FREE BANKING UNDER A LABOR STANDARD -- THE PERFECT MONETARY SYSTEM

Submitted by

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No one to my knowledge has prescribed a financial system that would, at least within familiar economic paradigms, guarantee an automatic, simultaneous cure for all of our macroeconomic maladies (viz., inefficient fluctuations in employment, persistent and highly variable rates of inflation or deflation, and governmentally created, artificial scarcities of money). Economists seem to believe that such a system does not exist. However, there _is_ a financial system -- one with a labor standard and free banking -- that would, at least theoretically, simultaneously prevent all macroeconomic ills _regardless_ of the kinds of shocks that hit our economy and without _any_ reliance whatsoever on discretionary policy intervention.

The _only_ governmental responsibility in this financial system is to make the dollar freely convertible into an amount of gold, or noncurrency redemption asset that government finds most convenient, just enabling the redeemer to purchase a _predetermined_, _fixed_ _amount_ of labor in the free market.

So, theoretically speaking, a dollar will always buy a constant amount, say five minutes, of U.S. labor. This creates a stable and intertemporally constant wage level. To see this, suppose that the free market level of money wages were to increase, ceteris paribus. The amount of gold required to purchase a unit of labor would increase correspondingly. Since the public could then obtain more gold for a dollar from the government than they could from the free market, arbitrageurs would profit by turning dollars into the government for gold and then selling the gold in the free market. The resulting, automatic drain of dollars from the system would serve to depress money wages. The induced reduction in the free market's money price of gold would _not_ reduce the arbitrage profit because a lower gold price immediately increases the amount of gold required to purchase a unit of labor and therefore the amount of gold one can obtain from the government for a dollar; as the financial return to the gold purchase and resale decreases, its cost decreases by the same amount. The currency drain, therefore, continues until the money wage rate is restored to its original level.

In a world with many kinds of labor, our standard would stabilize the quantity-weighted average wage rate, e.g., the 30-million worker, B.L.S. monthly wage index, thereby giving an individual, for his dollar, an amount of gold just enabling him to purchase a representative set of labor services totalling a constant number of man-minutes of U.S. labor.

Since monthly wage index data are not available until well into the following month, a practical problem arises as to how to determine the relevant

conversion prices. To solve this, the government should make its conversion payments assuming that the wage index will be at its theoretical value, but compensate all large converters ex post for subsequently observed increases in the index from its theoretical value and, of course, charge them for decreases in the subsequently observed index. Thus, the government would make its March conversion payments assuming that the average cost of five minutes of labor during March is $1.00; but if this average cost turns out to be, say $1.02, then all large converters would be due an extra 2% gold payment while if the index were, say, at $.97, the large converters would have to pay 3% more dollars to the government. Thus, if informed speculators thought, on balance, that the March wage index was going to be above $1.00, they would, on balance, convert dollars to gold, simultaneously sell the gold in the free market, and wait for their expected compensation from the government in the following month. The dollar drain created by this operation would depress the expected wage level until it reached unity. In this way we would always have an expected wage index, an expected dollar cost of five minutes of labor, of $1.00.

Another practical problem, a temporary one, is posed by the fact that existing contracts are geared toward about a 10% annual increase in money wages over the next few years. Allowing gradual decreases in the labor conversion rate for a few years, commencing at a 10% annual rate, before stabilizing it at, say, five minutes of U.S. labor for a dollar (i.e., to where the average wage level is $12 per hour) would preclude potentially very costly recontracting and at the same time substantially reduce the redistributional component of the increase in the value of existing long-term bonds. Alternatively, a new, recognizably distinct, labor-convertible dollar could be printed. This would not only allow existing contracts requiring the delivery of future dollars to be executed in the old, Fed-controlled, depreciating dollars and thereby permit an immediate move to an intertemporally constant wage level in terms of the new currency; it would also, by enabling the government to prohibit the Fed from transacting in new dollars, prevent the Fed from inadvisedly attempting to neutralize the efficient, labor-standard, currency flows between the Treasury and Public. After a while, once most old-dollar obligations have been fulfilled, and the new dollar has supplanted the old, the Fed could take over the Treasury's conversion operation, although this would presumably require an Act of Congress. Such an Act should also eliminate reserve requirements, bank interest rate regulations, rediscounting and open market operations as needless constraints on the free market's efficient, competitive provision of a currency-convertible medium of exchange. The intertemporally constant wage rate would insure the automatic absence of inefficient business-cylce unemployment and the removal of the artificial constraints on the banking system would assure a statically efficient, competitive banking system.

While inefficient fluctuations in employment would disappear under a labor-standard, they would be greatly exacerbated by returning to a simple gold standard because money wages and employment under a gold standard are altered by variations in the free market's relative price of labor in terms of gold and because the relative price of assets fixed in supply to the world has become highly unstable and should be expected to remain so over the foreseeable future. For the same reason, adopting the discipline of a commodity index standard would induce more severe employment swings than we've witnessed over the past decade. Moreover, unlike a gold standard, a labor standard would neither require international cooperation nor lay us open to foreign economic sabotage.

Finally, the resumptions of convertibility that would occur under a labor standard following wartime convertibility suspensions and inflations -- in sharp contrast to gold standard resumptions -- would create nothing like the gradually decreasing money wages and great depressions characteristic of our sordid past under the gold standard. Resumptions of convertibility under a labor standard would instead produce the immediate wage and price level adjustments characteristic of harmless currency reforms. The system would be depression-proof.

1 back to commodities such as gold. Now, maybe that there are
2 certain properties of gold which just make gold conducive to
3 being used as a basis of a commodity standard.
4 Whatever reasons, I think the boot's on the other
5 foot. Those who oppose gold have to show why it should not
6 be gold.
7 But even if we do go to a gold standard, going to
8 a gold standard is not enough. The source of the system is
9 not as important as the mechanism. Backing gold -- backing
10 dollars to a 40 percent Reserve cover will not lead to an
11 end to inflation. What stabilizes the value of dollars is
12 the government intervening and creating expectations in the
13 value of money in the future will be as stable as in the
14 present.
15 So, the intervention mechanism is probably more
16 important than what is behind the dollar.
17 Thank you.
18 SECRETARY REGAN: Thank you very much, Dr. Miles.
19 Dr. Thompson?
20 STATEMENT BY DR. EARL THOMPSON
21 DR. THOMPSON: I found myself agreeing quite a bit
22 with Dr. Fellner and Dr. Miles.
23 Gold has become much more unstable in its real
24 value than it has or was in the last couple or three centuries.
25 And the problem is that gold, oil, collectibles, all those

1 assets that are relatively inelastic in supply in the world
2 are being pressed in the -- have been pressed in the 1970's
3 and are probably going to be more pressed as population and
4 world income grows. Because they are an inelastic supply.
5 So, what's happening in the world in the '70's, and
6 it's probably going to continue happening, is that the value
7 of assets in fixed supply to the world are going to become
8 more and more unstable, highly -- more and more highly in-
9 variable as oil prices, as antique prices, silver, gold,
10 diamond prices, all that, what that tells you is that maybe
11 the gold standard worked fairly well 100 years ago, 200 years
12 ago, during peacetime because there -- there was not great
13 pressure on the fixed supplies of that asset to give you a
14 lot of price variability, but we've entered an era, and it's
15 going to afford us in the forseeable future a very high
16 variability of that kind of asset. Which means that if we
17 went back to the gold standard or anything like that, now
18 we'd be in for gigantic -- I'm sorry. I'll say that again.
19 Gigantic business cycles.
20 My estimate in one of the little hand-outs I'd had
21 summarizes paper, is that we had gone back on the gold stan-
22 dard in -- if Nixon had gone back on the gold standard in
23 1971, convertibility at $35 an ounce -- and said that's what
24 we're going to do instead of going off it, right now the
25 price level would be approximately 1/20 of what it is today.

1 That means like -- are you complaining about buying
2 a pair of shoes for $50 now that cost you $20 then, it would
3 cost you $1 now. The labor required to make that shoe would,
4 of course, sell for 1/20 of its value. That's the biggest
5 depression that we've ever observed, and it would destroy our
6 economy, probably our political system.
7 So, we're not talking details here. We're not
8 talking fine tuning here when we're talking about going back
9 to a gold standard in the modern world. It's a very dangerous
10 system in the modern world.
11 The -- and not only that, but even going to a
12 system of convertibility into a market basket of goods, which
13 is what has been long proposed by people saying that the price
14 of gold is too variable, even that in our world would be
15 extremely cycle inducing.
16 The reason is, just take the '70's. The oil price
17 shots have reduced for periods of time, reduced real wages
18 15 percent. Okay.
19 Now, over short periods of time -- now, if that
20 would have -- if we'd of had price level stability, right?
21 Price level stability in that period, what we'd end up with
22 is 15 percent lower money wages. Fifteen percent lower money
23 wage offers.
24 Well, knowing labors, knowing labored contracts,
25 knowing unions, 15 percent lower wages would have created a

1 depression in this country. When contracts are geared to 5
2 percent increases like they were in the late '60's, and you
3 offer 15 percent less instead of 5 percent more, that's like
4 a 20 percent wage reduction. That's going to give you depres-
5 sion conditions, just with price level stability in this coun-
6 try.
7 One of the best things we've had in this country
8 in the last ten years is inflation, is price level increase.
9 We wouldn't have had that, wages would have fallen substan-
10 tially because of the oil price increase, and we'd of had a
11 good depression. There's something on the order of magnitude
12 of the Great Depression.
13 So, we shouldn't be so quick to criticize our exist-
14 ing system. There's no system that I heard yet from anyone
15 that I consider superior to our existing managed paper money
16 supply system.
17 However, there is a system that is superior to all
18 financial -- all our current financial system, and all systems
19 that I've ever heard of, and I would like to propose that, and
20 let me say what it is.
21 It's a system of convertibility of money into gold
22 at a variable rate where you get variable amounts of gold, in
23 particular an amount of gold that will enable you to supply
24 a fixed quantity of U.S. labor. Like five minutes of U.S.
25 labor for your dollar.

1 So that means if the price of gold increases in the
2 market, you get for your dollar less gold because it's going
3 to require less gold to buy human labor.
4 So the system then would not be dependent on the in-
5 stability in the price of gold. Price fluctuations in gold
6 would have absolutely no effect on the wage level in that
7 economy. In fact, nothing effects the money wage level -- the
8 money wage level would achieve perfect stability. And it's
9 the fluctuation of the money wage level that's responsible for
10 all economic welfare analyses of business cycles that I'm
11 aware of. It's that fluctuation of the money wage level that's
12 given us our unemployment cycle.
13 Okay? Stabilize the money wage level and you --
14 and you've killed the business cycle. Put the money wage
15 level on a gradually increasing trend and you'll create a
16 little bit of wage creep, which people consider fairly healthy.
17 I don't know. And price stability.
18 Stabilize the wage level of values, we get a little
19 bit of price level decrease. People have praised that.
20 Anything in that range between wage level stability
21 and price level stability is just fine. The system, however,
22 is not convertibility of the dollar into a basket of goods.
23 It's convertibility of a dollar into gold at a variable rate,
24 at a rate that will enable you to buy a fixed quantity of
25 labor. And that this quantity of labor can take constant

1 overtime, which would give you wage level stability and gra-
2 dual price decrease. Or it can be at a gradually decreasing
3 quantity of labor and, therefore, approximate price level
4 stability and a wage level creep, but at a fixed rate.
5 The point is, that if it's at a fixed known rate
6 so labor would not make the mistakes that they make now, any-
7 time the wage level drops of thinking there's a better deal,
8 or else leaving their employment for a better occupation or
9 for back to school, or for unemployment insurance, or whatever
10 it is, or even leisure in the case of fixed contracts, that
11 causes our business cycle.
12 So the point is that if we stabilized our money
13 wage, if we made the dollar convertible into gold ar a variable
14 rate so as to fix our money wage level, which is extremely
15 easy to do, I've gone through the details of that system in
16 the handout in Title 3, "Banking Under a Labor Standard," and
17 it's an extremely system to administer. If we did that, one,
18 we would kill the business cycle. Okay.
19 Two, we would end inflation at our will. Okay.
20 One day we just end inflation. Of course, contracts are now
21 set for inflation, so I recommend a gradual decrease over a
22 ten year period in the amount of gold -- amount of the labor
23 you can get for your dollar, which would create a gradual
24 decrease in the inflation rate.
25 So, anyway, after a few years of adjustment you'd

1 have knocked out inflation gradually. You'd have killed the
2 business cycle. And not only that, but since you have done
3 those things, you no longer need any monetary management at
4 all. We could go back to free banking institutions, and let the
5 free market supply money under this convertibility system
6 with absolutely no money management at all.

7 So we're getting free banking -- the dramatic
8 efficiency of free banking, the absence of money management
9 through a rule, no business cycle, no inflation, okay, we're
10 making some use of our -- just our gold stock is just sitting
11 around there. And we're ending the government monopoly on
12 the creation of money.

13 This is everything that -- this is almost the
14 ideal system in terms of the notes that I've read of your
15 first meeting. Those notes -- I decided those were the ideals
16 that you had, those were exactly the ideals that I had in
17 making up the system. And I think it would have been adopted
18 long ago if economists would have thought of it. Or the
19 economists would have had -- the old economists would have
20 had the benefit of the modern theory of unemployment, which
21 tells them that the thing you want to do is subsidize -- is
22 stabilize money wage. Okay? Not the price level, but money
23 wages. Stabilizing the price level doesn't do you that much
24 good. It does not destroy business cycles because they're
25 variations in productivity that are substantial at times.

1 And they will create business cycles.

2 In addition, during a war, we go off the gold stan-
3 dard and we have gone off our previous standard. I will also
4 recommend going off the labor standard for wartime financing.
5 But going back on the labor standard would not create the
6 dislocations that going back on a gold standard creates.

7 Going back on a gold standard creates a gradually
8 increasing demand for gold for a gradually decreasing price
9 level. It happens every single time we've gone back on to a
10 gold standard after suspension during a war. Every single
11 time. There's no problem in looking at that history. You
12 can see it in the numbers.

13 We go on a war, we go off the gold standard, we have
14 our war inflation, which is very good. You got to have that
15 inflationary financed during a war to support emergency mea-
16 sure, emergency expenditures. We got to go off the gold
17 standard during a war.

18 But we go back on, convertibility and because of
19 the gradually increasing demand for gold in order to finance
20 the standards, we've always had gradually increasing real
21 price of gold, which is identical to, which means gradually
22 decreasing price levels which is always produced in depressions.
23 Every time. It will happen again and again. It's the same
24 process. It's theorectially inevitable.

25 Now, under a wage standard it would never happen.

1 Under a labor standard where -- what you do at the end of a
2 war is nothing gradual at all. You say we're going back to
3 pre-war wage convertibility. We're going back to the pre-war
4 wage level. And you say, "okay." You now can get, not like
5 during the war, you now can get --right at the end of the war,
6 even make it part of the law, you now can get less -- I'm sorry.
7 More labor for your dollar than you did during the war. Okay?
8 More labor for your dollar than you did during the war. You
9 specify the amount.
10 We're going back, for example, to the pre-war
11 quantity of labor. What immediately happens is the price
12 level -- wage level jumps down to the pre-war level. There's
13 no gradual deflation. There's no unemployment. There's no
14 post-war depression. Okay?
15 So you save the post-war depression problem.
16 All right?
17 So what I'm saying then is, within all economic
18 theories with which I'm aware, what we have is an ideal
19 economic system, okay? And I challenge you to find out what's
20 -- tell me what's wrong with it.
21 There's a -- let me just say that there is a his-
22 tory of these kinds of standards, the idea of a variable
23 gold standard was invented by an American economist, Simon
24 Newcomb, in 17 -- I'm sorry, 18 -- the late 1870's, when they
25 were considering going back to the gold standard.

1 He suggested inadvisely that we -- that we give
2 for the dollar a variable amount of gold. An amount that would
3 enable you to buy a fixed commodity basket of goods, the price
4 index. And his student, who was Irving Fisher, picked up the
5 same idea in the 1920's and suggested that we do exactly the
6 same thing. Let's go back to the variable gold standard.
7 They didn't have the wage rate, so they had really the kind of
8 the wrong thing to peg to. They didn't have the advantage of
9 our 30 million firm BLS wage index. But it's okay. They were
10 talking about price level stability.
11 And those systems -- going to those systems at that
12 time would have prevented the post-war price decrease that
13 we saw. The post-Civil War price decreases, and would have
14 prevented the Great Depression. Because we would have had
15 stable prices.
16 But those proposals were ignored, and I think they
17 were ignored because people were too lazy to think of seriously
18 of a better economic system. Okay?
19 Now, I'm challenging you, I don't want you all to
20 be too lazy. I don't want to be ignored. I'm challenging you
21 to tell me what's wrong with these systems. We would not have
22 had the depression if we had paid attention to Irving Fisher
23 seriously.
24 We would not have had that bout in the 18 -- the
25 late 19th century if they had just paid attention to Simon

1 Newcomb.

2 Okay. These are American systems. These are not
3 British systems. Okay. Maybe we don't have the confidence
4 to listen to Americans. We didn't then. We should have the
5 confidence now. We can have wage level stability. That means
6 full employment by every economic measure that we know. As
7 much prive level stability as we want, no monetary management,
8 completely competitive money supply creation. Exactly every-
9 thing you want very easily.

10 SECRETARY REGAN: Thank you very much, Dr. Thompson.
11 Dr. Williamson?

12 STATEMENT BY DR. JOHN WILLIAMSON

13 DR. WILLIAMSON: Thank you, Mr. Secretary.

14 After that exortation to listen to American econo-
15 mists, you have as your next guest a Britisher. I hope that
16 I can contribute something to the deliberations of this
17 Commission, although I would say that at this point in in-
18 tellectual history, American economists have been making a
19 lot of the running, and I don't think there's much danger
20 that you'll be here relying too much on British spirits.

21 Now, what I do -- in the first of my testimony, is
22 to examine six of the leading proposals that were on the
23 table, as I understand it at this Commission before this
24 morning, there's been a couple more this morning, I examined
25 six of the proposals to see whether they could be expected