://nobelprize.org/economics/laureates/1999/mundell-lecture.html>).
- Rueff, J. (1967) *Balance of Payments*. New York: Macmillan.