1981

Epistle to the Gold Commissioners

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Published In
Report to the Congress of the Commission on the Role of Gold in the Domestic and International Monetary Systems, 2.
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 the gold standard offer their nostrum as a means of stabilizing prices but offer few details about how this desirable goal would be reached. All that we are usually told is that the gold standard is a "supply-side" solution, a radical change that will reduce interest rates, stabilize prices and eliminate the summers excess supply of zucchinis. None of these claims is true.

Most of the claims mix wishes, hopes and dreams into a pot-pourri of misinformation. 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 so as 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 sizeable change affecting world demand and supply of goods and services -- causes domestic prices of goods and services to change.

These are not speculations about what may happen. They are a description of 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 even from decade-to-decade. The price level was approximately the same in 1913 as in 1882, but this gives a misleading suggestion of price stability. Recorded prices of goods and services fell 47% from 1882 to 1896 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 from 1945 to 1980, and expansions and recoveries were about one-third shorter. Per capita real income, a useful measure of standard of living, rose more slowly. In fact, the most reliable statistics we have suggest that real per capita income rose a bit faster in the disappointing decade of the 1970's than under the gold standard 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 between events in 1879 to 1913 with 1945 to 1980 cannot, by themselves, decide the issue of whether the gold standard is superior or inferior in some global sense. They do tell us, however, 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 and third thoughts about returning to a gold standard -- any kind of gold standard.

Advocates of the gold standard complain about current variability of money growth and about the uncertainty created by changes in monetary policy. A return to gold does not solve these problems by eliminating or reducing uncertainty about weekly, monthly or yearly money growth. On the contrary, 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 many other factors. From 1879 to 1913, many of the major countries either adopted or remained on the gold standard. They accepted part of the responsibility for fixing the price of gold. Every fifty 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 fifty 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 new 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 fifty years or every
century. This happened in the past because new gold mines 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 that 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 ninety per cent 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 Federal Reserve 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 twenty-four collective eyes, represented on the Federal Reserve committee that makes monetary policy decisions, finally convinced a majority of the committee's 12 members that one target achieved is better than a basketful of failed promises. The twenty-four eyes are now glued on one target -- the announced growth rate of the money stock -- in hopes of repairing the Federal Reserve's damaged credibility. Let's hope they stay there.

A gold standard is not a more believable way, or a more 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 United States. People pound on the door, offering gold in exchange for dollars. The Federal Reserve, 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.

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 $35.00 an ounce, we did a lot of buying. The stock of monetary gold rose fifty per cent 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 thirties, or deflationary gold flows? Don't make the mistake of thinking that someone else knows exactly the right price to set and keep constant for the next hundred years. They don't. That's why advocates of the gold standard, despite their frequent public statements, never suggest or even 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 and takes big jumps everytime the Russians start the motors on their tanks.

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