

Editorial: The Inflationary Chaos Ahead

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The monetary outlook for the United States—and for the world—was never darker than it is today. The federal budget is unbalanced by some \$200 billion a year, and the prospect of getting it back to a balance even five years from now is very dim. At the moment of this writing, the president and the Senate majority leadership have worked out a courageous spending reduction schedule for fiscal year 1986, but congressional Democrats have decided to oppose this plan even if a Senate majority agrees to it, on the ground that it lacks “compassion.” Huge deficits will probably continue.

What is happening in the United States is happening in most other countries. Governments have practically all adopted the welfare state, and the political forces within each country seem to ensure its continuance. Scores of pressure groups, from people on unemployment insurance to people on Social Security, insist on the continuance of the payments they have become accustomed to, and on their automatic increase with every increase in the cost of living. But this means that the greater the past or present inflation, the greater must be future inflation. It was estimated in the *New York Times* on April 28, 1985, that in Israel inflation was running at about 1,000 percent a year. It was reported the day before that the inflation in Argentina was expected to reach an annual rate of more than 900 percent that month.

And so it goes. While there is no single source, to my knowledge, where one can find a day-to-day calculation of the latest annual or monthly rates of inflation of each of the world's principal currencies, a mere listing from the daily foreign exchange table of the rates at which some of them now exchange for a U.S. dollar (which is itself depreciating against commodities) indicates what has been happening. A dollar (as of April 26, 1985) bought 4,900 Brazilian cruzeiros, 1,186 Indonesian rupiahs, 932 Israeli shekels, 2,001 Italian lire, 253 Japanese yen, 246 Mexican pesos, 8,688 Peruvian soles, and 495 Turkish lire.

It may be thought that what happens to the currency in other countries is irrelevant to the prospects for future inflation in the United States or chances for returning to a gold standard. But it is not so. Bad currencies depress better currencies.

This was illustrated by the Bretton Woods system set up in 1944 and 1945. The framers of that system, after explicitly permitting not only devaluations at any time by individual countries, but also *uniform* devaluations of member currencies by agreement, paid obeisance to the gold standard by providing that one country, the United States, would keep the dollar convertible into a fixed weight of gold and accept other currencies (at their official rates) in exchange for the dollar.

When the dollar was thrown off gold on August 15, 1971, the result was blamed on President Nixon, who made the announcement. Mr. Nixon must of course bear part of the blame, but his was far from the sole guilt. On the day he stopped gold payments, U.S. gold reserves amounted to only about 2 percent of outstanding currency and demand and time bank deposits. There was only \$2.23 in gold to redeem every \$100 of U.S. paper promises.

But this takes no account of outstanding Eurodollars or even of the outstanding currency and bank deposits of all the foreign signatories to Bretton Woods (who were entitled under the agreement to turn in their currencies for conversion into dollars or gold). The ultimate gold reserves on which the conversion burden could legally fall under the system must have been only some fraction of 1 percent of the total paper obligations against them. The Bretton Woods system was inherently impossible to maintain. Even if Mr. Nixon had not closed the gold window on August 15, 1971, he would probably have been forced to close it a week or so later for lack of further gold reserves to pay out.

What in 1971 was a run on gold has become in 1986 a run on the dollar. In terms of its exchange rate against goods, the dollar continues to depreciate. But it is considered the world's least unsafe currency of which there is a substantial supply. Therefore, businesspeople and wealthier citizens of foreign countries buy it as an international currency to do business with each other and as a store of value—or at least a better hedge against inflation than their own currencies. This temporarily has increased the demand for dollars and therefore their exchange rate against other currencies. But it has also tended to increase the supply of dollars further—partly to meet the increased demand, and partly because the increased supply of dollars is not immediately or proportionately reflected in the inflation rate.

But the process is ominous. It means that, in a world in which every currency is on a paper basis, the citizens of the countries whose currencies are depreciating fastest will try to exchange them for a major currency that is depreciating least, and therefore make the stronger currency in turn tend to depreciate faster. The worst will pull down the better.

I wish I could foresee a stopping point to this process—a point that would at least lead to the emergence of political responsibility. I regret that I cannot envisage this now. I cannot imagine how democratic politicians, with their eyes fastened on the next election two years or two months away, can bring themselves to substantially reduce, not to whisper abolish, most of the hand-outs to pressure groups that now make up the welfare state.

One more point needs to be clarified. There is only one workable currency reform—a return by all the leading economic nations to the old-fashioned gold standard. There are no trick reforms that would “economize” the use of gold. Such reforms, as economists have found, merely lead to renewed inflation, and eventually break down. But there is no use even in talking about a return to a gold standard until the United States has abolished the deficit in the federal budget and has kept it balanced or overbalanced for a couple of years.

When will the world learn, after the countless credit booms and busts throughout history, after the American Continentals of the 1776 Revolution, the French assignats of 1789, the German mark disaster of 1918–23, and the world monetary disorder promoted by the Bretton Woods agreement, that inflation is not the main remedy for economic ills but is instead the main cause of them?