Making the Transition to a New Gold Standard

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Suppose for the sake of argument that we all agree to the following proposition: If we could change the monetary regime with zero switching cost, merely by snapping our fingers, we would prefer the United States to be on a gold standard. In the most general terms, a gold standard means a monetary system in which a standard mass (so many grams or ounces) of pure gold defines the unit of account, and standardized pieces of gold serve as the ultimate media of redemption. Currency notes, checks, and electronic funds transfers are all denominated in gold and are redeemable claims to gold.[1] We then face the question: What would be the least costly way for the United States to make the transition to a new gold standard? We need to choose a low-cost method to ensure that the agreed benefits of being on the gold standard exceed the costs of switching over.

Two transitional paths suggest themselves (1) let a parallel gold standard grow up alongside the current fiat dollar, and (2) set a date after which the U.S. dollar is to be meaningfully defined as so many grams of pure gold. This second, more conventional path, was followed after the suspension of the gold standard during the U.S. Civil War. It is more commonly described as establishing an effective parity stipulating so many dollars per fine troy ounce of gold. In our present situation, where Federal Reserve liabilities (book entries

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[1]For the generic definition and supply-demand analytics of a gold standard, see White (1999: chap 2).

and currency notes) and Treasury coins constitute the basic dollar media of redemption for bonds and commercial bank liabilities, that implies converting the Federal Reserve System's liabilities and the Treasury's coins into gold-redeemable claims at so many grams of gold per dollar (or equivalently so many dollars per ounce of gold).

We see analogs to these two transitional paths when we observe how two countries have made the transition to using the U.S. dollar. In Ecuador in 1998–2000, a parallel unofficial U.S. dollar system emerged as the annual inflation rate in the local currency rose from low to high double digits, then to triple digits. The private sector of the economy was already heavily dollarized when the plug was finally pulled on the heavily depreciated local currency unit in 2000. In El Salvador in 2001, the government chose to permanently lock in the dollar value of the currency—by switching from a dollar-pegged exchange rate to outright adoption of the U.S. dollar—while inflation was low and the local currency still dominant. In a nutshell, when the official switch to the harder currency came in Ecuador, it was an act of necessity in the midst of a hyperinflation crisis. In El Salvador it was an act of foresight, to rule out such a crisis.

Allowing a Parallel Gold Standard

Clearing away the legal barriers to a parallel gold standard is fairly simple and can be done without immediately altering existing financial institutions. Rep. Ron Paul's HR1098, the Free Competition in Currency Act of 2011, represents one straightforward approach. It would (1) ensure the enforceability of contracts denominated in units other than fiat dollars by removing legal tender status from Federal Reserve notes and Treasury coins, (2) remove taxes on gold and silver coins that Federal Reserve notes do not face, and (3) remove sections of the U.S. Code that have been used to criminalize the victimless activity of privately minting distinctive pieces of metal intended to circulate as money (White 2011). If these steps seem unprecedented, note that Federal Reserve notes did not become legal tender until 1933. Bank of England notes are not legal tender today in Scotland or Northern Ireland, where private banknotes (also not legal tender) predominate. Note also that in Switzerland "the purchase and sale of Gold is not subject to taxes (such as value-added tax or capital gains tax) under current Swiss law" (Ledoit and Lotz 2011: 2).

Further legal and regulatory changes are necessary to allow citizens who adopt the parallel gold standard to have access to gold-denominated banking services. Banking services, including the issue of gold-redeemable paper currency notes and token coins, are of special importance for the success of a gold standard given the awkwardness of making small—or very large—transactions in physical gold coins. Either existing bank holding companies would have to be free to operate separate gold-denominated subsidiaries, or new gold-based institutions would have to be free to open.

The case for a level playing field between the fiat dollar and other monetary standards rests on the simple proposition that the well-being of consumers is better served by competition than by monopoly. Keeping alternatives to fiat dollar at a legal disadvantage, like silver- and gold-backed bank-issued monies, or foreign currencies, limits the options of American consumers to their disadvantage. The option to use an alternative to the fiat dollar is naturally most valuable in an environment of high dollar inflation. Consumers who don't like the ongoing shrinkage of the value of the currency in their pocketbooks and wallets are then not limited to complaining, or trying to lobby the Fed or Congress for better policy, but can "vote with their pocketbooks" to protect their assets by moving into less inflationary alternative currencies.

We should not expect a spontaneous mass switchover to gold, or to Swiss francs, as long as dollar inflation remains low. The dollar has an incumbency advantage due to the network property of a monetary standard. The greater the number of people who are plugged into the dollar network, ready to buy or sell using dollars, the more useful using dollars is to you. Conversely, if you are the first on your block to go shopping with gold coins or a gold-denominated debit card, you will find few stores ready to accept payments in gold. But like the benefit from using dollars in a peso economy, the willingness to accept gold-denominated money in a fiat dollar economy increases with the incumbent currency's inflation rate and its uncertainty. As Camera, Craig, and Waller (2004: 535–36) express the general theoretical proposition, "The local currency sustains internal trade if the purchasing power risk is kept very low, but once that risk gets very high substantial currency substitution kicks in." Should the U.S. inflation rate return to double digits, consumers would find it very helpful to have an alternative currency network available. Potential competition might even help incentivize the Fed to keep inflation low.

Who is likely to produce private gold coins once they are recognized as legal? Gold medallions and biscuits in various sizes, from private producers around the world, are already widely held. Investors in coined gold normally pay a premium over the value of uncoined gold, which covers the cost of coining. In a recent working paper, Olivier Ledoit and Sébastien Lotz, two economists at the University of Zurich, raise an interesting possibility while discussing a proposal to allow private gold coinage in Switzerland. They envision that "Gold Francs would be minted by Commercial Banks, [and] the Banks would be allowed to put their brand name and/or logo on one side of the coin. The marketing benefits from having the bank logo in every citizen's wallet would clearly cover any minting costs, so these coins could be sold at par value with the market value of their weight in Gold" (Ledoit and Lotz 2011: 5). It is actually not clear that marketing benefits would cover minting costs. It is true that *if* the public prefers to use full-bodied coins, gold coins could circulate practically in larger denominations. Historically, however, the everyday circulation of gold coins became rare once people found banknotes more convenient and sufficiently trustworthy. At $1,600 per ounce of gold, full-bodied gold coins are completely impractical at perhaps $50 and below.

We can therefore expect most bank-issued coins to be tokens, essentially metallic banknotes, redeemable in gold (upon presentation of a minimum quantity) at the bank. Such tokens can carry the bank's logo, but they will pay for themselves by sparing the issuer the expense of using precious metal in coin production, and will save the system the burdens of incidental wear and tear and deliberate shrinkage that accompany full-bodied precious-metal coinage. As with paper banknotes, the float revenue rather than only the advertising value will cover the production and circulation costs. Ledoit and Lotz (2011) appear to overlook the standard historical solution to the problem of keeping small currency at par—redeemable tokens and banknotes—because they assume that payment services would be provided only by money warehouses, and do not consider that money-users might be induced by competing banks to prefer the lower-cost alternative of fractional gold-reserve bank liabilities.

Reestablishing a Gold Definition of the U.S. Dollar

The network property of a monetary standard supports the case for not simply legalizing a parallel gold standard, but reestablishing a

gold definition for the U.S. dollar. Strong network effects imply that an uncoordinated piecemeal switchover to a superior standard would not occur except during a painful period of high and uncertain inflation in the incumbent standard. There is a strong practical case for avoiding that pain through a coordinated switchover before high inflation occurs. That is, we would do well to follow the Salvadoran model of transition rather than the Ecuadoran model.

In considering the reestablishment of a gold dollar now, more than 40 years after President Nixon closed the gold window, the question of the appropriate new parity (how many dollars per gold ounce) naturally arises. It is widely recognized that it would be foolish to try to relink the dollar to gold at the pre-1933 parity of $20.67 per ounce, the 1934–71 parity of $35 per ounce, or the post-1972 accounting price of $42.22 per fine troy ounce. It would be foolish because the U.S. price level has risen more than 5-fold since 1971, and the real price of gold has risen in addition, so that $42.22 per ounce or anything lower implies a massive deflation not anticipated in existing nominal contracts. Great Britain's painful deflation during Churchill's ill-considered attempt in 1925 to return to gold at the prewar parity, after the high inflation during the First World War, stands as a stern warning. The purchasing power of gold was greater in the rest of the world than in Britain at the prewar rate, gold accordingly fled Britain, and pound-sterling values faced inescapable downward pressure. Fortunately, this point is widely appreciated today, and nobody advocates returning to such a low parity.

By similar logic, it would be foolish to declare a new parity of (say) $8,000 per ounce, five times the current price. The result would be a sharp transitional inflation, and a very expensive *importation* of gold from around the world. Gold would rush in to take advantage of its higher purchasing power in the United States, until the U.S. price level rises approximately five-fold, to the point that $8,000 no longer buys more than one ounce of gold.

The gold parity that would avoid any transitional inflation or deflation is something close to the current price dollar price of gold. "Close to" because there will be some change in the real demand for monetary gold following the stabilization of the gold value of the dollar. On the one hand, with lower expected inflation, the cost of holding non-interest-bearing money will be lower, and hence the real demand to hold money in the form of M1 dollars will rise. On the other hand, with dollar inflation risk dramatically reduced, the

dollar-inflation-hedging demand for gold Krugerrands and Eagles and bullion will fall dramatically. The latter effect is likely to dominate, seeing that inflation-hedging demand is the main reason why the real price of gold is higher now than it was when the United States abandoned the last vestiges of gold redeemability in 1971.

Does the U.S. Treasury own enough gold to return to a gold-redeemable dollar at the current price of gold? Yes, assuming that they have what they say they do. At a market price of $1,600 per fine Troy oz. (to choose a recently realized round number) the U.S. government's 261.5 million ounces of gold are worth $418.4 billion. Current required bank reserves are only $83 billion. Looked at another way, $418.4 billion is 19.9 percent of current M1 (the sum of currency and checking account balances), a more than healthy reserve ratio by historical standards.[2] Combined with the likelihood that U.S. citizens' inflation-hedging demand for gold will shrink by more than banks' reserve demand will grow with larger real demand for M1 balances, I expect that the denationalization and remonetization of the U.S. bullion stock at the current price would allow the U.S. economy to *export* some excess gold. There will be a small transitional windfall for U.S. citizens, getting imported goods and services in exchange for excess gold.

Expeditiously establishing a new gold definition for the U.S. dollar thus requires the following two steps:

1. Withdraw most of the $1.6 trillion in nonrequired reserves that banks have accumulated since September 2009 by eliminating interest on reserves and selling the mortgage-backed securities that the Fed acquired in QE1 (its first "quantitative easing" program), plus enough Treasuries to bring total bank reserves down to the current value of the U.S. government gold stock.
2. Redeem Federal Reserve liabilities with the U.S. government's gold at the then-current market price.

Why Not Establish 100 Percent Reserves for M1?

The approximate figure we get if we divide October 2011's M1 (about $2.1 trillion) by the stock of gold held by the U.S.

[2]In counting all the gold as bank reserves I am assuming that coins in circulation would become redeemable tokens, not become full-bodied gold coins. The current numbers update White (2004).

government (261.5 million ounces) is $8,000 per ounce of gold.[3] Some economists who favor 100 percent gold reserves for currency and checking accounts have offered this approach as the way to set a new parity. As already noted, however, such a high parity implies a large influx of gold from the rest of the world, a large loss of other U.S. wealth in exchange, and a sharp transitional U.S. inflation. The United States cannot establish 100 percent gold backing for M1 without great expense. To be specific, at $1,600 per ounce of gold, the difference between M1 (about $2.1 trillion) and the current value of the U. S. government's stock of gold (about $400 billion) is nearly $1.7 trillion. To ensure 100 percent backing of M1, American taxpayers would have to buy $1.7 trillion worth of gold—a very expensive proposition. And that is only the one-time cost. In an economy with 3 percent per annum real GDP growth, assuming a flat trend in the ratio of gold to GDP, a constant purchasing power of gold implies the importation each year of 3 percent of the gold stock. For a gold stock of $2.1 trillion (100 percent of M1), that would mean an annual expense of $63 billion. With a 20 percent fractional reserve against M1, the annual expense would be only one-fifth of that figure.

It should also be noted that with 100 percent reserves, the historically familiar sort of currency—circulating redeemable private banknotes and token coins—is infeasible. A money warehouse would be unable to assess storage fees on anonymous currency holders. Debit cards would still be feasible, but the warehouses issuing them would have to charge storage fees (White 2003).

What about the Central Bank?

Because the nation's stock of money becomes endogenous under a gold standard, no monetary policy is needed. Retaining a central bank committee to "manage" the gold standard undermines its

[3]The Fed's gold certificate entry as reported on its balance sheet (H.4.1, October 6, 2011) is $11,041 million, the product of the bookkeeping price of $42.22 times 261.511 million fine troy ounces of gold. See also Federal Reserve Bank of New York (2008: 17), which notes: "A majority of these reserves are held in depositories of the Treasury Department at Fort Knox, Kentucky, and West Point, New York. Most of the remainder is at the Denver and Philadelphia Mints and the San Francisco Assay Office." I ignore the U.S. share of gold held by the International Monetary Fund.

automatic operation, creates uncertainty by opening the door to policies that lead to devaluation or suspension, and thus does more harm than good. A central bank inevitably faces political pressures to pursue monetary policies inconsistent with redemption for gold at a fixed rate. It can endanger or suspend redemption with legal impunity, and it faces no competitive pressure to maintain its reputation. When the central bank runs a policy inconsistent with maintaining the gold standard, typically the gold standard gives. Competing private banks, which *do* face legal and competitive constraints, have a better historical track record than central banks for maintaining gold redemption (Selgin and White 2005). The classical gold standard of 1879–1914 functioned quite well without a central bank in countries like Canada that did not weaken their commercial banks with legal restrictions. Even in the United States, despite several financial panics that (to judge from the Canadian example) could have been avoided by banking deregulation, the business cycle was not worse than it has been under the Fed's watch since 1914 (Selgin, Lastrapes, and White 2010).

Nor does the gold standard require a central bank for other purposes. Many of the banks that issue checking accounts may also be relied upon to issue gold redeemable circulating currency notes, as they did before the Federal Reserve monopolized banknote issue, and token coins. The Fed's other useful functions can be returned to private clearinghouse associations, namely the clearing and settlement of payments, the setting and enforcement of standards for solvency and liquidity, and the last-resort lending of temporary liquidity support to solvent member banks (see Timberlake 1993: chap. 14). Because their members' own money is at stake and they cannot simply print fiat money, clearinghouse associations do not and cannot bail out insolvent banks at taxpayer expense, whether through direct capital injections, asset purchases at above-market prices, or loans at below-market rates.

The journalist Martin Wolf (2010) has written:

> The obvious form of a contemporary gold standard would be a direct link between base money and gold. Base money—the note issue, plus reserves of commercial banks at the central bank (if any such institution survives)—would be 100 percent gold-backed. The central bank would then become a currency board in gold, with the unit of account (the dollar, say) defined in terms of a given weight of gold.

Actually, although irredeemable central bank notes are base money today, under a gold standard only coined gold and bullion reserves are base money. Notes in circulation are redeemable liabilities of the issuers and not part of actual or potential bank reserves. And although a currency board is less likely than a central bank to undermine the gold standard, there is no need for either. The most efficient form of a contemporary gold standard makes gold the base money—that is, the medium of redemption and unit of account—while currency and other common media of exchange are the fractionally backed gold-redeemable liabilities of commercial banks.

Wolf (2010) rightly recognizes that "it is wasteful to hold a 100 percent reserve in a bank, if depositors do not need their money almost all of the time." However, he does not draw the obvious conclusion that a currency board in gold is therefore less efficient than fractional-reserve banking under a gold standard.[4] Wolf expresses the common worry that the later system is inherently unstable: "In good times, credit, deposit money and the ratio of deposit money to the monetary base expands. In bad times, this pyramid collapses. The result is financial crises, as happened repeatedly in the 19th century." Yet, the banking system is more robust than he suspects, as seen in Scotland, Canada, Sweden, and other less-regulated systems without central banks under the gold standard. Repeated financial crises were a feature of the 19th century banking systems in the United States and England, weakened as they were by legal restrictions, but not of the less restricted systems elsewhere (see Dowd 1992, Selgin 1996).

Eichengreen's Recent Critique of Reinstating the Gold Standard

In a recent critique of proposals for reinstating a gold standard, the economic historian Barry Eichengreen (2011) has repeated the often-made but nonetheless absurd claim that a gold numeraire is equivalent to a commodity price support, writing: "Surely a believer in the free market would argue that if there is an increase in the demand for gold, whatever the reason, then the price should be allowed to rise, giving the gold-mining industry an incentive to

[4]Wolf incidentally remarks that "economists of the Austrian school wish to abolish fractional reserve banking," but this is true only of a fraction of Austrian-school economists.

produce more, eventually bringing that price back down. Thus, the notion that the U.S. government should peg the price, as in gold standards past, is curious at the least." Surely Eichengreen understands that if there is an increase in the demand for gold under a gold standard, whatever the reason, then the *relative* price of gold (the purchasing power per unit of gold over other goods and services) will in fact rise, which will in fact give the gold-mining industry an incentive to produce more, which will in fact eventually bring the relative price back down. That one dollar, defined as so many grams of gold, continues be worth a specified amount of gold—or in other words that one unit of gold continues to be worth one unit of gold—does not involve the pegging of any relative price.

"More curious still," Eichengreen continues, "is the belief that putting the United States on a gold standard would somehow guarantee balanced budgets, low taxes, small government and a healthy economy." Of course "guarantee" is too strong a term, and a budget balanced each and every fiscal year is not the right goal. But a gold standard does help to ensure budget balance in the desirable present-value or long-run sense, by requiring a government that wants to sell its bonds in the international market to stay on a fiscal path consistent with full repayment in gold (see Sargent 2010).

"Most curious of all" to Eichengreen "is the contention that under twenty-first-century circumstances going back to the gold standard is even possible." This time is somehow different, apparently. But going back to the gold standard by reestablishing a dollar-gold parity requires today only what it has always required (1) a sufficient real gold stock, which the U.S. government already has on hand, and (2) the political will to do so. Developing a parallel gold standard, using present-day technologies for money transfer, would probably be easier today than it has ever been.

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