

Re-Establishing the Gold Standard: Fixing the Flag on the Titanic

By Michael Hart

- **A mounting public debt burden, the reintroduction of quantitative easing (QE) and the relentless slide of the U.S. dollar have prompted investors to seek refuge in perceived safe haven assets. This has not only pushed the price of gold to historical highs, but also reignited the debate on the establishment of a new monetary system anchored on gold.**
- **Advocates of a gold standard (GS) cite its ability to provide stability: It limits government profligacy by capping the central bank's ability to issue money and promises price stability by tying the supply of money to holdings of gold while the resulting constraints on the banking system avoid credit bubbles.**
- **However, a gold standard is no panacea. In the presence of unsustainable policies, a GS can prompt brutal economic adjustments and exacerbate inflationary/deflationary forces via accelerated capital flows. In addition, a GS is incompatible with the demands of modern economies, most critically a fractional reserve banking system and open capital accounts.**
- **More broadly, the crisis that has engulfed the advanced economies during the past three years may have many causes, but it is primarily a credit crisis. Tensions in currency markets are symptoms and collateral damage rather than the cause of the crisis. Accordingly, solutions also lie elsewhere.**

Fears of ongoing currency debasement abound as U.S. economic performance continues to disappoint, public debt climbs relentlessly and the Fed engages in another round of QE. These developments not only continue to depress the U.S. dollar, but also prompt investors to seek refuge in traditional safe haven assets. Aside from calls for increased policy and FX coordination in response to global economic imbalances, the combination of a sliding dollar and rising gold price has led to calls for new global monetary arrangement and in particular the reestablishment of some form of gold standard.¹

A gold standard can be thought of as a "multilateral commodity currency board." It is a currency board in the sense that it fixes the supply of money to an externally determined anchor, be it the U.S. dollar (as in Argentina during the "Convertibility Plan"), the euro (as in the Baltic States), silver (as in the U.S. from 1785 to 1806) or gold (as the Gold Bullion Standard in the UK from 1925 to 1931).² The effective abdication of monetary sovereignty is intended to impart credibility to tainted monetary authorities.³ But a GS extends beyond the commitment mechanism of a mere currency board in that it requires coordination of participating economies via the exchange of the reserve asset.

The advantage of a gold standard is that it ties the central banks' hands. The disadvantage of a GS is that it ties the central banks' hands. To wit: Advocates of the gold standard value it for its perceived ability to deliver price stability (as the money supply is tied to the discovery or acquisition of gold). In addition, the inability of the central bank to alleviate the public debt burden either explicitly through debt purchases or by inflating away the real burden puts an effective constraint on fiscal spending. As a consequence, credit

¹ Note that the current discussion was reignited by comments from World Bank head Robert Zoellik who argued for a system that used the gold price as a "reference value," not an outright gold standard. Nevertheless, we find it useful to frame the discussion in terms of a GS as it highlights the features of a fixed, commodity-based FX regime.

² Note that the Bretton Woods system operating between 1946 and 1971 actually established a "gold-dollar standard" whereby only the U.S. dollar was directly exchangeable against gold but other currencies maintained a fixed peg against the U.S. dollar.

³ Remember that the origins of the gold standard lie in the period of free banking. However, even today's central banks continue to experience credibility problems as they are faced with unsustainable policies. This problem was thought to have been put to rest with the introduction of central bank independence and explicit inflation targets.

bubbles such as the one experienced over the past decade would not easily develop. However, none of these benefits are assured, even under the rigidity imposed by a GS. In addition, there are further conceptual and practical considerations that condemn to failure proposals of a move towards a GS.

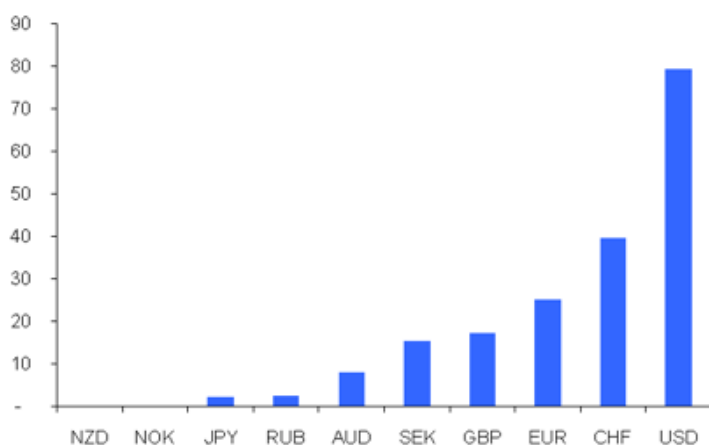
Adjustment Shocks: Under a GS, economic imbalances such as the ones that have increasingly characterized the global economy over the past decade (be it between China and the U.S. or within the eurozone) threaten either brutal adjustment or the survival of the system. Under strict GS, balance of payment surpluses/deficits are settled via physical shipments of gold, implying sharp adjustments in price levels over a short period. In turn, this forces radical adjustments in activity and employment. But unlike a simple fixed exchange rate regime, there is an endgame to this process: When a country runs out of gold as a result of successive deficits, it essentially goes bankrupt. And indeed, this is what has repeatedly led to the suspension or abrogation of GS systems in the past.

Conceptual Hurdles: A key difficulty is to determine what money really is. Is it simply the monetary base (notes and coins in circulation plus bank reserves)? Does it include private bank deposits? What about the multitude of transactions that are conducted electronically and in quasi-currencies? In addition, the quantity theory of money—which underpins the argument in favor of a gold standard—has been plagued by the inability to determine a reliable link between the supply of money to the target variable (be it inflation, nominal income or something else). Hence, even with a hard anchor, the outcome would be highly uncertain, all the more so if economic and financial transactions continue to evolve rapidly in nature. That being said, it appears fairly clear that money supply growth constrained by the discovery/acquisition of gold would be unlikely to support the economic dynamism world economies have become used to. While this pace of expansion may have been unsustainable given its reliance on excessive credit extension, there will likely be insufficient political will to accept such a cap on growth deliberately and ex ante.

Transition Difficulties: As some press commentators have pointed out, the stock of gold and the stock of deposits are wildly out of whack. While the level at which the money supply is fixed does not matter in principle, if it is too high the promise of a few grains of gold might not suffice to stave off financial panic. What is more, gold reserves are currently very unevenly distributed among reserve holders (**Figure 1**), implying inflation for some countries and deflation for others. Finally, G20 leaders have achieved little by way of coordination even in the thick of the financial crisis. U.S. Treasury Secretary Tim Geithner's recent suggestion that countries agree on current account targets was dismissed out of hand by his foreign counterparts. It is unlikely that agreement on such precise parameters as would be necessary for the establishment of a GS could be reached when incentives and economic demands diverge so widely.

Financial Stability: Establishing a gold standard also has implications for the financial system. For one, under a 100% coverage ratio for the money supply, the central bank would have no further resources to

Figure 1: Gold Reserves as % of Total Foreign Reserves



Source: World Gold Council, IMF, Author

respond to a financial crisis. Unless there is overcollateralization of base money or a fiscal reserve fund (Hong Kong and Bulgaria, among currency board countries, have had such an arrangement), no bank could be allowed to lend funds for which it does not have matching assets. As such, the fractional banking system (where banks lend out the majority of deposits that are not in continuous demand) would likely need to be abolished. Naturally, it would also mean that the shadow banking system is cut off from official support and thus severely curtailed.

More broadly, the shift from a fiat money to a gold exchange standard would transform much of the risk in the financial system. With no real monetary tools, the burden of financial sector support would ultimately fall on the fiscal authorities and shift from inflation risk to credit risk.

Open Economies: Similarly, it is not clear how a GS could cope with a world in which the largest payment flows emanate not from current account transactions but from the capital account (e.g. FDI or portfolio flows), which is both more sizeable and volatile. Heightened capital flows into or out of an economy may well be generated by the (perceived) quality of policies and thus prompt inflationary or deflationary pressures. As such, the adoption of a GS in the presence of unsustainable policies would not only fail to bring about stability, but also would add to the threat of instability. Moreover, if one or more systemically important economies were not to participate in the new monetary arrangement (e.g. China), the 'external' levels of exchange may yet come under pressure and threaten to destabilize the system.

Bottom Line

Arguments for a change in exchange rate systems somewhat resemble solutions in search of a problem. With the present crisis originating in the housing sector and then percolating through the financial sector—aggravated by a series of cumulative policy errors over the past decade and the build-up of large-scale economic imbalances—the vagaries of the exchange rate market and tensions therein primarily represent collateral damage rather than the ultimate cause of the crisis. Accordingly, solutions to the crisis also lie elsewhere.