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What if we dumped the Fed and returned to the gold standard?

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Countries adopted the gold standard so that they could more easily trade with Britain, which was the leading economic power from the late 1700s to World War I.

Last week I sketched the evolution of the U.S. banking through 1913 to understand some of Ron Paul’s economic ideas. This is important to Minnesota voters because Kurt Bills, the GOP nominee for U.S. Senate, and other candidates are Paul supporters.

Understanding U.S. banking before the Fed is the first step in understanding Paul’s economic views. Next, “To understand exactly why the Fed must go, one must realize that a commodity used as money is needed for a society to be free. It’s as much an argument for gold as it is against a central bank,” Paul writes in his book “End the Fed.” Paul believes that the Federal Reserve should be abolished and a strict gold standard put in its place.

What would this mean? To answer that question, let’s take a look at the gold standard in theory and practice.

**Commodity money**

To an economist, money is any asset that can be used in making purchases. Historically, societies have used sheaves of wheat, bundles of tobacco, seashells and all kinds of physical objects as money. These are known as commodity money since the money itself (wheat, tobacco) has intrinsic value.
Copper, silver and gold were the leading forms of commodity money in 17th century Europe. Great Britain moved to a gold standard in 1717, and over the course of the next 200 years most countries followed Britain’s lead. This was not because gold was clearly superior to copper or silver standards. Rather, countries adopted the gold standard so that they could more easily trade with Britain, which was the leading economic power from the late 1700s to World War I.

In theory, a gold standard has three components:

- each country fixes the value of their currency in terms of gold;
- gold can be owned by anyone;
- gold can be traded freely across international borders.

So, for example, in 1791 Alexander Hamilton proposed (and Congress agreed) that the value of the dollar be set to 24.75 grains of gold. At the same time, the British pound-sterling was worth 112.75 grains of gold. American citizens and British subjects owned gold and could sell it both within each country and to one another.

This meant that there was a fixed exchange rate between the dollar and the pound, in this case $4.56 per pound. More generally, a gold standard creates fixed exchange rates between all pairs of countries.

The system maintains these exchange rates through gold flows. If the price of gold in one country gets out of line with the price in another, gold will move from the country where it is less valuable to the country in which it is more valuable the original exchange rate will be reestablished.

Notice that, in theory, this system is self-equilibrating. This is one of the most attractive features to Paul and his followers: theoretically, there is no need for governments to do anything except set the price of gold. Banks and individuals all over the world hold gold as money and gold flows do the rest.

**How gold standard really worked**

This is not how the gold standard actually worked before World War I. The big reason was that gold flows meant changes in the money supply and either inflation (in the case of gold inflows) or deflation (gold outflows), neither of which was desirable from the point of view of policymakers. (I explained the relationship between changes in the money supply and inflation in my March 29 column.)

For instance, if the Bank of England perceived a discrepancy in the price of gold between New York and London, they would either raise interest rates (to make it more attractive to keep gold in Britain) or decrease them (to keep gold from arriving.) Central banks in countries such Britain, Germany and
France all used interest-rate adjustments as a way of minimizing gold flows and keeping price movements in check.

The United States was an exception to this pattern for the simple reason that it did not have a central bank until 1913. American monetary policy was thus dictated by two factors: British interest rates and the amount of gold Americans held.

This meant that American banking was the most unstable in the industrialized world until the creation of the Fed. Changes in British interest rates and changes in the amount of gold in the United States caused financial panics, and banks had to suspend gold payments when depositors rushed to withdraw their money. The financial system would seize up resulting in a recession or in some cases a deep depression.

These panics were, among other reasons, a driving force behind the Populist movement in Minnesota and throughout the Midwest, and led to calls for coinage of silver as an alternative to gold and the printing of paper money. It also led to calls for breaking up the large banks in New York and other financial centers, and contributed to the unique structure of the Federal Reserve (12 district banks in 1913 rather than a single central bank).

**Implications for banking and trade**

There are three implications in following Paul’s advice.

First, the Federal Reserve would be abolished and a price for the dollar set in terms of gold by the U.S. Treasury.

Second, banks and individuals in the United States would hold gold directly and use it as money or hold it indirectly via bank-issued certificates entitling the bearer to gold on demand. The gold could take any form from government-issued gold coins (from any government, not just the United States) to gold bars.

Third, the exchange rate between the dollar and other currencies would be determined by the price of gold in dollars and the price of gold in the other currencies. Since, no country in the world currently values its money directly in terms of gold, other countries would either have to adopt official gold prices or allow international gold markets to determine the price.

All of this would require radical changes in U.S. banking and international finance. To start, domestic banks would need to hold gold so that their depositors could make deposits and withdrawals. Similarly, international financial institutions and central banks would need to replace their dollar holdings with gold or other currencies.

The benefits of these changes and the other changes required under a gold standard are hard to fathom.
Would inflation be lower? It’s hard to imagine given that the Fed has kept inflation around 2-4 percent for the past 30 years. Would business cycles be less likely? I doubt it, given that expansions and contractions were at least as pronounced before the Fed was created and perhaps even worse.

The gold standard is not the cure for our difficulties. Instead of tinkering with the monetary system, we need to deal with fundamental issues such as the size and role of government generally and the relationship between the financial system and government in particular.

Using gold, silver, copper, seashells, or anything else instead of paper won’t help us face these problems.

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Louis Johnston writes Macro, Micro, Minnesota for MinnPost, reporting on economic developments in the news and what those developments mean to Minnesota. He is Joseph P. Farry professor in the Eugene J. McCarthy Center for Public Policy and Civic Engagement at Saint John’s University. He is also a professor of economics at the university.