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Economic Outlook

All That Glitters: A Primer on the Gold Standard

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The periodic debate around whether the United States should adopt a gold standard—a monetary system tied to the value of gold—has heated up again recently. Though some see such a system as a way to prevent inflation and excessive government debt accumulation, history has proven that it can lead to instability and sharp periods of inflation or deflation, as seen during the Great Depression and in the failure of the Bretton Woods monetary policy system in the early 1970s. Serious consideration of a widespread return to a gold standard would be warranted only if the Federal Reserve's recent QE3+ quantitative easing measures and economic stability around the world lead to prolonged periods of high inflation and if a major world economic player—such as the United States or Great Britain—is willing and able to peg its currency to gold to provide a benchmark for price stability.

In August, discussion of the costs and benefits of a US return to the gold standard became a popular topic when the Republican platform included a proposal for a commission to consider "the feasibility of a metallic basis for the US currency." As the platform statement indicated, a gold commission appointed shortly after the election of President Ronald Reagan considered the feasibility of a gold standard and advised against such a move. Now, over thirty years later, does a gold standard make sense for the United States? The question takes on extra urgency now that the Federal Reserve has moved toward targeting higher inflation with QE3+. (See September's *Economic Outlook*.[1])

The quick answer to this question is "no" if the aim is to unilaterally return the United States to a gold standard in today's world of floating exchange rates and the absence of any other currencies pegged to gold. That said, the gold standard issue still deserves serious consideration. The expectation is that at some point in the future there might be an effort to design a new international monetary system that includes a link to gold.

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Key points in this *Outlook*:

- Republicans have called for an investigation of the feasibility of a gold standard, a suggestion that seems particularly intriguing in the face of the high inflation expected under the Fed's recently announced QE3+ plan.
- The current combination of flexible exchange rates, ability of private citizens to own gold, and lack of a link between the central bank gold holdings and the money supply would make it difficult for the United States to engineer a return to the gold standard.
- Returning to a more stable monetary system anchored to gold may become a more attractive option if the world economy sees a sustained period of high inflation.

The Gold Standard and the Great Depression

The postwar gold exchange standard had its roots in the interwar period, specifically in the experience that followed Great Britain's return to a pegged gold exchange rate in 1925. Prior to World War I, the world had been largely on a gold standard. But the pressures of wartime finance after 1914 prompted most countries to cut the link to gold so that central banks could accommodate massive government borrowing associated with the expenses of the war. The break from gold resulted in substantial inflation after the war—especially in Germany, where, saddled with reparations it could not pay, the German government resorted to massive money printing that led to hyperinflation and a virtual destruction of the German currency.

The British link to gold had formed the heart of the prewar gold standard, and the British were eager to restore currency convertibility to gold to help stabilize their monetary system and the global monetary system. In 1925, Britain reestablished the prewar peg to gold by fixing the exchange rate between its currency and the dollar. The dollar price of gold was fixed at $20.67 an ounce, so a peg to the dollar amounted to a peg to a fixed sterling price of gold.

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As it turned out, Britain's effort to return to gold at the prewar parity was a mistake. In effect, the peg overvalued sterling by setting the sterling price of gold below an equilibrium level. If a currency is overvalued as part of a gold standard, the country with the overvalued currency tends to run a balance of payments deficit that is settled by exporting gold to surplus countries. As British gold was exported, investors lost confidence in the sterling peg to gold and capital outflows increased pressure on the country's dwindling gold stock. By 1931, Great Britain was forced to abandon the gold standard in the midst of an intensifying global depression.

Britain's departure from gold in 1931 led Americans to doubt that the fixed exchange rate between the dollar and gold at $20.67 per ounce would be maintained. In other words, in a volatile global environment, the dollar price of gold was too low, so speculators purchased gold from US banks. The loss of gold at the banks caused US depositors to convert their bank deposits into currency because they feared for the safety of the banks.

The resulting negative cascade effect of a loss of currency and bank deposits caused the US money supply to shrink by a third between 1931 and 1933. The gold standard forced a monetary contraction at a time when the US economy was very weak. Finally, in January 1934, Congress passed the Gold Reserve Act, which nationalized the gold stock and prohibited the private ownership of gold. The price of gold was raised to $35 an ounce, resulting in a substantial devaluation of the dollar by over 40 percent. The sharp dollar devaluation helped encourage larger US exports of agricultural products and arrest the deflation that had set in after 1931 when the depletion of the Fed's gold stock had forced it to tighten monetary policy in a global depression.

The negative experience of Britain and the United States with a rigid gold standard after 1925 illustrates a basic problem tied to establishing a currency link to gold. If, as was the case with sterling in 1925, an excessively low currency price of gold leads to overvaluing of the currency, speculators will purchase gold for hoarding, expecting that the currency price of gold will have to be increased—that is, that the currency will have to be devalued against gold. But under the rules of the formal gold standard, a loss of official gold holdings requires a contraction of the money supply or some other restrictive monetary measure like higher interest rates, which causes wages, prices, and output to fall and unemployment to rise, especially if wages are somewhat sticky in a downward direction.

The fixed money price of gold implies a deflationary or contractionary tendency if it is set too low and leaves the government vulnerable to losses in its gold stock that in turn require a contraction of the money supply. Conversely, if the money price of gold is set too high—above a market equilibrium level—then gold flows to the government offering a higher price and, under the rules of the gold standard, the central bank is forced to increase the money supply. A gold standard can be inflationary or deflationary.

Of course, the movements described here are self-correcting under a classical gold standard, when the majority of countries adhere to the standard. In 1925, when Britain fixed the sterling price of gold, the world was on a gold standard where every central bank ultimately had to tie the supply of money to the supply of gold in its coffers. The overvaluation of sterling created a balance of payment deficit and capital outflows, so the British gold stock fell. The reverse occurred in the

United States as gold flowed in but the United States did not let the money supply rise and push prices back up. Most of the adjustment burden fell on the United Kingdom, where wages and prices were forced even lower and an external deficit reduced the gold stock until Britain was forced to devalue sterling in 1931. If all countries do not link their money supply to their supply of gold, the gold standard breaks down.

A Modern Gold Exchange Standard: The Bretton Woods System

After World War II, with the US dollar peg to gold having remained fixed at $35 an ounce and the United States in a hegemonic position with regard to most other nations, a monetary system was once again established based on a fixed exchange rate between the dollar and gold, the Bretton Woods system. Under the gold exchange standard, with gold pegged at $35 an ounce, other currencies were pegged to the dollar at a fixed price once they restored convertibility after the war, giving them a fixed value in terms of gold. As the world economy prospered, the need for international reserve assets rose, and other developed countries, particularly Europe and Japan, accumulated dollars transferred to them as the mirror image of their rising balance of payments surplus with the United States.

The resulting accommodation of US external deficits, which under the gold standard would have reduced the US money supply but under the gold exchange standard did not, eventually boosted US inflation to a level that meant that $35 an ounce as a gold price effectively overvalued the dollar. US trading partners began to convert dollars earned as a result of their balance of payment surpluses with the United States into gold, reducing US gold holdings.

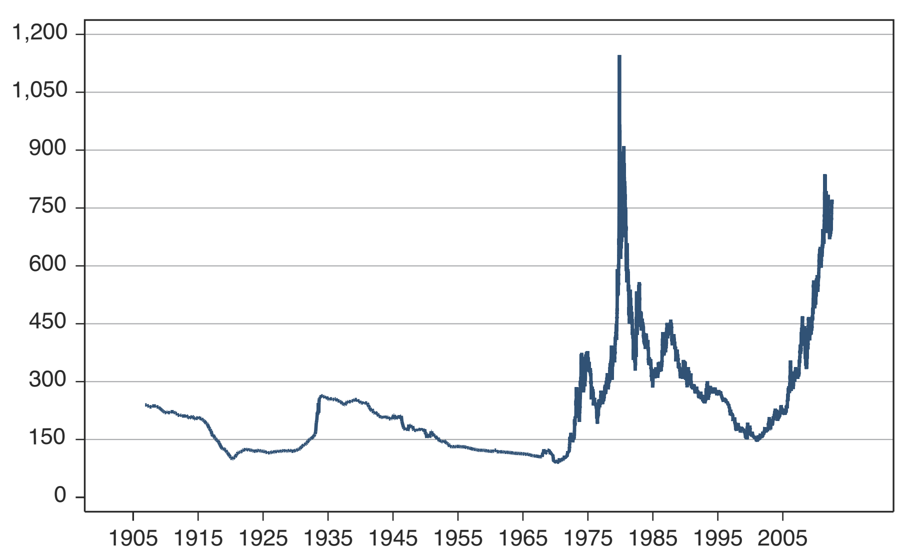
With no link between the quantity of US money or US monetary policy and the country's physical stock of gold, US monetary policy was not constrained. The overvaluation of the dollar grew until, by 1971, then-president Richard M. Nixon had to either stop pegging the US dollar price of gold at $35 an ounce or let the gold flow out and sharply tighten US monetary policy. He chose to close the gold window, ending the convertibility of the dollar into gold for foreign governments, as well as the Bretton Woods system. The break of the dollar peg to gold set the stage for a rapid increase in the dollar price of gold (figure 1), which was followed by a rapid increase in US inflation during the 1970s (figure 2).

The end of the Bretton Woods system began a new monetary regime that makes it very difficult to reinstitute a traditional gold standard. A combination of flexible exchange rates, permission for US citizens to own gold after 1974, and an absence of any link between the quantity of gold held by the central bank and the money supply has ushered in an entirely new system.

During the 1970s, sharp increases in the price of oil depressed US growth, acting as a tax on US consumers and producers. Efforts to maintain growth with accommodative monetary policy boosted US inflation and weakened the dollar against most other major currencies. With individuals able to own gold as an inflation hedge, the price of gold rose rapidly as US inflation intensified, and by 1979, it had reached over $800 per ounce. Higher

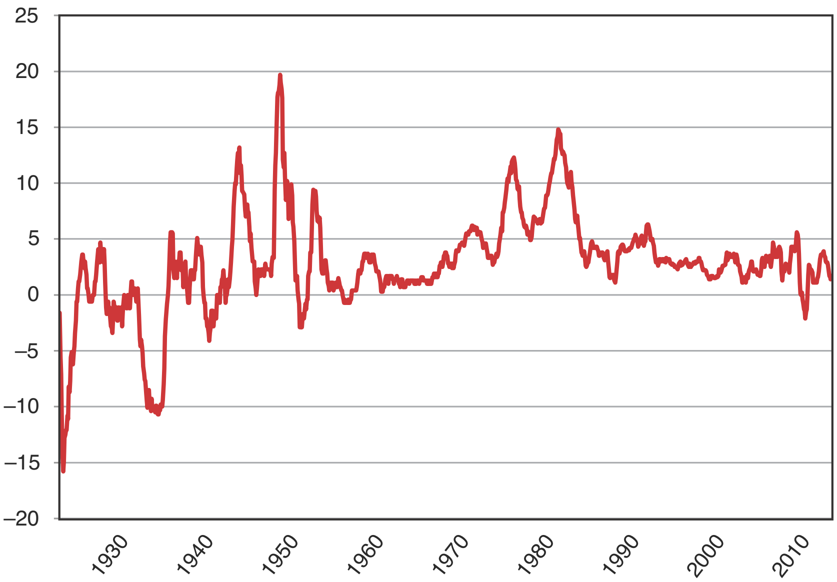
FIGURE 1

REAL PRICE OF GOLD (INFLATION-ADJUSTED US DOLLARS PER TROY OUNCE)



Source: Global Financial Data; George F. Warren and Frank A. Pearson, *World Prices and the Building Industry*; Commodity Research Bureau Commodity Yearbook; *Wall Street Journal*; Haver Analytics; Bureau of Labor Statistics.

FIGURE 2
CONSUMER PRICE INDEX, ALL ITEMS (PERCENT CHANGE, YEAR OVER YEAR)



Source: Bureau of Labor Statistics.

US inflation prior to 1971 had effectively pushed the United States off of a gold link that obliged it to sell gold to foreign governments at $35 an ounce. By 1980, US inflation was running well above 10 percent per year and interest rates on thirty-year bonds had risen above 14 percent, reflecting fears of ever-rising US inflation.

Volcker Tames US Inflation

A return to a gold standard or a gold exchange standard was not a viable option for the United States in 1980. There was a gold market to set the price of gold, and any government effort to set it at a different level would mean that the government would have to either acquire unlimited quantities of gold or sell unlimited quantities of gold to establish a new pegged price. Instead, the United States went on a "Volcker Standard." After he became Fed chairman in 1979, Paul Volcker simulated a tighter gold standard by sharply reducing money supply growth. The result was a sharp upward spike in interest rates as the Fed withdrew support from money markets, and a collapse in US growth. Inflation fell rapidly, and by 1982, the US economy began a sustained recovery.

The Volcker standard did a good deal to restore the Fed's credibility and commitment to low and stable inflation. (See figure 2). That commitment has been kept reasonably well over the past several decades, but it has been called into question given the tripling of the Fed's balance sheet in response to the 2008 financial crisis. Since then, the Fed has purchased over $2 trillion worth of government securities and mortgages. The result has been a sharp increase in the liquidity held in the US economy that many fear could not be withdrawn rapidly enough were prices to rise, causing a sharp reduction in the currently elevated demand for liquid assets on the part of households and firms.

That said, so far the rapid increase in the monetary base (cash and bank reserves), the result of the large increase in the Fed's balance sheet, has not been associated with any persistent rise in inflation or expected inflation. However, the Fed's September 13 introduction of QE3+ has increased the chance of higher US inflation because the Fed has signaled a willingness to tolerate higher inflation to reduce unemployment.[2]

The Fed's sharply increased purchases of government securities have partially accommodated a sharp rise in the issuance of government debt and will continue to do so under QE3+. Many gold standard advocates see the prevention of such accumulation as a primary reason for a gold standard. That said, enlarged foreign purchases of government securities, especially from China, have also accommodated enlarged deficit spending, to finance both existing programs and the numerous stimulus programs aimed at boosting growth in the weakened US economy. The surge in US deficits and the majority of the $7.7 trillion rise in the US debt over the past decade was financed only partially by a $2 trillion expansion of the Fed's balance sheet since 2008.

Further, so far, as evidenced by the continued fall in interest rates on US government securities, neither elevated inflation fears nor default fears have resulted from the Fed's expanded financing of US government borrowing. Interest rates on ten-year US government bonds, even after QE3+, are around 1.6 percent,

Figure 3
Real Interest Rates on Ten-Year Treasury Bills, Adjusted for Inflation (in Percent)

Source: Federal Reserve Board

to help them shift a larger share of tepid global spending growth onto their own exports of goods and services.

Consider for a moment a thought experiment wherein the US government unilaterally decides to fix the dollar price of gold at a level that implies lower inflation. Under the rules of the gold standard, that would imply setting the dollar price of gold at a level below the current world market price. But that would not work. At such a level, private gold buyers would purchase their gold from the United States and experience a windfall gain. The US gold stock would fall, and the US money supply would fall as well, given a rigid gold standard rule. That kind of a deflationary shock would be disastrous in the current environment, where the Fed and other central banks have promised highly accommodative monetary policies aimed at increasing their holdings of government securities.

It may be that the current highly accommodative stance of the Fed and the European Central Bank will be highly inflationary. QE3+ has increased the chance of this outcome. That unhappy result would sharply erode confidence in fiat money. Support might grow for the development of a new international monetary system that includes a gold standard or some other mechanism to limit central banks' ability to arbitrarily adjust the money supply to accommodate large government borrowing.

But in the absence of a hegemonic financial power, like Britain before WWI and the US after WWII, that is willing and able to peg its currency to gold, it is difficult to see how a modern gold standard would evolve and function. The gold standards like those in place during the late nineteenth century can deliver relatively stable prices, and perhaps falling prices if the supply of gold does not rise rapidly enough. But it also delivers high volatility in real output and tends to be associated with more financial crises. Like it or not, the modern world has grown used to central banks that aim at price stability and full employment and provide an elastic currency in

below core inflation and thus negative in real terms. (See figure 3.)

If investors are willing to hold US government securities earning far below their historical average of about 2 percent real yield, it is hard to imagine either that fears of inflation are rampant or that expected risk-adjusted returns on alternative assets are high. That said, the continued application of QE3+ may test the markets' complacency about future inflation. If inflation fears grow, the price of gold will rise further.

How Would a Gold Standard Work Now?

We are in a world still struggling with the aftermath of a financial crisis, where Europe has entered a bitter recession, the United States is experiencing sluggish economic growth and persistent high unemployment, and Chinese growth is slowing. It would be difficult for the United States to unilaterally engineer a return to a gold standard. Such a gold standard in a modern era of huge international capital flows would require an international agreement to fix exchange rates, something that seems highly unlikely—not to mention undesirable—in today's world of volatile markets and weak demand, where most policymakers would prefer a weaker currency an effort to achieve higher growth while avoiding financial crises.

If there is a gold commission after this year's election, it will probably discover—like the gold commission after the 1980 election did—that a unilateral American move toward a gold standard is not feasible at this time. That said, if a widespread episode of high inflation emerges in coming years, an international consensus may develop for a need to return to a more stable monetary system anchored to gold—a tall order in a world where no hegemonic country exists to peg its currency to gold and provide a benchmark for price stability for other countries.

Even the post-WWII Bretton Woods system broke down when the international reserve role of the dollar tied to its link to gold enabled the United States to run overly expansionary policies that eventually created inflation that eroded confidence in the dollar pegged to gold. The ease with which the US government brushed aside that link does not instill confidence in the durability of a new system that depends on a credible peg between gold and a major currency like the dollar.

Notes

1. John Makin, "The Fed Takes a Gamble," AEI *Economic Outlook* (September 2012), www.aei.org/outlook/economics/monetary-policy/federal-reserve/the-fed-takes-a-gamble.

2. Ibid.