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Myths and Facts About the Gold Standard

No monetary system can absolve a nation of its fiscal sins.

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While many people believe the United States should adopt a gold standard to guard against inflation or deflation, and stabilize the economy, there are several reasons why this reform would not work. However, there is a modern adaptation of the gold standard that could achieve a stable price level and avoid the many disruptions brought upon the economy by monetary instability.

Let's start by clearing up some common misconceptions. Congressman Ron Paul's attraction to gold, and Federal Reserve Chairman Ben Bernanke's biggest criticism, is that a gold standard implies an end to monetary policy and the Federal Reserve. It does not.

Under a gold standard, the U.S. Treasury could exchange dollars for gold at a price of, say, $1,000 per ounce. In practice, that means banks would freely exchange their dollar accounts at the Fed for electronic claims to gold.

Nevertheless, the Fed could still buy government debt or other securities in exchange for newly created reserves, lend its reserves to banks, and set interest rates on its loans to banks. A gold standard would not stop the Fed from being the lender of last resort, bank regulator and financial crisis firehouse.

This isn't theory. It's history. The Bank of England operated an active monetary policy under a gold standard for two and a half centuries. And the U.S. Federal Reserve was founded under the gold standard in 1914.

Moreover, the history of the gold standard is not just happy centuries of price-level stability. It is also a long history of crises, devaluations, suspensions of convertibility, and defaults on sovereign debt.

Debauching the currency—the great bugaboo of gold-standard champions—will always remain a temptation: If the government promises $1,000 per ounce and a recession comes along, it can say "we need to stimulate. Now it's $1,100 per ounce." The success of a gold standard in achieving stable prices depends heavily on its rules and commitments against devaluation—rules honored in the past, until they weren't.

A gold standard does not eliminate debt crises or debt-induced inflation. No monetary system can absolve a nation of its fiscal sins.

Imagine a government with $15 trillion of debt, $2 trillion of money outstanding, and $2 trillion of gold reserves. Then its debt comes due. If the government can't raise tax revenues, cut spending, or persuade investors to lend against credible future budget surpluses, it must print $15 trillion of cash not backed by gold, devalue the currency, or default on the debt. Worse, if people see that outcome looming, they will run to change their money for gold ahead of time, causing a crisis as the government's gold stocks run out.

A successful gold standard needs a clear way to deal with such crises. Here is one plan: Instead of printing unbacked cash, the government lowers the coupon payments on its bonds and notes—similar to the way corporations can cut dividend payments. Of course, this is effectively a gentle "default" in times of stress. But at least a fiscal impasse would not lead to a devaluation of the currency.

Yet if you don't expect magic, you are not disappointed by its absence. With these warnings, a modern version of the gold standard is attractive.

Why not the old version? Most of all because the value of gold is poorly linked to other prices in the economy, which is what we want to stabilize. Fixing the price of gold today would do little to control the general price level. There are two big reasons for the disconnection between gold and other prices.

First, in the past, inventory demand for gold coins linked the value of gold to other goods. If prices rose, people needed to hold more gold coins to make transactions. They would spend less on other goods and services, which brought prices down again. But that channel is absent in a modern economy. Since people could buy and transfer gold deposits with a click of a mouse, nobody would have to hold substantial inventories. And we are not going back to a 19th-century payments system based on lugging around gold coins.

Second, features that made gold such good money in the past—it is hard to produce and has few other uses—make its price especially badly connected to other prices. The relative price of gold has skyrocketed, yet few of us abandon our jobs to go mine gold, and few of us substitute buying gold to buy other things. These economic pressures to realign gold and other prices are nearly absent.

The solution is pretty simple. A gold standard is ultimately a commitment to exchange each dollar for something real. An inflation-indexed bond also has a constant, real value. If the Consumer Price Index (CPI) rises to 120 from 100, the bond pays 20% more, so your real purchasing power is protected. In place of gold, the Fed or the Treasury could freely buy and sell such inflation-linked securities at fixed prices. This policy would protect against deflation as well as inflation, automatically providing more money when there is a true demand for it, as in the financial crisis.

The Fed currently interprets "price stability" to mean 2% inflation forever. A CPI standard could enforce 2% inflation. But why not establish a price-level target instead? The CPI could be the same 30 years from now as it is today, and long-term contracts could carry no inflation risk.

The Fed's main objection to a price-level target has been that 2% inflation gives it more stimulating power. With 2% inflation, setting a nominal interest rate of zero allows the Fed to achieve a negative 2% real interest rate, which may encourage people to borrow even more than at a zero real rate. Whether such interest-rate stimulation is needed, wise, successful on average, and worth its cost of perpetual inflation is the key question. I think not.

More deeply, the history of discretionary, shoot-from-the-hip monetary policy is one misstep after another, and of turbulence induced by guessing what the Fed will do. Since the demise of the gold standard, thoughtful economists have been searching for a replacement rule—Milton Friedman's money-growth rule, for example, John Taylor's interest-rate rule, and inflation or nominal GDP targets. Rules advocates understand that the economy works better overall with stable units, rather than the government manipulating units to trick us into buying more or less. A price-level standard is a firm rule.

In sum, a rule like the CPI standard could achieve the price-level stability that motivates the longing for a return to gold.

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