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These articles argue generally against a gold standard.

Forum

ECONOMIC AFFAIRS / William Nordhaus

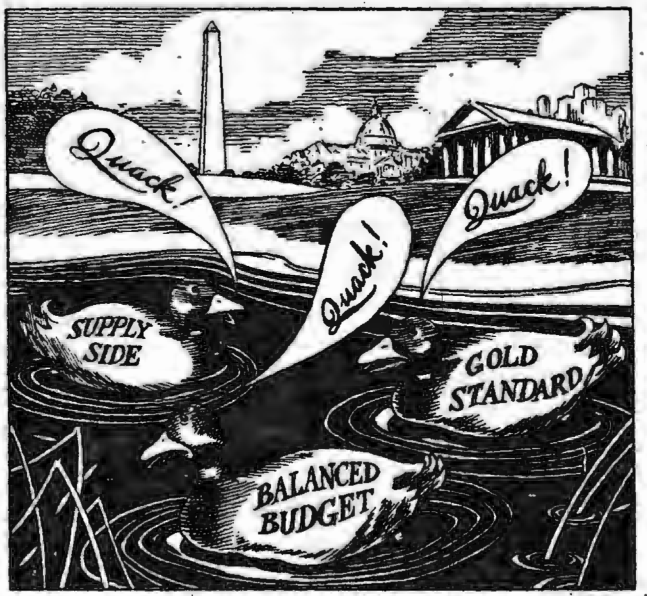
Gold in the Year of the Quack

HOW will 1981 be entered in the annals of the history of economic thought? Will it be recorded as a year of intense intellectual turmoil, of struggles to cast aside the discredited consensus of the 1960's and 1970's? More likely, I think, 1981 will be viewed as a period in which eccentric voices temporarily won the ear of political leaders, the year of the economic quack.

The first victory of the Quixotic Revolution was supply-side economics. After a decade in which economists and Presidents preached there were no easy answers, supply-side economists dashed their pessimism.

Soon, however, the supply-side elegance was called threadbare. Why are interest rates so high? Why is the deficit not disappearing? The answer, according to the supply-side theorists, is that our debauched paper standard should be replaced by a gold standard. They sing to the lords and ladies of Byzantium, of golden ages past, or passing, or to come.

Unlike the earlier supply-side proposals, the gold standard has a long and well-documented history. It may therefore be useful to review the various kinds of gold standards and to evaluate their usefulness today.



Proposals to return to the gold standard rest on the view that by relying on paper money the economy has lost its anchor and therefore is depreciating (prices are inflating) in a chaotic fashion. To correct this defect in the monetary mechanism, gold proponents would like to anchor prices to a commodity in such a way that prices will stabilize over the long run.

The fundamental technique for anchoring the dollar to gold is by defining money in terms of gold. Under the gold standard, we would peg the dollar to gold at some fixed parity, such as today's 0.00237 ounces of gold per United States dollar.

There are three levels at which a gold standard can operate: as international money, central bank reserves or national currency. As international money, gold serves as a medium of exchange and reserve among national governments, allowing them to settle accounts.

For the period from World War II until 1971, gold played just such a role. During the late 1960's, however, the gold standard was progressively unable to contain the centrifugal forces of undervalued gold, divergent inflation rates and an overvalued dollar. Consequently, in 1971 the dollar was formally taken off the gold standard and declared inconvertible into gold at the parity of $35 per ounce.

A second kind of gold standard occurs when a nation's central bank uses gold as its reserves, when gold forms the "monetary base" for the dollar. In this case, the money supply would be a multiple of the gold base.

The use of gold as a monetary base — although a fiction maintained until the late 1960's — dates back to the period before the central bank monopolized currency and made paper money secure. Today, proposals to link the money supply to gold have a completely different motivation. A rule that fixed the size and valuation of the gold stock and insisted the money stock be a fixed multiple of that, would force monetary policy into a fixed growth rate rule.

Such a fixed-gold-stock rule by itself is simply monetarism in gilt garb. Gold is completely unnecessary to enforce a rule that the money stock should grow at a fixed rate — such a rule is possible with today's banking system. Its wisdom or folly depends not at all on whether the monetary base is paper or gold.

A FINAL version of the gold standard, gold as national money, occurs when a national currency is defined in terms of gold. Such a situation bears a superficial resemblance to the first plan. But while in the first plan gold is used simply to settle accounts between different nations, under the third plan gold actually becomes a legal tender. Either the Government or private parties then pledge that their i.o.u.'s will be paid in gold at the official price. Under this plan, unlike the first, no devaluation is allowed to occur. You cannot one day be told to exchange your dollar for 50 cents.

Of these three concepts, the most likely to be proposed is a combination of the first two — return to a gold-backed dollar, with a tie of the money supply to gold.

What are the pros and cons of a gold standard? The major argument in its favor is that, if the political authorities cannot be trusted to maintain appropriate economic policies, particularly to stabilize prices, then a gold standard will provide an automatic anchor for prices. Unfortunately, not only is the anchor sometimes unreliable — indeed dangerous in stormy weather — but the gold standard poses many serious difficulties as a tool for managing the economy.

First, if the dollar had followed the trends of gold, prices would have followed a roller coaster much worse than they otherwise did in the 1970's. The inflation rate in terms of gold was 58 percent in 1979, 98 percent in 1980, but negative 38 percent over the last year.

However subject to temptation central bankers are, it is clear that they have managed the dollar in such a way that it was much more stable than gold. In addition, the fate of the dollar would be intimately tied to the policies of suppliers like the Soviet Union and to gold holders such as the Organization of Petroleum Exporting Countries.

Second, because of the volatility of the price of gold, countries would be forced to build up stockpiles to buffer short-run price swings. This would require outlays of real goods and services simply to build a buffer stock to replace the much lower cost paper standard.

Third, even if the "technical" problems of managing gold could be solved, this would not lead to an easy cure for chronic inflation. Workers and managers who do not follow the esoterica of finance would have to be persuaded to wind down the wage-price spiral — at the cost of prolonged unemployment and excess capacity. It is hard to see why the cross of disinflation would be markedly reduced under the gold standard.

Finally, a workable gold standard must be joined by all major nations. The United States would therefore spend considerable political capital attempting to persuade others to join a new gold regime — after having forced its abandonment just 10 years ago.

What then is the appropriate role for gold? It has no place in the management of a modern economy like the United States. Fiat money, managed by the Federal Reserve, will serve the nation's varying and varied interests more securely.

As Macaulay wrote a century ago, "Those who compare the age in which they live with a golden age, which exists only in imagination, may talk of degeneracy and decay; but no man who is correctly informed as to the past will be disposed to take a morose or desponding view of the present." ■

William Nordhaus is John Musser Professor of Economics at Yale and a former member of President Carter's Council of Economic Advisers.

Comment Comment

Do We Need a Gold Standard?

JOHN H. MAKIN
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Despite the efforts of the Reagan Administration to lower anticipated inflation rates with a credible program of monetary control, interest rates have remained high. One explanation advanced is the view that markets are just waiting for the Fed to cave in again when tight money really weakens the economy. A gold standard is under consideration as a means effectively to tie the U.S. money stock to an arbitrary commodity standard thereby removing the possibility of a discretionary return to easy money policies.

A Gold Commission has been formed to consider the possibility of a return by the United States to a gold standard. The commission has held an initial meeting and is reportedly scheduled to meet again to discuss a preliminary report. Membership on the commission is diverse and so a wide range of views will be aired. The important questions surrounding the gold standard concern what form it will take, its international implications and, most basically, whether it will accomplish its stated objective more effectively than some alternative plan.

Workings of a Gold Standard

A gold standard for a closed economy is a relatively simple proposition. Under a credible gold standard U.S. citizens would be allowed to own gold. The government would offer to buy or sell gold at a fixed price expressed in terms of dollars.

In principle the initial price chosen does not matter. If the initial dollar price of gold set by the government is perceived by dollar holders to be too low, the dollar will be overvalued against gold, and deflation will ensue as dollar holders convert dollars into gold causing the supply of dollars to fall. This process will continue until the supply of dollars shrinks relative to the available supply of commodities sufficiently to cause enough dollar appreciation (deflation) to validate the initially "low" dollar price of gold. Of course if the price is set too high the government must buy gold, thereby monetizing it and causing inflation until the "high" dollar price of gold is validated.

In actual practice the shock involved in the transition to a gold standard will depand rather critically on what dollar price of gold is selected. A price set too low causes deflation and attendant ills while a price set too high would only exacerabate inflation. While crucial, selection of the "right" price will not be particularly easy.

The market price of gold, currently just over $400 per ounce embodies daily the current expectations of market participants regarding its use as a commodity and as a reserve asset. If rumors of a U.S. gold standard became credible, market prices would be strongly affected by speculation about the level at which the price would be set.

If the U.S. government were to say that it would simply select the market price on the day the standard was implemented, speculators would buy as much gold as possible, bidding up the price and then sell the gold back to the government once the gold standard became effective. Everyone but the last buyer at the close of business on the day before the standard went into effect would make money. In effect the price would assuredly be set too high and thereby the policy would be inflationary.

This scenario, while unlikely, does illustrate a fundamental problem in implementing a gold standard, that of selecting an initial price and maintaining it. A price that at any time seems wrong to the market can cause either inflation or deflation, thereby either frustrating the original purpose of the standard or causing an abrupt drop in the money supply which would very likely result in temporary but sharp dislocations in labor, financial and commodity markets.

These problems are multiplied by international implications of a U.S. gold standard. First, consideration must be given to the exchange rate regune that would accompany such a standard. Traditionally, fixed exchange rates would accompany a gold standard. This format would require decisions by all major industrial countries on the exchange rate at which they wish to peg their currency to the dollar. Alternatively, it would be possible to continue with the current regime of limited floating or even free floating with a U.S. gold standard, but exchange markets would then be tied to the vicissitudes of the gold market.

Suppose, for example, that a U.S. gold standard was accompanied by a return to fixed exchange rates. The results would be a system very much like the Bretton Woods system, gold-exchange standard with the additional feature that U.S. citizens would be permitted to buy and sell gold to the government, along with foreign governments. In effect the world would be on a gold standard. A dollar price of gold perceived to be "too low" worldwide would cause worldwide deflation while worldwide inflation would result from a price perceived to be too high.

Efforts by some governments to avoid the discipline of a gold standard would result in a crisis-prone system similar to the fixed-rate system of the late 1960s and early 1970s. If the dollar price of gold were set at a level which implied that foreign currency "x" was perceived to be overvalued relative to the dollar (currency x price of the dollar "too low"), residents of x would convert their currency into dollars. If the government of x resisted deflation by sterilizing outflows, the process would continue until x's dollar reserves fell sufficiently to require devaluation of currency x against the dollar.

Under limited floating, the same adjustment for currency x would be accomplished by a combination of depreciation against the dollar and reduction of the supply of currency x in country x through outflows to the United States. With either fixed or floating exchange rates, however, the world monetary system would be subject to shocks originating in the gold market. Political problems which shifted up the demand for gold thereby causing the dollar to become overvalued at a fixed price would result in deflationary pressures. A major increase in the supply of gold would be inflationary.

If a discretionary gold standard were adopted to cushion the monetary system from "random" fluctuations in the gold market, the U.S. government would become involved in discretionary market intervention of the very sort it has eschewed in the foreign exchange market. Suppose, for example, that a war scare in the Middle East pushed

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up the demand for gold.

If central banks replenished the money stock exchanged for gold at a fixed price (sterilized the exchange) the excess demand for gold would persist unless the original reason for the increase in demand for gold disappeared or was in some way reversed. Failing this, chronic excess demand for gold would eventually exhaust official gold stocks and wreck the gold standard or require an increase in the dollar price of gold, which, if it occurred too frequently, would amount to the same thing.

Overall, a number of characteristics of a gold standard are unavoidable. First, a United States gold standard effectively means an international gold standard under which either relative money supplies or exchange rates are tied to shifts in demand and supply in the gold market. Even if an initial dollar price of gold is selected which clears the market, subsequent shocks to the gold market could make a gold standard either an engine of worldwide deflation or worldwide inflation.

Discretionary intervention by governments to shield their economies from vicissitudes of gold demand and supply could well be destabilizing and in any case would not ultimately shield economies from the instability inherent in an arbitrary commodity standard for money.

No Short Cut to Credibility

The initial thrust for a U.S. gold standard is probably related to an understandable frustration within the Reagan Administration that fixed-income markets won't believe that a serious, long-run program of monetary control is in place. A gold standard may appear to be a short cut to credibility on this crucial issue.

The difficult truth is that there is no such short cut. Gold standards legislated into existence can and have been legislated out of existence. Those who think current efforts to lower and stabilize money growth are a temporary measure will think the same thing of a gold standard. In addition, such a standard entails additional risks enumerated here.

There is a superior alternative to a gold standard that is under construction right now. Quite simply it is a central bank which consistently sets and consistently achieves non-inflationary growth of the money supply. The Federal Reserve, it appears now, has begun to do both. If it continues to do so, inflation and inflationary expectations will gradually disappear, notwithstanding existence of a single commodity standard. The basic need is to restore confidence in the overall commodity value of the dollar, not just in its gold value.

The Trouble With a New Gold Standard

By Alfred L. Malabre Jr.

A new species of gold bug has recently appeared in various parts of the U.S. It differs from the old-fashioned gold bug in a number of ways. It's more articulate, more concerned about politics, more complicated and potentially more dangerous.

The old-fashioned bug can be glimpsed in people like James Dines, Harry Schultz and the late Col. Edward Harwood. Through investment letters, books and speeches, their pitch back in preinflationary post-World War II years was simple. Invest in gold, they warned, because a big price spiral is on the way and when it arrives gold will soar.

They were right, of course, as their fortunate disciples can attest.

The new breed of gold bug is represented by people with weightier matters in mind than investment advice. They focus on such problems as high interest rates and unemployment. Their aim is to avert the economic chaos that now threatens, they maintain, unless the dollar is once again linked to the yellow metal.

How, in their view, would a gold-dollar link avert this impending chaos? Why do they press the case for gold at this time? Does it make good sense?

Examples of new-breed thinking appeared on this page Feb. 18 ("The Means to Establishing Financial Order") and July 30 ("The Case for the Gold Standard"). Both articles were by Lewis E. Lehrman, a drugstore-chain executive and a member of the U.S. Gold Commission, established recently by Congress to study the feasibility of tying the dollar to gold. The case for gold, as clearly set forth by Mr. Lehrman, boils down to this:

> Inflation and troubles associated with it stem mainly from excess money in the economy. The Federal Reserve isn't willing or perhaps even able to tailor the money supply to levels consistent with noninflationary economic growth. Unlike dollars, gold can't readily be overproduced. Over the centuries, gold output has climbed about 1.5% to 2% a year. That, by happy coincidence, is in approximate line with what many analysts, not just gold bugs, think constitutes a healthy, noninflationary growth rate for money in the long term. It follows that legislation mandating the exchange of dollars for government-held gold at a set price would bring an end to the inflationary overproduction of money.

Restoring the Economy

The chaos that the new breed foresees unless the dollar is made convertible into gold is depicted in a recent article by Jude Wanniski, a former editorial writer here who now heads a New Jersey-based consulting firm. He has worked closely over the years with Arthur Laffer, the California economist who gained wide attention in the 1970s with his "Laffer curve" theory that the economy could be painlessly restored to good health through tax cutting aimed at spurring work incentive. The cuts would bring a brisk, inflation-damping expansion in the economy's "supply side" and also serve—with the rise in business activity and thus tax receipts—to move the federal budget into surplus despite the tax cutting.

The tax legislation that President Reagan has pushed through Congress this summer contains much that Messrs. Laffer, Wanniski and other so-called supply-siders have long advocated. Accordingly, it's disquieting to read in Mr. Wanniski's Aug. 5 report to clients, titled "Now, Money," that the economic outlook remains grim. Indeed, he warns that "only a return to a gold-convertible dollar will spark a bond rally of major significance." He continues that there's "growing apprehension" that the Federal Reserve "will not be able to break inflationary expectations. ... The vision of GOP candidates ... having to defend 20% interest rates in 1982 is too awful to contemplate."

This hardly is the sort of commentary that one might have anticipated from a long-time promoter of supply-side tax cutting on the heels of sweeping tax cuts. At the root of the dismay, apparently, is concern that the Fed is under the influence of "monetarist" economists, such as Nobel-laureate Milton Friedman and Treasury Under Secretary Beryl Sprinkel. These monetarists espouse a slow, steady increase in the money supply, administered by the Fed without regard to actual short-term demand for money—which, in the supply-side view, should now begin to climb as the tax cuts inspire increased economic activity.

Mr. Wanniski argues that such monetarist policy just now produces a far too restrictive Fed policy that "is sucking short term capital from every corner of the world" and invites "global depression as we try to finance our deficits externally instead of through the release of internal resources that the Fed is strangling." He declares: "The public flogging of Beryl Sprinkel would do wonders for the bond market."

If investors were told, he continues, that "henceforth all government bonds will be redeemed in dollars that can be converted ... into a fixed weight of gold," there would ensue a "mad, global scramble to get into noncallable Treasury bonds." This scramble, he believes, "would drive long rates down so fast that [Budget Director David] Stockman would be able to balance the fiscal 1982 budget," which a recent congressional estimate places at some $60 billion in deficit.

The crux of the argument for tying the dollar again to gold, however, is that this would largely take money-supply management out of the Fed's hands. In essence, monetary growth would be linked to the government's gold stock. At present, Treasury coffers hold more than 8,000 tons of ...

An immediate question arises: In any return to a gold-dollar tie, what would constitute an appropriate official gold price? Too low a price would act to depress business because it wouldn't allow for a sufficient supply of money; too high an official price would tend, by the same token, to rekindle inflation.

Finding a price that's right is only one problem posed by a gold-dollar link. Mr. Lehrman is correct that growth of gold output "over centuries has been about 1.5% to 2%." However, that's a yearly *average*. In fact, a chart showing world gold production over the long term resembles a roller-coaster ride. In the past century, for example, the output level soared between 1890 and 1910, plunged for about a decade, soared for about two decades, plunged in World War II, soared again and so on. In some of those years the dollar was tied to gold; in others it was not.

Reasons for the output fluctuations include gold-field discoveries, new gold-recovery techniques, such as the use of cyanide, and wartime interruptions in mining activity. (It's no surprise that inflation in the U.S. began to worsen severely around the turn of the century, even though the dollar was on a gold standard at the time; this was precisely when vast new fields in South Africa were emerging and the gold rush was under way in Alaska).

Analysts generally doubt that further inflation-spurring discoveries are likely anytime soon. But there's concern over possible interruptions in gold output, which of course could prove deflationary under a gold-dollar standard. South Africa and Russia are the leading gold producers. Black-white tensions in the former could lead to production stoppages in some future racial blowup there. Cold-war tensions militate against depending on the latter as a source.

The deflationary possibility should be carefully weighed. Mr. Lehrman stresses that "the true gold standard has been associated with balanced budgets, reasonable price stability and low interest rates." The other, unmentioned side of the coin is that the U.S. was on a form of gold standard when the Great Depression began, until 1933. Inflation and high interest rates were [illegible] no problem in those dismal years, but massive unemployment was. Severe joblessness was also a sporadic problem in earlier decades when the U.S. was on a highly rigid gold standard.

An illuminating study of the Depression period was undertaken by the late Ragnar Nurkse, economist for the old League of Nations, in an out-of-print volume titled "International Currency Experience—Lessons of the Inter-War Period." In nation after nation, he reported, economic growth followed on the heels of a particular currency's "collapse"—that is, its departure from some previous fixed rate of exchange with gold and other currencies linked with gold. Mr. Nurkse indicated, in fact, that economic contraction during the period invariably occurred *before* a currency's collapse, when efforts were still under way to preserve its fixed value. He observed, for instance, that French currency was among the last to be cast free from a fixed link with gold, in late 1936. The French economy, significantly, didn't begin to pull out of the Depression until 1938.

'A Domestic Expansion'

Mr. Nurkse's conclusion from the statistical record of the 1930s was, essentially, that as each currency came unstuck from gold, this "was followed by a domestic expansion of investment and national income." He also found that such improvement, in case after case, tended "to stimulate foreign trade all around." A note should perhaps be inserted—that world gold output was appreciably higher as far back as 1910-15 than in the pre-Depression 1920s or the very early 1930s, when most key economies hit bottom.

It's also worth noting that the general U.S. price level declined sharply between the mid 1860s and the late 1870s—which happens to be one of the few intervals between 1834 and 1933 when the country wasn't on some sort of gold standard.

The list of questions posed by the idea of returning to gold is long. Proponents generally plug for an international as well as a domestic standard, but it's unclear that other nations would readily go along. Much of the complaint about present Fed policy is that it's too restrictive, but a return to gold could force an ever tighter Fed policy, in the absence of a new surge in gold production. A gold standard ultimately would depend on the willingness of government leaders to stick by it; if doing so necessitated a great deal of fortitude, would the standard long survive?

Altogether, the case against a return to gold is such that one must wonder why so many supply-side advocates appear so enthusiastic about the idea right now. A cynic might suggest that it neatly provides an "out" if, just possibly, supply-side tax cutting turns out to be a budget-buster instead of a painless, free-lunch route out of the current inflationary quagmire.

Whatever the explanation, a couple of points should be underscored. The Reagan administration conveys to many a take-charge, can-do image. A gold standard would serve to reduce its power to control the nation's economic course. More importantly, as the new chrysophiles are wont to emphasize, Washington's management of money remains highly imperfect. Focusing on the gold question—as in the recent creation of the Gold Commission—only detracts attention from where it should be: on improving monetary and fiscal policies so that the economy's future will prove happier than its recent past.

Mr. Malabre is a news editor of the Journal.

An Epistle to the Gold Commissioners

By Allan H. Meltzer

The gold standard is an idea whose time is past—long past. The classical gold standard is not a superior method of solving our current problems of inflation and unemployment, whatever its merits a century ago.

Advocates of a return to gold offer their nostrum as a means of stabilizing prices but offer few details about how to reach this desirable goal. All we are usually told is that the gold standard is a "supply-side" solution, which will reduce interest rates, stabilize prices and eliminate the summer's excess supply of zucchini. None of these claims is true.

The fact is that a gold standard stabilizes only one price—the dollar price of gold. Whether other prices, for example an average of the prices of the goods and services that people buy and sell are relatively stable or unstable then depends on what happens to the aggregate demand and supply of these goods and services.

Suppose the world price of oil falls and Arabian sheiks or Iranian mullahs sell gold to maintain their spending. The U.S. must buy the gold to prevent the gold price from falling. This expands the domestic money stock—whether that stock is entirely in gold or is a mixture of gold and paper with gold backing. The required increase in the money stock raises aggregate demand and the prices of all other goods and services in the U.S.

There is nothing special about oil. A failure of the Russian wheat crop, the growth of world productivity relative to U.S. productivity, world inflation—any sizable change affecting world demand and supply of goods and services—would cause domestic prices to change.

Most Classical Period

These are not speculations about what may happen. They describe what did happen under the gold standard in its most classical period. Prior to 1913, we did not have a central bank. Gold coins circulated and checking deposits, many bonds and other financial assets were redeemable in gold.

The U.S. price level was not stable from year to year, or decade to decade. The price level was approximately the same in 1913 as in 1882, but this gives a misleading suggestion of stability. Prices of goods and services fell 47% in 1882-96, then rose 41% from 1896 to 1913.

Real economic activity was more variable under the gold standard than in the recent past. Recessions lasted twice as long, on average, from 1879 to 1913 as in 1945-80, and expansions and recoveries were about one-third shorter. Per capita real income, a useful measure of the living standard, rose more slowly. The most reliable statistics suggest that real per capita income rose a bit faster in the disappointing decade of the 1970s than under gold prior to 1913.

All economic problems cannot be blamed on the monetary standard or cured by changing the monetary standard from gold to paper or from paper to gold. Comparisons of events in 1879 to 1913 with 1945 to 1980 cannot, by themselves, decide whether the gold standard is superior or inferior in some global sense.

They do tell us that the gold standard neither guarantees nor brings smoother growth in standards of living, higher real growth, shorter recessions, more durable expansions or year-to-year price stability. If we care about these things, we should have second thoughts about returning to a gold standard.

Advocates of gold complain about current variability of money growth and the uncertainty created by changes in monetary policy. A return to gold does not solve these problems. The gold standard makes the quantity of money in the U.S., and its rate of growth, depend on the decisions of Arabian sheiks, South African central bankers, the productivity of foreign workers, the budget and monetary decisions of major countries and other factors.

From 1879 to 1913, many major countries adopted or remained on the gold standard. They accepted part responsibility for fixing gold's price. Every 50 years or so, the demand for and supply of gold brought the broad index of prices of goods and services into an equilibrium that was the same as the equilibrium reached about 50 years earlier.

The belief that prices will return to the same value within a few decades probably reduced the cost of financing long-term capital, like railroads, a principal investment in the late 19th Century. But it is a mistake to regard the gold standard as a guarantor of price stability even in this long-term sense.

The supply of gold depends on discoveries and improved methods of mining and extraction. Nothing in the gold standard mechanism guarantees that relative changes in demand and supply for gold will return the price level to some fixed value every 50 years or every century. This happened in the past because gold deposits were discovered, better methods of extraction developed and banking panics occurred often enough to wipe out some of the money stock and lower the price level.

The only permanently fixed price under a gold standard is the one that the government fixes—the price of gold. The alleged discipline of the gold standard is a political decision to set the price of gold once and forevermore.

Gold standard advocates should be praised for insisting tirelessly that the only way to maintain price stability is by controlling money growth and for reaffirming that the most reliable way to control money growth is from the supply side. These are views that they share with people like Milton Friedman or the members of the Shadow Open Market Committee whom the press describes as monetarists.

Similarity in the views of monetarists and advocates of the gold standard does not extend to the means of controlling money from the supply side. Monetarists insist there is only one way to control money reliably. The central bank must control the size of its own balance sheet by restricting the dollar value of the assets it buys. About 90% of the assets are government securities purchased in past failed attempts to set interest rates or exchange rates.

If the Federal Reserve controls the amount of assets on its balance sheet, the principles of double-entry bookkeeping *guarantee* that their liabilities are controlled. These liabilities, and the corresponding assets, are known as the monetary base, so the monetarist prescription is: Control the size or growth rate of the monetary base.

Without divine intervention, neither the Fed nor anyone else can control the monetary base, interest rates and exchange rates simultaneously. We are—they are—permitted to make one choice from these three (and all the other) proposed targets.

Many attempts to watch multiple targets by using the 24 collective eyes on the Federal Reserve committee that makes monetary policy decisions convinced a majority of the committee's 12 members that one target achieved is better than a basketful of failed promises. The 24 eyes are now glued on one target—the announced growth rate of the money stock—in hopes of repairing the Fed's damaged credibility. Let's hope they stay there.

A gold standard is not a more believable or reliable way to control money or the monetary base. Such statements are the very opposite of the truth because no one can choose both the price of gold and the rate of money growth. If the announced price of gold is too high compared to the demand for gold and the world supply of gold, gold flows to the U.S. People pound on the door, offering gold in exchange for dollars. The Fed, or the government's gold buyer, is required to issue more money. The stock of money increases, and prices rise. If the announced price of gold is too low, people offer dollars and buy gold. The stock of money falls and prices fall. If these changes in offers and demands for gold are difficult to forecast, and they are, we have booms and recessions whenever there is a large change up or down in the demand for gold.

No Doubt About the Effect

Again, these are not speculations about what could happen. They are a description of the past performance. After Franklin Roosevelt decided in 1934 to raise the buying and selling price of gold from $20.67 to $35 an ounce, we did a lot of buying. The stock of monetary gold rose 50% in the next three years. Prices rose, despite the Depression. To prevent the effect of gold purchases from further expanding the money stock, the government thereafter sterilized the effect of gold on money. Whatever one believes about the wisdom of these and subsequent decisions there is no doubt about the effect of the overvaluation of gold on the money stock.

Where would you set the gold price to prevent a repeat of the inflationary gold flows of the '30s, or deflationary gold flows? Don't make the mistake of thinking that someone else knows the right price to set and keep constant for the next 100 years. He doesn't. That's why advocates of the gold standard never suggest or hint at how or where the price of gold should be set to stabilize prices in an uncertain world. And don't look to the market for guidance. The market changes its collective mind every minute.

The administration knows that we cannot fix exchange rates or the price of gold and control money. Treasury Secretary Regan and Undersecretary Sprinkel should be lauded for insisting on a freely floating dollar. A free float removes one obstacle to better monetary control. It is a step on the path to lower inflation that has yielded benefits.

Other steps could be taken to make monetary control more certain, more reliable and less variable. But it is a mistake to think that a return to the gold standard is one of them.

Mr. Meltzer is professor of political economy and public policy at Carnegie-Mellon University.

All economic problems cannot be blamed on the monetary standard or cured by changing the monetary standard from gold to paper or from paper to gold.

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Business

THE GOLD STANDARD

Why We Ought to Go Slow

By JAMES E. SINCLAIR


Oliver Williams

THE appointment of a Federal commission to re-examine the role of gold in Government has done more than redeem a Republican platform plank and one of Ronald Reagan's campaign promises. It has touched off a new debate on gold that is tinged at times with more theological fervor than market wisdom.

Jude Wanniski, an economic consultant and one of the more outspoken supporters of a return to the gold standard, has argued that nothing less than a return to gold convertibility can bring down interest rates.

This device is appealing in its simplicity. In the kind of world that prevailed for much of the 19th and early 20th centuries, when the causes of world economic and political order were well served by the gold standard and the British Navy, it might work again. But today, gold is less a commodity and medium of exchange than a barometer of world anxieties, and under pressure of alarming news, gold demand can fly off the scale.

Such none-too-fanciful events as the fall of the House of Saud in Saudi Arabia, an announcement that Libya or the Palestine Liberation Organization had acquired nuclear weapons, a turn of events in Iran favoring the Soviet cause or a major Soviet military incursion in Southern Africa would touch off a run on the gold supply.

To proclaim convertibility — a standing offer to buy or sell unlimited quantities of gold at published prices — would, under these circumstances, be the monetary equivalent of lighting a fuse to a nuclear device.

Convertibility works best in a stable environment, a condition in which price and demand are so finely tuned that conversion is an unused option. In this circumstance, convertibility serves as a form of discipline upon the nation's money managers, not an option likely to be exercised. But in today's world, the risk is high that convertibility would result in conversion.

The Treasury might well be caught between depleting its gold stock or closing the gold window. Those were just the choices facing the Nixon Administration in August 1971 and the decision was inescapable. The Treasury ended convertibility and with it Washington's last direct link to the gold standard.

Those familiar with the day-to-day market operations have noted a shift in what moves them, particularly interest rates. As recently as the 1950's and early 1960's, economists assumed that interest rates were a function of the money supply, that a rapidly expanding money stock tended to foster low interest rates and slow or negative growth. But that relationship between money supply and interest rates became less predictable as psychological factors, particularly expectations, have exerted great influence on market behavior.

The apex of this trend was reached in January and February of last year, and since then markets have been responding more to fundamental factors and less to technical ones. One of the most important fundamental factors is rate of change. If money supply is increasing at an accelerating rate, that has a different impact on interest rates than if the money supply is increasing at the same rate, but at a decelerating rate of change because of the pace of inflation. Also known as the volume theory.

At a time when fundamentals are reemerging as a market force and interest rates appear to hinge more on what is happening and less on which might happen, there is some risk that the reintroduction of gold convertibility would bring upward pressure on rates.

THE volume theory of money, discussed above, made defunct by the onsurge of psychology seems to be operative in the market again. It could happen that convertibility would slow the growth of the monetary supply, making money dearer in the market place, thus pushing up interest rates. And any automatic brake now on money growth risks becoming the cure worse than the disease, especially when disinflation may be surfacing.

Mr. Wanniski has argued that gold-backed Government securities could be sold at far lower rates of interest than conventional Government bonds, enabling the Treasury to save large amounts on interest charges. This merits careful examination.

Indeed, if the lender could be assured that his capital, guaranteed in the form of gold, would retain its purchasing power, he could afford to lend his money for a nominal rate. However, the recent history of bullion-backed bonds gives some grounds for caution. One mining company sold an issue of bonds backed by silver, and some gold-backed bonds have been marketed in Europe recently. In all cases, these issues were received somewhat warily by potential buyers. Whether the Government could market enough such bonds to meet its full borrowing needs is a matter deserving careful study.

It is also worth remembering that one of the events that brought the roof down on the major silver speculators in March 1980 was their proposal to float an issue of bonds backed by their large stocks of silver. To the market, this move indicated weakness and helped touch off the nearly disastrous events of Silver Thursday, March 27.

If the Government floated a substantial issue of bonds secured by gold and returning a low rate of interest, what would happen? According to Mr. Wanniski, these bonds would find a ready market, even at a low coupon. My view is that these bonds would stampede the market only if the buyers anticipated an ongoing rise in the price of gold, in other words, continuing inflation.

But accepting the Wanniski scenario for a moment and assuming that the new gold-backed bonds proved highly popular, what would this do to the balance of the Treasury securities outstanding? Why would anyone buy an unbacked bond if gold-secured bonds were so attractive? The answer is obvious. There is no distinction in the market between old securities and new securities, old interest and new interest, so the popularity of the new gold-backed bonds could only have a depressing effect on the great body of outstanding Treasury securities, pushing down prices and pushing up yields.

It is possible that we can once again move to a gold standard, but in a modern, revised form that takes account of the vast evolution of the markets since 1971. Such a standard can function as a useful economic tool, but only as a tool, not as the economy's major driving force.

Perhaps if the Reagan Administration succeeds in bringing inflation under control and thus breaks inflationary psychology, it may be feasible to move gradually toward a gold-linked currency. The first stage might well be the adoption of a gold cover clause, legislating that sufficient gold be maintained in the Treasury to guarantee convertibility, leading to full convertibility and a full return to the gold standard. Under these circumstances, it may be possible to return to a gold-backed monetary system without causing the havoc of deflation in the interim.

While I have long been an advocate of gold as an investment and an inflation hedge, I am no theologian of gold and believe that an ill-considered return to the gold standard carries risks fully as great as the inflationary cycle it is intended to correct. ■

James E. Sinclair is managing partner of the Sinclair Group of Companies, which are specialists in currencies and metals, including gold.

Good as Gold

The sudden interest in the gold standard—backing our paper money with gold—ultimately stems from the same romantic impulse that, from time to time, bestows great popularity on such misconceived schemes as wage-price controls: the yearning for some simple idea that will put everything right.

The gold standard is an unlikely *cause celebre.* Indeed, it has little superficial appeal. At heart, it reflects a basic mistrust of democracy. Moreover, it would potentially give foreigners, including the Soviets, more control over our economy.

But these liabilities haven't counted for much recently. In but a few months, the gold standard has traveled immense distances—from the oblivion of a crackpot idea to the fringes of respectability. A commission created by Congress is studying its feasibility, and *Business Week* recently devoted a long article to its desirability. Even the popular press is taking notice.

At one level, all this attests to the political acumen of gold's advocates. First they managed to have Congress create a study commission; that's the sort of sop willingly thrown to fringe groups. Then, acting like a few soldiers impersonating a division, they created sufficient clamor to get noticed.

But, at a deeper level, gold's appeal is emotional. People have lost their belief in standard economic ideas. Most conventional economists now appear as practitioners of the dismal science, not prophets of growth and betterment. Onto this bleak landscape suddenly appear gold advocates with a refreshing optimism.

Theirs is not an idea but a religion. Those who have the faith seldom doubt that salvation lies down the path of righteousness. Here is Lewis E. Lehrman, a successful New York businessman and perhaps the most sophisticated gold advocate, visualizing a gold future:

"The price level would stabilize rapidly. Long-term interest rates would fall [sharply]. At lower interest rates, there would be a vast demand for investment capital. With a stable price level, a stable dollar and lower relative tax rates, . . . a flood of savings would flow into the market. Equity and debt capital would again pour into business enterprise. The nation's productive plant would be rebuilt. Therefore demand for labor would rise. Unemployment would decline."

The gut argument for the gold standard is that all mortals, when entrusted with political power, are inclined to cheapen the coin of the realm—in modern terms, to inflate the currency by printing more money—to solve their immediate political problems. Tying money to gold places money creation beyond manipulation.

Under a true gold system, the government would back the dollar with a fixed amount of gold. People who didn't trust the dollar could sell their dollars to the government for gold. This would lower the dollars in circulation and, presumably, depress either the economy or prices. By the same token, people with absolute faith in the dollar could sell their gold for dollars, which, unlike gold, earns interest. This would increase the dollars in circulation and, presumably, result in either economic expansion or price increases.

Simple though this may seem, it is fraught with dangers. Economies need money to run on. The constant danger of gold is that the supply of the metal won't increase fast enough to provide sufficient money for economic expansion.

Precisely that problem arose in the late 19th century, when gold reigned supreme. Population growth and technological developments fostered economic expansion, but gold was scarce. The collision caused economic collapses and depressed prices. In turn, lower prices created widespread discontent among debtors and farmers, who had trouble repaying their debts in increasingly expensive dollars. Agrarian unrest then begot William Jennings Bryan's "cross of gold" speech.

The economic and social dangers today are even more fearsome. Markets no longer work the way they did in the 19th century. Institutionalized wage and price practices mean that the price structure has lost much of its downward flexibility. And the supply of new gold is inherently uncertain. About three-fourths of it comes from two potentially unstable or untrustworthy sources: South Africa and the Soviet Union.

Immense practical problems compound the gold standard's conceptual flaws. To implement the standard, the government would have to pick a price at which to buy and sell gold. Gold prices now fluctuate, but once the government pegged a price, that would become the market price. Whenever pressures threatened to push the market price above this level, people would buy from the government—and vice versa.

So it's vital that the government set exactly the right price. This would be difficult; since January 1979, the price of gold has fluctuated between $217 and $850 an ounce. If the government set the price too low, it would risk massive gold purchases—and a huge withdrawal of dollars from the economy. An excessively high price would risk a large inflation.

And even if the government hit the right price, its great skill—or luck—could be undone in a flash.

Suppose there were a revolution in South Africa. Or suppose the Kremlin undertook to manipulate gold markets. Or suppose a political crisis in Saudi Arabia, Poland or France prompted nervous foreign investors to increase their demand for gold. All these episodes would profoundly influence money markets and economic conditions in the United States.

What this sort of gold standard does is assign control of the U.S. money supply not to some stable metal but to the whims of an unstable world. Indeed, many economic historians believe that rigid adherence to the gold standard in the early 1930s helped deepen the Depression. Higher gold demand caused countries to follow restrictive policies.

Any sensible money system aims not only at price stability but also at prosperity and broader economic and social stability. In the 19th century world, where social sensibilities were meager and booms and busts an accepted part of life, the gold standard could concentrate on one of these tasks. Today, the political and social climate can no longer tolerate such a single-minded obsession. It's what makes running the economy such a frustrating and contradictory job. □

The Dangers of a Return to Gold

Wash Post 11/29/81 p. F1

In a troubled world, it is something of a joke that grown-ups who could be occupied otherwise are seriously discussing going back to a gold standard to regulate the creation and value of money. Perhaps, as economist Herbert Stein has suggested, we should consider going back even further, "to wampum."

The idea is denounced as ridiculous not only by conservatives like Stein, who thinks there are better ways of controlling the money supply, but also by liberals, Keynesians and others who view the gold standard as a straightjacket that has never performed the anti-inflation miracles true believers claim for it.

There isn't a single central bank, including the one in Switzerland, that wants to return to the gold standard (although the banks do want to maintain a role for gold in the international system of reserves).

But gold is getting new and serious attention from a Gold Commission appointed by Congress, which by next spring is to make recommendations "concerning the role of gold in our domestic and international monetary systems."

Although an overwhelming majority of the commission appears to

HOBART ROWEN/ECONOMIC IMPACT

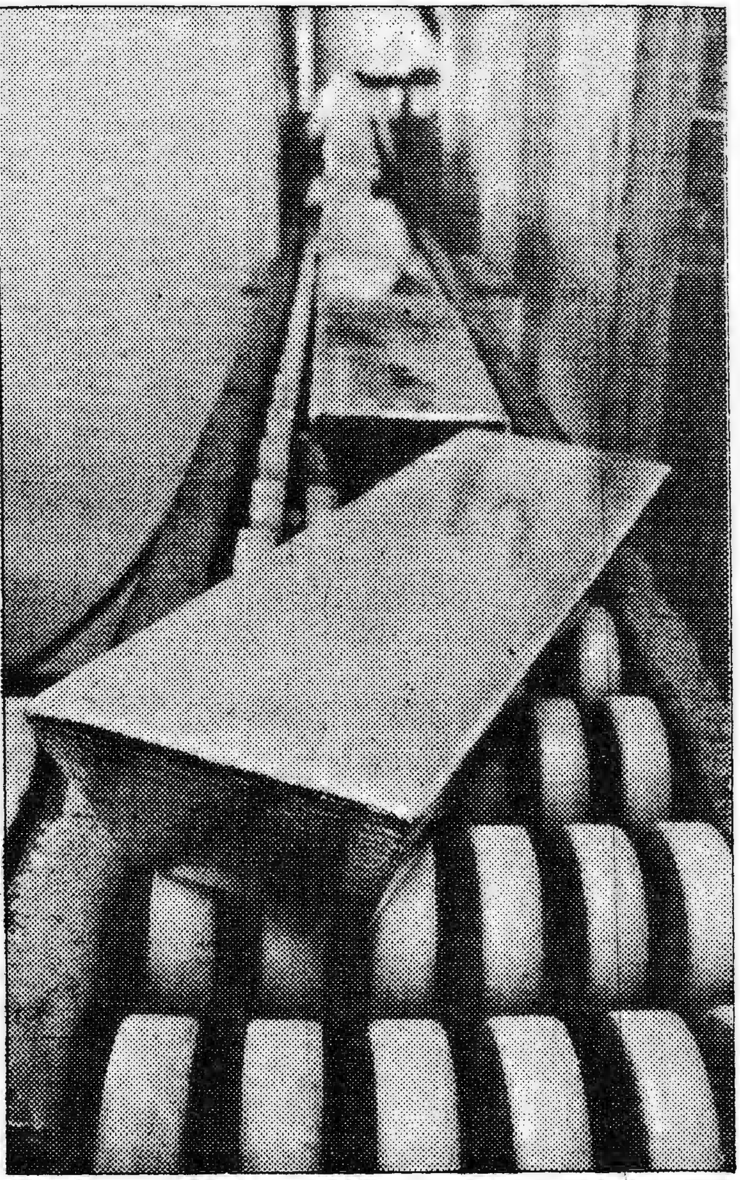
be against a gold standard, the idea is not being brushed aside. For example, Federal Reserve Board Governor Henry Wallich, one of the members opposing a gold standard, warned in a speech in Paris last week against "the simple arrogance of saying that the gold standard is ridiculous and not worth talking about."

Wallich's point is that modern-day methods of regulating the world's monetary affairs, adopted since the gold standard collapsed during the Great Depression, have not proved to be exactly brilliant or successful. A negative view of the gold standard, he holds, "must be based on the assumption that in the future, we can handle our affairs better than we have in the past."

That's fair enough. The gold standard would not be getting the attention it is getting, and there never would have been a Gold Commission, if the world's politicians and finance ministers had not exhibited such a thoroughgoing inability to regulate their countries' monetary or fiscal affairs or to promote economic growth.

In the United States, as David Stockman has certified for us, there is a disenchantment with Reaganomics. What Stockman, Wall Street and a lot of other people envision is not stable prices and full employment but inflation and huge deficits. And though a deficit is ac-

See IMPACT, F4



By Ken Feil—The Washington Post

Gold bars rolling off a production line in South Africa.

Commission

IMPACT, From F1

ceptable in the coming year to counter recession, it will be bad medicine when the economy may be expected to be humming along a few years down the road.

So along come the gold bugs, who say the only way to keep the value of paper dollars from eroding is to control the supply of money by tying its growth to the growth in the official gold stock. A correct price for gold would be established (itself quite a trick). The United States would then obligate itself to buy and sell gold freely at that official price.

Advocates of this system claim that so long as the gold price is

THE WASHINGTON POST

Should Block Return to Gold

steady, the dollar price of all commodities will remain steady. They claim that for more than 50 years prior to 1933, when Franklin Roosevelt took the nation off the gold standard, prices and exchange rates were steady.

There are lots of holes in this line of argument. As economist and gold expert Edward M. Bernstein points out, there was in fact a great deal of instability during this period, including the Great Depression itself and other financial panics. The "stability" gold bugs cite consists only of the fact that prices at the end of that 50-year stretch were about the same as they were at the beginning, a view which conveniently ignores the radical ups and downs that went on in between.

But suppose, for argument's sake, there had been price stability at a time when there was a gold-backed currency? That doesn't suggest that what may have worked in a horse-and-buggy era, when there was no commitment to full employment or other noble social goals, will work in today's much more complex and sophisticated world.

"In the global enviroment that prevailed for much of the 19th and early 20th centuries," says New York securities analyst James E. Sinclair, "when the causes of world economic and political order were well served by the gold standard and the British Navy, it might work again." He goes on to say that in a world dependent on instant communication, it would be easy to set off a run on the Treasury gold stock.

Imagine, he says, a successful revolution against the ruling House of Saud, or an announcement by either Yassir Arafat of the Palestine Liberation Organizaton or Col. Muammar Qaddafi of Libya that he had acquired nuclear weapons. Or imagine a Russian military incursion into South Africa. "In today's world," Sinclair concludes, "the risk is high that (gold) convertibility would move swiftly to conversion."

Bernstein points out that it wouldn't even take such cosmic developments to deplete the U.S. gold stock. "If members of OPEC could convert their current account surplus into gold at a fixed price, they would probably do so on a large scale," he says.

"Other countries could also decide to diversify their reserves by converting dollars into gold. Finally, private holders of dollars could present enormous amounts for redemption in gold if they thought the price was too low, and private holders of gold could sell enormous amounts to the Treasury for dollars if they thought the price was too high."

Many Americans, and the great majority of economists, Wallich concedes, still subscribe to Keynes' description of gold as "a barbarous relic." It is apparent that if the United States went back to a gold standard, we would be more dependent on the Soviet Union's and South Africa's decisions on how much gold to mine and market than on our own policy judgments and priorities.

Yet, as part of the monetarist revolution of the 1970s, and with the knowledge that President Reagan himself has a pro-gold bias, the danger is that the Gold Commission will be tempted to find a compromise, to throw a bone to the gold bugs, to do something that is not a total rejection.

One such proposal was made to the commission by monetarist Robert E. Weintraub of the Joint Economic Committee of Congress. Weintraub suggested a restoration of the regulation that until 1965 required the Federal Reserve to hold gold certificates—representing gold held in Fort Knox—as reserves against its paper notes and liabilities.

Weintraub argues that going back to the so-called "gold cover" will "put a lid on money growth and thereby stop inflation." He would start with a 9 percent cover, because that is the amount of gold certificates now held by the Federal Reserve, based on the legal value of gold at $42.22 an ounce. Weintraub would rigidly control future money-supply growth by gradually raising the legal value of gold until it exceeded $400 an ounce in 1988.

Weintraub's is a clever compromise: It would introduce a rigid rule into monetary policy, limiting money supply expansion by the annual amount of a pre-determined increase in the value of the "gold cover," thereby eroding the independence of the Federal Reserve. That takes care of what the monetarists want. And the gold bugs would get their foot in the door. Once they do, watch out! That's why the Gold Commission ought to block, firmly if politely, any effort to bring the barbarous relic back into the system.

Back to the Gold Standard?

Edward M. Bernstein

Persistent inflation and the inability of the United States to restore monetary stability have led to proposals to return to the gold standard. Bills have been introduced in the Congress to establish a gold coin standard and a flexible gold standard based on an adjustable price for gold. More important, Public Law 92-389, authorizing an increase in the U.S. quota in the International Monetary Fund, provides for the establishment of a commission of fifteen members under the chairmanship of the secretary of the Treasury, to "assess and make recommendations with regard to the policy of the U.S. government concerning the role of gold in the domestic and international monetary systems and to transmit to the Congress a report containing its findings and recommendations not later than one year after the date of enactment of this Act."

Edward M. Bernstein is an internationally recognized monetary expert and a guest scholar at the Brookings Institution.

The interest in returning to a gold standard is based on the assumption that if the creation of money were limited, inflation would stop for lack of the monetary fuel that powers it. Much of the support for a return to the gold standard, however, is based on an idealized view of the 100 years of the classical gold standard as an age of unparalleled monetary stability and economic progress. The fact is that under the gold standard prices rose and fell for twenty to thirty years at a time, and the history of prices in that period was one of alternating inflation and deflation.

Prices and Crises under the Gold Standard

The first inflation peak for which there are reasonably good data occurred in 1815, in Europe because of the Napoleonic wars and in the United States because of the War of 1812. From then until 1843, the U.S. wholesale price index fell by nearly 60 percent. After 1843, wholesale prices in the United States rose by 157 percent in the twenty-one years to 1864. Most of the rise, however, occurred during the Civil War, when the term inflation was coined. Prices fell moderately again in the following ten years. In Europe, which was on a silver, gold, or bimetallic standard, prices rose by about 60 percent in the thirty years to 1873.

In that year, the principal trading countries began to follow the newly created German Empire in abandoning the silver standard or the bimetallic standard and adopting a gold standard. This greatly increased the dependence of the world economy on gold production to provide the reserves necessary for the growth of the money supply. It was also the beginning of a new period of deflation. From 1873 to 1896, wholesale prices fell by 49 percent in the United States and slightly less in Europe. After the deflation ended, the U.S. wholesale price index rose by 233 percent between 1896 and 1920, mostly during World War I. Even from 1896 to 1913, however, U.S. wholesale prices rose by 50 percent. From 1920 to 1932, the U.S. wholesale price index fell by 58 percent, with most of the fall occurring in 1921. After this early postwar plunge in farm prices, the U.S. wholesale price index fell by one-third from 1922 to 1932.

The gold standard was marked by recurring monetary crises that sometimes degenerated into financial panics. In his *Business Annals*, Willard Thorp identified twelve such crises or panics in the United States and seven in England in the hundred years from 1815 to 1914. The crises were periods at the peak of the business cycle when it was not possible to meet the increased demand for currency and credit so that prices plunged and interest rates soared. The panics were extreme crises, usually accompanied by numerous bankruptcies. In England, the crises were due to the rigidity of the Bank Charter Act of 1844 and the modest size of the free gold reserves that the Bank of England customarily held. This made it impossible to meet currency needs in an emergency except by suspending the gold reserve provision of the act, which was done on a number of occasions. In the United States, the national banking system provided no flexibility at all in the issue of currency, and that was the cause of the recurrent crises.

The depressions that occurred twice in the nineteenth century and reached a new level of severity in 1929–33 resulted from the interaction of great wars and the gold standard. In brief, wartime inflation exhausted the money-creating power of a gold standard system. It was impossible to continue the growth of the money supply at a rate that would have sustained the price level reached during or immediately after the war. Furthermore, the inflation engendered by the war was very unequal among the belligerents, so that maintenance of the gold standard or a return to the historical gold parity of the currency required the more inflated countries to deflate their prices and costs. This created centers of deflation in the world economy that spread from country to country as they competed in deflating the money supply in order to protect their gold reserves.

What the Gold Standard Requires

There have been many forms of the gold standard, but they all had a few elements in common. First, the value of the currency was defined as a fixed weight in gold, and this gold parity was considered immutable. If the gold standard had to be abandoned in time of war, it was a moral imperative to restore it promptly after the war at the historical parity. Second, all forms of money were maintained equivalent in value to gold. This required the free coinage of gold to prevent the value of money from rising above that for gold and the gold convertibility of the currency to prevent the value of money from falling below that for gold. Third, the money supply was limited by the gold reserve. The usual link was to require a proportionate gold reserve against the currency and deposit liabilities of the central bank. Most important, the monetary authorities were expected to change their policy in response to the inflow or outflow of gold.

Crises and Panics in the United States and United Kingdom, 1815–1914[a]

Year	*Event*	*Country*
1815	Crisis	United States and United Kingdom
1825	Panic	United States and United Kingdom
1833	Panic	United States
1836	Panic	United Kingdom
1837	Panic	United States
1839	Panic	United States
1847	Panic	United States and United Kingdom
1857	Panic	United States and United Kingdom
1866	Crisis (severe)	United Kingdom
1873	Panic (violent)	United States
1882	Panic	United States
1890	Crisis	United States and United Kingdom
1893	Panic (severe)	United States
1907	Crisis (severe)	United States

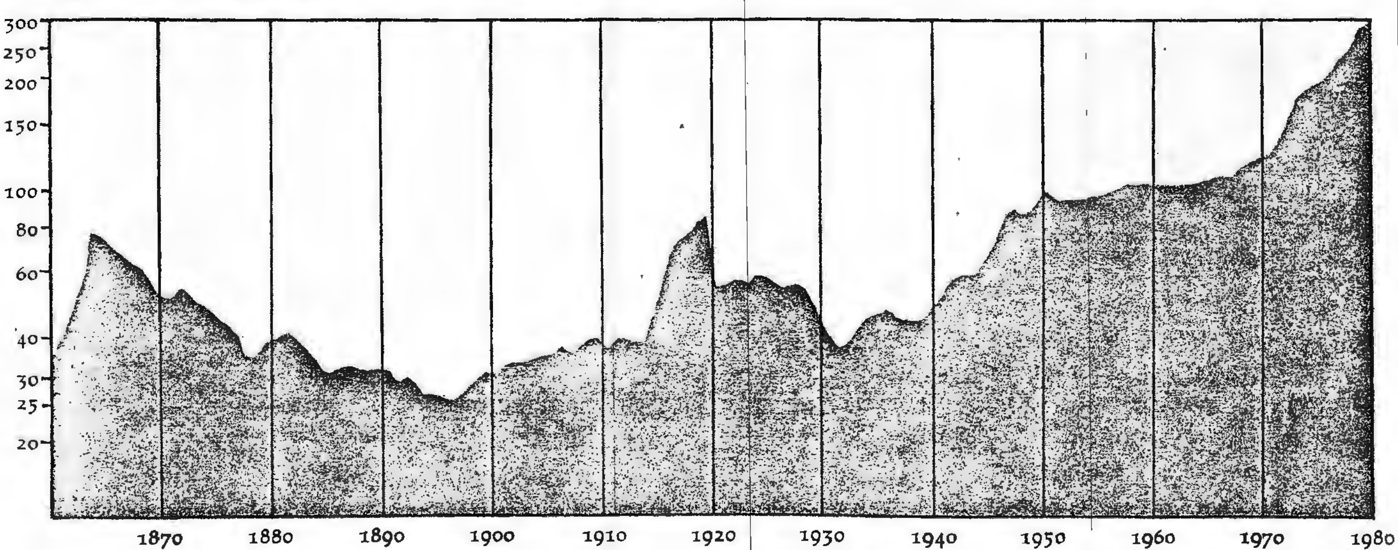
Source: Willard Thorp, *Business Annals* (National Bureau of Economic Research, 1926), pp. 42 and 44.

a. Does not include fourteen recessions in the United States and nine in the United Kingdom that are not classified as crises or panics.

By these tests, the gold standard came to an end in the Great Depression of the 1930s. Although by executive order under the Gold Reserve Act of 1934 the United States defined the dollar as 1/35 of an ounce of gold, there was no requirement of convertibility. The secretary of the Treasury, however, undertook to convert dollars into gold for foreign monetary authorities, but not for private holders, either domestic or foreign. This necessitated a major change in the operation of the inter-

Wholesale Price Index of the United States, 1861–1980

1957–59 = 100, ratio scale



Source: U.S. Bureau of Labor Statistics

national monetary system. Until 1933, exchange rates were kept within a narrow range (the gold points) by exchange and bullion dealers. When a currency reached the lower limit of the range, they converted the currency into gold, shipped it to the country whose currency was at the upper limit of the range, converted the gold into that currency, and sold it in the exchange market. Central banks bought and sold gold for their own currencies; they did not ordinarily intervene in the exchange market. The Gold Reserve Act compelled foreign monetary authorities to intervene in the exchange market if they wanted to stabilize the dollar exchange rates for their currencies.

As the money supply was determined by the gold reserve, an inflow or outflow of gold resulted in an automatic expansion or contraction of money and credit. Moreover, a large outflow of gold caused the monetary authorities to tighten money and credit in order to protect the gold reserve. This was orthodox monetary policy under the gold standard even during the Great Depression. During that depression, the money supply as measured by currency outside banks plus adjusted demand deposits fell from $26.7 billion at the end of 1928 to $19.8 billion at the end of 1933—a decrease of 26 percent. While monetary policy was directed toward protecting the gold reserve, which was slightly higher at the end of the depression than at the beginning, that was not the only reason for the deflation of the money supply. The depression reduced the demand for credit, and the fall in prices, profits, and incomes put pressure on the solvency of banks and their ability to supply credit. The Federal Reserve was not bold enough in countering these deflationary forces until the depression had become very severe.

The increase in the monetary price of gold from $20.67 an ounce to $35 an ounce in 1934 created the conditions necessary for recovery. It strengthened the competitive position of the United States in world trade and provided additional gold reserves to support a more expansionary monetary policy if that was considered necessary. In a basic way, however, the gold standard was changed after 1934. The dollar was still convertible into gold for foreign monetary authorities and the gold reserve requirements were unchanged, but the Treasury and the Federal Reserve no longer allowed the gold reserves to govern the money supply. This became apparent when the flood of gold into the United States after the devaluation increased the gold reserves from $4.0 billion (at $20.67 an ounce) at the end of 1933 to $22.8 billion (at $35 an ounce) at the end of 1941. In an attempt to avoid the enormous expansion of the money supply that the inflow of gold would have necessitated, the Treasury sold bills to finance its purchases of gold, which it then placed in an inactive account. The mounting interest cost as the gold piled up finally led the Treasury to terminate the inactive account and to monetize the gold it had previously bought.

A quite different problem emerged during World War II, when the gold reserves were reduced by $2.7 billion while wartime expansion of the money supply continued unabated. From the end of 1941 to the end of 1945, currency outside banks increased from $9.6 billion to $26.5 billion, demand deposits increased from $39.0 billion to $75.9 billion, and time deposits increased from $27.7 billion to $48.5 billion. With continued expansion of the money supply, the somewhat smaller gold reserves would not be adequate to meet the requirements on Federal Reserve notes and on the deposit liabilities of the Federal Reserve Banks, so legislation was enacted in 1945 reducing the gold reserve requirements. The gold reserves became inadequate for the money supply again in the late 1950s and 1960s, and the reserve requirements were reduced twice more until they were finally eliminated in 1968. Without a fixed limitation imposed by the gold reserves on the money supply, the United States could not be said to have been on a true gold standard.

Can the Gold Standard Be Restored?

It is possible to establish a gold standard if a country is willing to accept the restraints it entails and the economic consequences that may ensue. The minimum tests of a gold standard are (1) maintenance of the equal value of the currency and gold by the monetary authorities through the purchase and sale of gold freely at a fixed price, and (2) limitation of the money supply through gold reserve requirements, including the obligation to reduce the money supply when there is a diminution of the gold reserves. As a practical matter, a gold standard can function properly only as part of an international monetary system. Otherwise, sudden changes in the supply of or demand for gold would fall entirely on one country, as they did on the United States after 1934. Purchases and sales of gold by the monetary authorities at a variable free market price do not constitute a gold standard. Such gold transactions are merely another form of intervention in the exchange market and another type of open market operation.

Those who advocate a return to the gold standard assume that it would be possible to select some price of gold that would enable the monetary authorities to maintain the equivalence of gold and currency without being drained of their gold reserves or being swamped by a backflow of gold from hoarders, investors, and speculators. The change in the price of gold since 1973, and particularly its volatility, should make one skeptical of this possibility. It was possible to maintain the equivalence of the value of money and gold for generations under the classical gold standard because the allocation of private monetary assets between gold and money had been adapted to the traditional monetary price in the course of centuries. Changes in the preference for gold relative to money were small and took place gradually,

Because Soviet gold sales are so variable they cannot be regarded as a reliable source. But unless there were an adequate, steady, and assured growth of the monetary stock of gold, it would not be possible for a gold standard system to function effectively.

but the monetary authorities could keep gold and money equally attractive in the long run by allowing commodity prices to rise or fall with changes in the cost of producing gold and in the short run by changing interest rates, which raised or lowered the opportunity cost of holding gold instead of money.

Since the price of gold has ranged between $226 and $850 an ounce in the past two years, it is not possible to say now at what price the monetary authorities could expect to maintain the equivalence of gold and money under stable monetary conditions. If gold were an ordinary commodity, with production and consumption usually about equal, apart from relatively small changes in stocks, one could estimate what the price would be if supply and demand were at trend levels. In the long run, the price would have to reflect the cost of production and demand would be adjusted to the relative price of gold and other commodities. The supply of and demand for gold does not fit this pattern. Production accounted for about 59 percent of the supply in 1976–79 and consumption in the arts and industry—jewelry, dentistry, electronics, and other industrial and decorative uses—accounted for 70 percent of the private absorption of gold. The price has fluctuated sharply in this period with no apparent relation to changes in production or in the absorption of gold in the arts and industry.

The present price of gold and the fluctuations in the past two years were brought about by the demand of hoarders, investors, and speculators. Their demand is for holding gold as an asset, but the value of gold cannot be determined in the same way as the value of other assets. It is possible to estimate the value of such typical assets as stocks and bonds because they earn income. Their value is determined by discounting the future flow of earnings, and for bonds also the return of principal, at current interest rates. One may err in projecting corporate profits and the security of the principal of a bond, or the appropriate interest rate at which the flows should be discounted, but the method of valuation is clear. As gold is not an income-earning asset, it cannot be valued in that way. Its sole return to the owner is through a rise in price. What makes the price of gold $635 an ounce today is that buyers expect the price to be about $730 an ounce a year from now.

The view that the price of gold will increase at a rate in excess of the interest rate assumes that the present price is justified by economic conditions and that inflation will accelerate. The inflation of itself does not justify the enormous increase in the price of gold to its present level. At $635 an ounce, the purchasing power of gold as measured by the U.S. wholesale price index (290.8 in September 1980 on a 1957–59 base) is more than two and a half times as high as it was at the two previous peaks—in 1896, when the index was 25.4 and the price of gold was $20.67 an ounce, and in 1934, when the index was 41.0 and the price of gold was $35 an ounce.

The recent rise in the price of gold was not in response to the acceleration of inflation but to the political situation in Iran and Afghanistan. Without saying that world peace was an essential element of the classical gold standard, it is a fact that political disorder in the world adds to the difficulty of maintaining the equivalence of gold and currency at a fixed price. If, for example, the monetary authorities were to establish a gold standard now, with the price at close to the present free market price, a deterioration of the political situation could cause an enormous outflow of gold and a sharp contraction of the money supply, even if the economic situation should become more stable.

A Question of Supply

Under a gold standard, the increase of the money supply is limited by the increase in the gold reserves. Assuming that confidence in currencies were restored so that relatively little of the supply would be absorbed by hoarders, investors, and speculators, the growth of the monetary stock of gold would depend on newly mined production, net sales of the communist countries, and the consumption of the arts and industry. The production of gold outside the communist countries reached a peak of 41 million ounces in 1970, fell to 31 million ounces in 1975, and has remained at that level. The decline was almost all in South African production, although the output of other areas also fell slightly.

Sales by the communist countries, principally the Soviet Union, were very large in 1972–79. Such sales are for the purpose of acquiring foreign exchange to finance imports from the West. They are highly volatile, fluctuating directly with the Soviet balance-of-payments deficit and inversely with the price of gold. Because

Soviet gold sales are so variable, they cannot be regarded as a reliable source for the regular growth of the monetary stock of gold.

Even if hoarding, investing, and speculation were to fall to the moderate levels of the early 1960s, the supply of gold that could be added to the monetary stock would be very small. The absorption of gold in the arts and industry exceeded newly mined gold by 20 percent in 1976–79, though some of the gold purchased by fabricators may have gone into inventories. This occurred despite a large reduction in such use of gold in 1979 because of the high price and the economic slowdown in some industrial countries. Perhaps, if a gold standard with a fixed price of gold were restored, the gold-producing countries might increase their output. But unless there were an adequate, steady, and assured growth of the monetary stock of gold, it would not be possible for a gold standard system to function effectively.

The existing stock of monetary gold, apart from the holdings of the communist countries, is more than 1.13 billion ounces, including holdings of the international monetary institutions. Most countries carry these reserves at an average market value over a preceding period, although the United States still values its holdings at the old monetary price of $42.22 an ounce. No large country has monetized its gold reserves at the present price. These gold holdings constitute a huge reservoir of assets that would free the international monetary system from dependence on additions to gold reserves for the growth of the monetary base. Countries could monetize their gold holdings at a regular rate to assure the monetary growth they consider necessary. Sales could also be made from these gold holdings without the necessity of deflating the money supply, and purchases of gold could be added to these gold holdings if they were financed by sales of Treasury bills without inflating the money supply. But if the monetary authorities followed such policies, making the money supply independent of the increase or decrease in the gold reserves, it could not be said that the country was on the gold standard.

The bills introduced in the Senate (S. 3181) and the House of Representatives (H.R. 7874) would establish gold convertibility of the dollar or a gold coinage within a few months of enactment. This attitude of urgency in establishing a kind of gold standard is reminiscent of the debate on the resumption of specie payments after the Civil War. Some thought it would be prudent to accumulate a larger gold reserve and to reduce the amount of greenbacks in circulation before undertaking specie payments. Others, among them Chief Justice Chase, who had been secretary of the Treasury during the wartime inflation, believed that no delay was necessary, that "the way to resume is to resume."

Inherent in this approach to restoration of a gold standard is the assumption that if inter-convertibility of gold and dollars were established at some price previously determined in the New York market, purchases of gold from or sales of gold to the Federal Reserve Banks would by themselves adjust the money supply to an amount appropriate to the monetary price of gold. That could entail a large contraction of the money supply through Federal Reserve sales of gold or an excessive expansion of the money supply through Federal Reserve purchases of gold. It would be ironic if restoration of the gold standard were itself to have a seriously destabilizing effect on the money supply. Actually, it is questionable whether the monetary systems contemplated in the bills referred to above would constitute a gold standard in the usual meaning of that term.

The gold standard is not an end in itself but a means of achieving certain objectives. The first is to restore and maintain a reasonably high degree of stability of prices and costs. This cannot be achieved automatically by establishing gold convertibility of the dollar. It requires greater budgetary discipline, a more cautious monetary policy, and limitation of the growth of incomes to the growth of productivity. The second objective is to achieve greater stability of exchange rates. Initially, the target could be to maintain the average foreign exchange value of the dollar within a moderately broad range relative to the other currencies in a unit of Special Drawing Rights—the D-mark, sterling, the French franc, and the yen. Ultimately the dollar would have to be stable in terms of the strongest of these currencies. That would necessitate keeping down the inflation to the same rate as in the most stable industrial country and giving greater consideration to the behavior of the exchange rate in formulating monetary policy.

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These are the conditions that would have to be established before the United States could safely return to a gold standard. If the United States could achieve such a degree of price and exchange stability, there would be no need for a gold standard.