Greg Kaza

Is There a Case for the Gold Standard?

To many Americans, the gold standard evokes images of a rapacious laissez-faire capitalism that led directly to the Great Depression. This view is reinforced by liberal academic economists hostile toward a role for gold in the international economic order. John Maynard Keynes called gold "a barbarous relic."[1] "How absurd," Paul Samuelson declared, "to waste resources by digging gold out of the bowels of the earth, only to inter it back again in the vaults of Fort Knox, Kentucky!"[2] Ever since the Great Depression, liberal economists have ridiculed the idea that gold should play a central role in the world's monetary order.

Sixty years later, serious discussion of the gold standard is limited largely to conservative and libertarian economic circles. Occasionally, a major Republican political figure expresses support for gold. Examples include Jack Kemp and publisher/politician Steve Forbes. Federal Reserve System chairman Alan Greenspan testified in support of the gold standard before the U.S. Senate Banking Committee in February 1995, but his remarks went largely unreported.[3] Indifference to Greenspan's remarks can perhaps be attributed to a preoccupation with fiscal policy (taxes and regulation) to the exclusion of monetary policy (money and central bank action). Nonetheless, Greenspan's remarks mark the first time in decades that a Federal Reserve chairman has advocated a role for gold.

The climate, however, may be changing. Kemp's recent nomination as the Republican vice-presidential candidate could create an opportunity for proponents of gold to publicly discuss the nature and relevance of the gold standard in the same way that Clarence Thomas's nomination to the Supreme Court created a national conversation on the nature and relevance of natural law theory.

In addition, a number of economic developments since the U.S. dollar's last link to gold was severed in 1971, when the Bretton Woods monetary system collapsed, have underscored the need to reconsider a role for gold in the monetary order. These include:

- The decline of the dollar, which has lost two-thirds of its value against other major currencies such as the Japanese yen and the German deutschmark;
- High interest rates, currently in the five to seven percent range, that have risen to as high as 18 percent at times;
- A rising Consumer Price Index (CPI) that is evidence of a persistent inflation.

Can gold play a role in the international monetary order? Before answering that question we need to understand the gold

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standard, and consider its historical record.

A nation can be said to be on the gold standard when it meets the following conditions:

- Defines its monetary unit in terms of a certain quantity of gold;
- Stands ready to convert gold into paper money and paper money into gold at the rate stipulated in its definition of the monetary unit;
- Allows gold to be freely exported and imported.[4]

For example, Great Britain maintained a fixed price of gold at 3 pounds, 17 shillings, 10 ½ (d) from 1821 to 1914, while the U.S. maintained the gold price at $20.67 per ounce from 1834 to 1933, with the exception of the Greenback era[5] from 1861 to 1878.[6] Under this fixed price system, the exchange rates between national currencies were fixed, not because they were arbitrarily controlled by government, but in the same way that one pound of weight is defined as being equal to 16 ounces.[7] Thus, one of the characteristics of the gold standard were *fixed* exchange rates for currencies.

In 1821, Great Britain went on the gold standard when it restored specie payments[8] after the Napoleonic Wars.[9] From 1821 to 1880, the gold standard steadily expanded as more nations ceased using silver as a monetary standard. By 1880, the majority of modern, industrialized nations in the world were on some form of gold standard.[10] The awe in which the gold standard was held in the late nineteenth century was vividly illustrated by an incident in 1871 during the brief reign of the socialist French Commune. The French Communards in Paris took over all public and private institutions except one, the Bank of France, which they left alone, its gold reserve untouched.[11] Marxists, including Karl Marx, accepted the gold standard as an integral component of capitalism.

Why did gold emerge as the monetary standard of choice? Governments did not select gold arbitrarily to serve this function. Rather, gold emerged because it had developed for many centuries as the best money; as the commodity providing the most stable and desirable monetary medium.[12] Gold has the desirable properties of money that early economists emphasized in their writings. It is durable, portable, divisible, and easily standardized. Changes in its stock are limited, in the short-run, by high costs of production, making it costly for governments to manipulate. As a result of these attributes, gold emerged as one of the earliest forms of money.[13] More important, gold was a commodity money, and a commodity money standard has a very desirable property: a tendency toward long-run price stability.[14]

Under a commodity money standard, the purchasing power of a unit of commodity money will tend toward equality with its long-run cost of production. The gold supply in the long run is determined by the opportunity cost of producing gold—the cost in terms of foregone labor, capital and other factors involved in producing an extra unit of gold. In the long run, competition in the gold-producing industry ensures that gold's purchasing power in terms of other goods equals the opportunity cost of producing an extra unit of gold money.[15] Economist Michael Bordo describes this process:

> (C)onsider what happens when a technological advance improves productivity in the non-gold producing sectors of the economy. This improvement leads to a rise in real economic activity, an increase in the demand for money (gold coins) and, with an initially given stock of money, a fall in the price level (a rise in the purchasing power of gold money). The fall in the price level means that gold producers will be earning economic profits. These profits will

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> encourage existing owners to increase production and new entrepreneurs to enter the industry, resulting in an increase in gold production. At the same time, people will take gold previously used for nonmonetary purposes (e.g., gold jewelry) and convert it to monetary uses. These forces will increase the gold coin supply, reversing the initial decline in the price level.[16]

In a similar manner, increases in the price level reduce the purchasing power of gold money and cause individuals to shift gold from monetary to nonmonetary uses. Eventually, production in gold-producing industries is reduced. Bordo explains:

> Both factors will tend to reduce the gold money supply and reverse the initial rise in the price level. Thus, under a gold standard, one would expect to observe long-run price level stability, though it may take several years for a declining or rising price level to be reversed.[17]

What was the historical record of the gold standard? Liberal critics dwell on the Great Depression and the end of laissez-faire capitalism, while ignoring the gold standard's record. The period of 1880 to 1914, the heyday of the gold standard, was marked by rapid economic growth, the free flow of labor and capital, virtually free trade, and, for the most part, world peace. The gold standard played a vital role in the emergence of capitalism as a dynamic force in the pre-World War I era. Most importantly, it provided an internationally solid unit of account and medium of payment. Economic development in the late nineteenth century would have been greatly hindered without such a uniformity in currency arrangements.[18]

The gold standard's importance cannot be appreciated in isolation from the psychological background that characterized the world in the decades before WWI.[19] Here is how economist Oskar Morgenstern described the world before 1914:

> ...There was freedom of travel without passports, freedom of migration, and freedom from exchange control and other monetary restrictions.... Capital would move unsupervised in any direction, and these movements could take any form.... [T]ariffs...were exceedingly low. There were hardly any quantitative restrictions on international trade (quotas, import prohibitions, etc.).... [I]t was a world of which many...would have been inclined to assert that it could not be created because it could never work....[20]

The gold standard meant that the benefits of having one money medium were extended throughout the modern world. One money—one international unit of account—facilitated freedom of trade, investment and travel throughout that monetary area, with the consequent growth of specialization and the division of labor.[21] By 1912, 49 countries were on the gold standard.[22]

That world was markedly different than the world we live in today. First, it was characterized by balanced national budgets. Second, government expenditures were financed by the sale of long-term bonds, not by the inflationary practice of debt monetization. Third, it was an industrial world of steady real growth—at an average annual rate of about three percent during the six decades before 1914. Fourth, nominal wages and prices were relatively low with rising living standards. Finally, interest rates were low, often in the two-three percent range.[23]

Today, by contrast, governments routinely operate budget deficits, monetize their debt, experience stagflation, inflation, and real interest rates twice as high.

At WWI's onset, fiat money[24] advocates were considered cranks and eccentrics, and the gold standard was the foundation of the international monetary order. With gold the common currency base, the money and credit supply of each country could be expected to adjust itself, except for short-term fluctuations, to the international flow of gold, and vice versa. The role of the gold

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standard in unifying the modern world's economy cannot be overestimated. It was the condition *sine qua non* of the international monetary order, a basic instrument in "opening up the world to economic progress and modern Western capitalism.[25]

On the eve of WWI, "doubts about the gold standard came only from...political propaganda...but not from a belief that the gold standard mechanism could not cope with (economic) difficulties."[26] Foremost among these economic difficulties was war. The truth is that it is very difficult for a nation to finance a war while on the gold standard. Indeed, the nineteenth century appears relatively peaceful when contrasted with the conflicts of the twentieth century. The gold standard was destroyed by WWI. To wage the catastrophic war[27] each government had to inflate its own money supply. Inflation was so severe that it was impossible for warring European governments to keep their pledges to redeem currency with gold; they were forced off the gold standard and relied on fluctuating fiat currencies. Only the United States, which entered WWI late, in 1917, remained on the gold standard. The consequences of the gold standard's breakdown soon emerged; many have continued throughout the 20th century. These competitive currency devaluations, warning currency blocs, exchange controls, tariffs and quotas, and inflation.

Few economists at the time accepted this climate as the monetary ideal; gold was briefly reinstated from 1925 to 1931 in the form of the gold exchange standard. Under the gold exchange standard, countries could hold both gold and dollars or pounds as reserves, except for Great Britain and the U.S., which held only gold reserves. But the gold exchange standard collapsed in 1931 following Britain's departure from gold in the face of massive gold and capital flows.[28] The collapse was precipitated by the fateful decision of the British to return to gold at the overvalued pre-WWI par of $4.86 a pound instead of the post-war $3.50 free market price.[29] They took this action for reasons of British national prestige, and in a vain attempt to re-establish London as the "hard money" financial capital of the world.

The U.S. stayed on the gold exchange standard for two more years, until 1933. Americans could no longer redeem dollars in gold, and were prohibited by the administration of Democratic president Franklin Delano Roosevelt from owning any gold.

But the U.S. remained on a pseudostandard until 1944 in which the dollar was redefined as 1/35th of a gold ounce, and made redeemable in gold to foreign governments and central banks. A new international monetary order emerged in 1944 at an economic conference at Bretton Woods, N.H. The Bretton Woods System was an attempt to return to a modified gold standard using the U.S. dollar as the world's key reserve currency. The U.S. fixed the price of gold at $35 per ounce, and settled external accounts with gold bullion payments and receipts. All other countries—except for those linked to the British pound sterling—settled their international balances in dollars.[30]

Under the pre-1914 gold standard, the American people had the freedom to de-

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mand gold as redemption for dollars. An increase in redemption's was a market signal to tighten the money supply; a decrease was a sign to ease. But under Bretton Woods, gold's role was allegedly to serve as a formal "price rule" for the world's central banks. Power no longer rested with the people, but with government central banks that could demand gold for their dollars. This occurred rarely at first. Bretton Woods assumed that the U.S. government would maintain an honest game. But U.S. politicians cheated by forcing the Federal Reserve to inflate to pay for the Great Society and the Vietnam War. By the late 1960s the world's central banks had caught on. This confidence problem, coupled with many nations' aversion to paying an "inflation tax" to the U.S., led to the breakdown of Bretton Woods. When the world's central banks demanded gold for their overvalued dollars, President Richard Nixon responded by decoupling the dollar from gold on August 15, 1971.

Nixon claimed a dollar not linked to gold would "never again be subject to international speculation." In December 1971, the U.S. led the world into the Smithsonian Agreement, a world monetary role with no link to gold. Nixon hailed the Smithsonian accord as the "greatest monetary agreement in the history of the world, but it lasted only one-and-a-half years before collapsing. Since that time the U.S. and the rest of the world have allowed their fiat currencies to "float" freely without any link to gold.[31]

Since the gold standard's end, price levels in the U.S. have been rising on average. From 1914 to 1979, the U.S. price level increased by an average annual rate of 2.2 percent. It takes nearly $3.75 today to match the 1971 purchasing power of $1 because of inflation.[32] The dollar has lost two-thirds of its value against the Japanese yen and German deutschmark since Bretton Woods' collapse in 1971. The Swiss franc has gained more than 300 percent against the dollar during the same period.

Against this inflationary backdrop, Fed chair Greenspan has advocated a return to the gold standard. Greenspan told the U.S. Senate Banking Committee: "...(A)nything which would change the view of long-term inflation prospects in the United States, whether it be a gold standard, whether it be credible monetary and fiscal policy, or some combination, will effectively reduce both nominal and real interest rates."[33] Greenspan's remarks surprised many observers, who are seemingly unaware of his earlier, obscure essays on the topic. "An almost hysterical antagonism toward the gold standard is one issue which unites statists of all persuasions," Greenspan wrote in 1965. "They seem to sense—perhaps more clearly and subtly than many consistent defenders of laissez-faire—that gold and economic freedom are inseparable, that the gold standard is an instrument of laissez-faire and that each implies and requires the other."[34]

Returning to the gold standard presents many practical problems, including fixing a gold price that is consistent with market forces. If the price is too low, the total U.S. government stock of gold would be oversubscribed. If the price is too high, the U.S. Treasury would have to redeem more gold offerings than the market could bear. The payments for the gold drawn on the Treasury's account at the Federal Reserve would add to commercial bank reserves and act, in the short-run, to expand the money supply and add to inflation.[35]

The greatest obstacle to restoring the gold standard is the problem of re-entry into the international monetary order. An immediate return to gold convertibility would create a serious problem: the large worldwide excess of fiat currency, especially dollars. The claims to gold would be substantial. One way to gradually restore a role for gold

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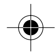

would be for the U.S. government to issue Treasury notes with the principal and interest payable in grams or ounces of gold. Greenspan discussed such a development in a 1981 essay:

> With the passage of time and several issues of these notes we would soon have a series of 'near monies' in terms of gold and eventually, demand claims on gold. The degree of success in restoring long-term fiscal confidence will show up clearly in the yield spreads between gold and fiat dollar obligations of the same maturities. Full convertibility would require that the yield spreads for all maturities virtually disappear. If they do not, convertibility will be very difficult, probably impossible, to implement.[36]

Another advantage of gold notes is that they are likely to reduce current budget deficits. Every 100-basis points[37] saved by the U.S. government in financing costs would save taxpayers $50 billion, given the current $5 trillion national debt. Treasury notes sold in today's markets could be sold at interest rates several hundred basis points lower than what they sell for today under such a system. Yet another advantage of gold notes is the pressure they would put on the president and Congress to cut wasteful spending and address the federal budget deficit.

Can a case be made for gold in the international monetary order? The costs of such a policy must be weighed against the benefits. Those advocating a return to the gold standard must be aware that such a policy would represent a fundamental change to our nation's economy. The potential costs, and obstacles, are significant. The most important benefit would be the long-run price stability and low interest rates that gold's historical record suggests. Whatever the case, it is today crucial that the American people regain their veto power over government monetary policy. Restoring a role for gold would give the people that power.

Notes

1. John Maynard Keynes, *Tract On Monetary Reform*, 1923. **2.** Paul A. Samuelson, *Economics* (1970) 8th ed. **3.** Alan Greenspan testimony before the U.S. Senate Banking Committee, Feb. 22, 1995. One of the few exceptions was the *Detroit News*, which editorialized, "If there is a *Contract With America* for the second 100 days, making the dollar once again as good as gold should be at the top of the list. The *Detroit News*, "Time For Monetary Reform," Mar. 28, 1995, 8A. **4.** Campbell R. McConnell, *Economics* (New York: McGraw-Hill, 1978, 7th ed.). **5.** The U.S. government used paper greenbacks and government bonds to finance the Civil War's cost. Federal expenditures skyrocketed from $66 million in 1861 to $1.3 billion four years later. Ron Paul and Lewis Lehrman, *The Case For Gold* (Washington: The Cato Institute, 1982), 74. **6.** Michael D. Bordo, "The Classical Gold Standard: Some Lessons For Today," *Federal Reserve Bank of St. Louis Bulletin*, May 1981, 2. **7.** Murray N. Rothbard, *What Has Government Done To Our Money?* (Libertarian Publishers: San Rafael, Ca.), 50. **8.** Gold coin payments. **9.** The Napoleonic Wars, fought between 1803 and 1815, were marked by persistent inflation. **10.** Bordo, *Op. Cit.*, 7. **11.** R. Sedillot, *Le Franc* (Paris: Receuil Sirey, 1953), 201. **12.** Rothbard, *ibid.*, 51. **13.** Bordo, *ibid.*, 3. **14.** Milton Friedman, *Essays in Positive Economics* (Chicago: Univ. of Chicago Press, 1953). **15.** Bordo, *Op. Cit.,* 3. **16.** Bordo, *Op. Cit.*, 3. **17.** Bordo, *Op. Cit.,* 3. **18.** T.B. Gregory, *The Gold Standard and Its Future* (New York: Dutton, 1931), 10. **19.** Melchior Palyi, *The Twilight Of Gold* (Chicago: Henry Regnery Co., 1972), 6. **20.** Oskar Morgenstern, *International Financial Transactions And Business Cycles* (New York: National Bureau Of Economic Research, 1957), 17-19. **21.** Rothbard, *Op. Cit.,* 51. **22.** D.L. Kemmerer, "The Gold Standard In Historical Perspective," *Commercial and Financial Chronicle* (New York), Aug. 5, 1954. **23**. Palyi, *Op. Cit.,* 7. **24**. Paper money. **25.** Palyi, *Op. Cit.,* 8-9. **26.** Morganstern, *Op. Cit.*, 17. **27.** An estimated 10 million soldiers and 6.5 million civilians were killed as a result of the conflict, including two million Russian civilians. **28.** Bordo, *Op. Cit.*., 7. **29**. Lionel Robbins, *The Great Depression* (New York: Macmillan, 1934). **30.** McConnell, *Op. Cit.*, 907-910. **31.** Rothbard, *Op Cit.*, 61. **32.** U.S. Chamber of Commerce. **33.** Alan Greenspan testimony before the U.S. Senate Banking Commitee, Feb. 22, 1995. **34.** Alan Greenspan, "Gold And Economic Freedom," *The Objectivist*, July 1966. **35.** Alan Greenspan, "Can The U.S. Return To A Gold Standard?" *Wall Street Journal*, Sept. 1, 1981. **36.** Greenspan, *WSJ, ibid.* **37.** A basis point is one-100th of a percentage point of interest.

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