The United States Deserves a Monetary Standard

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November 12, 2000

The United States is almost alone among industrial countries in having no monetary standard. It has, that is, no institutionalized guarantee or even explicit objective concerning the purchasing power of its money. Between 1971 and 1990, this was true of most industrial countries but since then almost all others have adopted monetary policy regimes that provide some guide to the future development of the purchasing power of their monies, i.e., some objectives regarding future inflation rates. The eleven countries of Euroland, including all the large economies of Western Europe except the United Kingdom, have a monetary standard as a consequence of the statutes governing the European Central Bank, while the U.K., Canada, Australia, New Zealand, Sweden, and several other nations have standards as specified by their adoption of inflation targeting regimes.[1] By contrast, the commitment of the Federal Reserve to price stability is determined primarily by the attitudes and beliefs of the members of the Federal Open Market Committee—especially those of the Chairman of the Federal Reserve's Board of Governors.

Of course, the performance of Chairman Greenspan and the FOMC over the past decade and a half has been excellent and so has the macroeconomic performance of the

[1] Many smaller countries have standards—though often unreliable—via fixed exchange rates. The important case of Japan will be discussed below.

U.S. economy. But there are no institutional constraints or guidelines in place that are designed to keep the United States from returning to the damaging and unpopular practices of the late 1970s and early 1980s, when inflation and its consequent economic distortions led to very poor macroeconomic performance. It is entirely possible that some future Chairman could have a very different attitude toward the importance of avoiding inflation. Thus it would be desirable to have institutionalized guidelines, which could be easily provided by the modification of a few sentences in the Federal Reserve Act.

Throughout history prior to 1971, monetary standards were provided in almost all civilized nations by adherence to a commodity money arrangement such as the gold standard or some other metallic standard. It was recognized that these arrangements might be abandoned in wartime, but it was generally presumed that any such abandonment would be only temporary; that the normal course of affairs involved a metallic standard. Thus the value of a country's paper currency would be determined by the value, relative to goods in general, of the standard metal. If the latter were gold, its characteristics provided a de facto guarantee that there would be no prolonged periods of large and continuing decreases (or increases) in the purchasing power of money. The monetary standard of the United States, for example, was initiated by the Coinage Act of 1792, which provided operational content to the portions of the Constitution that concerned monetary affairs.[2]

Under such arrangements, central banks did not have the responsibility of determining how the purchasing power of money would evolve over time. They were required to manage their affairs subject to the constraints of the metallic standard in

[2] The Coinage Act of 1792 provided that coins would be denominated in dollars, with a dollar equal to 371.25 grains of silver or 24.75 grains of gold. Thus the first U.S. monetary standard was bimetallic.

force, and the latter determined (for better or worse) how inflation and the price level evolved. It is interesting to note that from 1792 until 1971 the average inflation rate in the United States was only 0.7 percent per year. Let us compare that with recent conditions. Over the past year, we have been having a CPI inflation rate of about 3.5 percent. To some, that may not seem like much, but the effects of non-zero inflation cumulate geometrically over time. If the rate had been just 3.5 percent per year on average between 1792 and 1971, instead of 0.7 percent, the price level in 1971 would have been 136 times as high as it actually was![3]

The situation changed drastically in 1971, when the United States unilaterally—though partly in response to uncooperative attitudes of other nations—abrogated its duty under the Bretton Woods system of maintaining the dollar price of gold at $35 per ounce. This part of the Bretton Woods system was designed to keep the entire world on a modified gold standard, since the other member nations kept their exchange rates to the dollar fixed unless there were "fundamental" imbalances. But then, after August 1971, without a fixed price of gold in terms of dollars, the international system had no monetary standard. For any nation with a floating exchange rate, the evolution of the price level would henceforth depend primarily on how rapidly or slowly its central bank created paper money (in relation to the growth of real national income). For a nation with a fixed exchange rate, this evolution would depend on the rate of money creation in the nation or nations to which its currency was fixed. [4]

[3] The numbers are as follows. First, $1.035^{179} = 472.4$. But actually the U.S. price level in 1971 was about 3.47 times as high as in 1792. Then $472.4/3.47 = 136$. Also, $3.47^{1/179} = 1.0070$.

[4] While the gold standard prevented major, sustained inflations or deflations, it did not prevent severe year-to-year fluctuations. I do not mean to suggest that the gold standard would be desirable today.

Since this was the first time in history that central banks—there were none prior to 1668—had the responsibility of providing monetary standards, it is not too surprising that they did not perform well at first. The 1970s and early 1980s resulted in an experience that Allan Meltzer and John Taylor refer to as "The Great Inflation." But central bankers came to realize that (i) it had become their job to provide a monetary standard, (ii) that inflation was costly and unpopular with most citizens, and (iii) that continuing inflation brought no benefits whatsoever in terms of enhanced output or employment. So central banks welcomed developments, sometimes begun by other governmental bodies, to give them explicit targets or target bands for inflation. These provided monetary standards; if a central bank has as its primary monetary responsibility the task of keeping inflation close to (say) two percent per year, then this requirement constitutes a monetary standard. It provides the nation's citizens and businesses a framework within which to plan and make contracts.

The closest thing now existing to an explicit statement of monetary policy objectives for the Federal Reserve was entered into the Federal Reserve Act by "The Federal Reserve Reform Act of 1977," Title II of P.L. 95-188, which was modified by the Humphrey-Hawkins Act of 1978. The relevant portion now states that the Fed should conduct monetary policy "… so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." One trouble with this statement is its ambiguity. Although it is true that from a long run perspective there is no conflict between stable prices and optimal employment, it is also true that at each point of time the Fed could probably increase employment by providing more monetary stimulus—and the more such stimulus the larger the long run effect on the price level. So

inclusion of the word "maximum," and failure to be specific about whether the employment objective pertains to long-run average conditions or to current conditions, together render the statement unsatisfactory. Furthermore, no concrete meaning is given to the terms "price stability" and "moderate interest rates." Actually, keeping inflation low would tend on average to produce low, not moderate, interest rates.

The European Central Bank and most of the inflation targeting countries have explicit numerical objectives for inflation (as defined by some specified index) and these are given primacy over employment and/or output objectives. The reason is not that monetary policy has no effect on employment—and certainly not that employment is unimportant—but because it has no long-run effect on employment and does have approximately one-for-one long-run effects on inflation. These long run effects are well understood and reliable, whereas monetary policy's short-run effects on output and employment are highly unreliable and sharply disputed. Furthermore, from a long-run average perspective the best thing that monetary policy can do for output/employment is to avoid sharp, unexpected reversals and other forms of erratic behavior. In short, primacy for an inflation target is desirable because this goal is feasible and is helpful on average for meeting employment goals as well. A similar point of view has frequently been expressed by Chairman Greenspan.[5]

A desirable statement would specify that the Fed should conduct monetary policy with a primary objective of maintaining a specified, negligibly low, rate of inflation on average. It should add that a secondary objective is to help, to the limited extent possible,

[5] It is unfortunate, however, that Chairman Greenspan has occasionally made statements suggesting that inflation prevention is not of value in itself, but only as a condition for generating the best long-run performance in terms of real variables (i.e., output and employment). An example occurred in his July 22, 1997 testimony to the Congress.

to dampen cyclical fluctuations in aggregate output and employment. An explicit criterion for negligible inflation—e.g., 1–2 percent per year—should be given and expressed in terms of a specified price index. With such a statement, the nation would have a monetary standard and a sound basis for believing that inflation will not again be permitted to seriously disrupt economic activity.[6] This would be highly desirable for households and businesses alike. Furthermore, it should be welcomed by the Federal Reserve itself—which deserves to have a coherent job description.

It is worth emphasizing that a monetary standard is desirable not only to prevent excessive inflation, but also deflation. The case of Japan provides an important example. Japan is the other major economy, besides the United States, that currently has no monetary standard. Over the past decade the Bank of Japan has sought to prevent inflation, but without any clear-cut objective. Partly as result, perhaps, it has pursued policies that have been excessively restrictive for much of the last ten years, occasionally generating negative inflation even by its measures that are biased upward. This excessive restrictiveness is in large part to blame for the recession that has plagued Japan and damaged the world economy for several years.

[6] The precise nature of the standard would depend not only on the inflation target value, but also on whether or not target misses would subsequently be reversed (i.e., whether "base drift" is permitted).