THE GOLD STANDARD
Think of it Like
"Planting a Pivot Foot"

Stephen L. Bakke June 21, 2012

A basketball player plants a pivot foot in order to establish position and to determine the point from which future plays develop. It is, most importantly, also a limit on that player's immediate future movement. So too is the concept of establishing a gold standard a reference point and a limitation of government's ability to expand the money supply, spending, and debt. Like a "pivot foot," a gold standard prevents the government from "walking all around the court," making "spur of the moment" decisions and committing the country to higher inflation, deficits and debts. – Stephano Bachovich, obscure (but wise) economics scholar.

It all started with our Constitution. The federal government, to the exclusion of the states, was given complete authority over managing our money supply. Following are the relevant sections:

> ***U.S. Constitution - Article 1 – The Legislative Branch, Section 8 - Powers of Congress*** *– The Congress shall have Power ……. To coin Money, regulate the Value thereof, and of foreign Coin, and fix the Standard of Weights and Measures ……To make all Laws which shall be necessary and proper for carrying into Execution the foregoing Powers ……* ***Section 10 - Powers Prohibited of States –*** *No State shall ...... coin Money; emit Bills of Credit; make any Thing but gold and silver Coin a Tender in Payment of Debts ......*

What is a Gold Standard?

Believe it or not, it's hard to pinpoint a precise and simple definition of a "gold standard" because there have been so many nuances of interpretation and application. One common element is that such a system has as its standard economic unit of account, a fixed mass of gold. Major variations of this are: currency consists gold coins only; or currency is not the gold itself, but one in which the paper currency is convertible to gold at a fixed price; finally, similar to the last item, the currency could be backed by a certain amount of gold held by the government, but such currency is not freely or automatically convertible to gold bullion.

Since the founding of the U.S., I believe we have dabbled in the last two examples, using currency certificates, but with some "gold coinage" mixed in. Remember the old "Double Eagle" $20 gold coin? They were minted until 1933? Then in 1971 Nixon eliminated the gold standard in order to have more flexibility in managing our money supply.

Theoretically, under a gold standard, the prices of goods and services will adjust to the supply of gold. Without the gold standard what backs our currency? It must be the full faith and credit of the United States of America, and the perceived relative strength of our economy. But, is that enough?

Why Was Gold Ever Chosen as a Monetary Standard?

Alan Greenspan once wrote an essay (long, long, long ago) about what money should constitute:

> *…… [money] had to be based on a desired commodity …… What medium of exchange will be acceptable to all participants in an economy is not determined arbitrarily …… First, the medium of exchange should be durable. The medium of exchange must be a durable commodity, usually a metal. A metal is generally chosen because it is homogeneous and divisible: every unit is the same as every other and it can be blended or formed in any quantity. Precious jewels, for example, are neither homogeneous nor divisible*
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> *…… More important, the commodity chosen as a medium must be a luxury …… desires for luxuries are unlimited …… always in demand …… always be acceptable …… Gold, having both artistic and functional uses and being relatively scarce, has always been considered a luxury good. It is durable, portable, homogeneous, divisible, and therefore, has significant advantages over all other media of exchange.*

I can't add anything to that explanation?

Advantages and Disadvantages

I will provide here some of the arguments relative to the gold standard. By presenting them, I am not necessarily endorsing them. There's probably some truth and some fiction in most of these.

Advantages include:

- The gold standard is Constitutional money – paper, merely fiat currency is not.
- Long-term price stability – self regulating and stabilizing effects on the economy.
- Limits the power of the government to inflate prices through expanding the money supply.
- Stable, fixed international exchange rates for countries on the gold standard.
- Limits the potential for governmental deficit spending.
- Despite arguments to the contrary, there IS adequate gold now available for this purpose.
- Savers are protected because their savings aren't destroyed through inflation.
- Limits credit booms and boom-bust cycles, because of the inelastic money supply.
- Widespread prosperity will result from the gold standard.
- Herber Hoover wrote: "The government cannot easily confiscate the savings of people by manipulation of inflation and deflation …… Once free of convertible standards, the executives of every 'managed currency' country had gone on a spree of government spending, and the people thereby lost control of the public purse – their first defense against tyranny."

Disadvantages include:

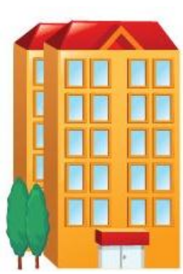
- By its very nature, economic growth could be artificially limited by a gold standard.

- Monetary supply policies would be determined by the rate of gold production. That is not the right criterion to determine economic growth.
- Very limited supplies of gold are available – too small to serve as a monetary base. The current value of all the gold ever mined (see separate section), even at today's price is only a bit over $6 trillion. The monetary base of the U.S. is roughly $2.7 trillion at the end of 2011. And we are only 20% of the world economy. God prices would likely increase significantly.
- Trying to get other countries to return to a gold standard would be futile, and their participation would be important, or at least desirable.
- Inflexibility of actions and strict adherence to the gold standard (via a tight monetary policy) significantly prolonged the Great Depression.
- Mainstream economists believe economic recessions are exacerbated by inflexible adherence to a gold standard. Sometimes the money supply simply must be increased.
- Long term price stability may result, but history tells us there will often be short-term price volatility under a gold standard.
- The size and health of a country's economy is dependent on its supply of gold, not the resourcefulness of its people and business.
- The unequal distribution of gold makes the gold standard much more advantageous in terms of cost and international economic empowerment for those countries that produce gold. That shouldn't be an important determinant of economic growth? The largest producers of gold, in order, are China, Australia, the U.S., South Africa and Russia.
- It's difficult to manipulate a gold standard to tailor to an economy's demand for money. This causes practical constraints against the measures that central banks might otherwise use to respond appropriately to economic crises.
- What happens if a nuclear blast hits our tiny supply of gold? Poof! All gone, isn't it? That shouldn't spell the end of our economy, should it?

How Much Gold Is There?

In the entire time of human history, a total of 165,000 metric tons have been mined. One metric ton is a little more than 1800 pounds. To put that in perspective, if all of that were piled up, it would fill just under 300,000 cubic feet. That's fills a building about the size of a small apartment building with 6 floors and 12 apartments of a little over 2,000 sq. ft. each.

WOW! – or at least I think that deserves a huge wow! I would never have imagined that!



And get this! I've always pictured the gold in Ft. Knox as being room after room of gold ingots piled high. As of a recent report, there are only a little less than 4,600 metric tons of gold there. Again, picture that apartment building and picture one of those apartments. Our gold at Ft. Knox would fill only a little more than 1/3 of that apartment. Unbelievable!

What Would "Uncle Milty" Think?

Should we return to the gold standard? I tend to gravitate toward paying attention to Milton Friedman when analyzing a complex economic theory. Friedman is a conservative economist who generally believes adamantly in a free market capitalist system. But what was his position on the gold standard? That's harder to answer than I thought.

From all that I have read, Friedman was not sold on the gold standard. Yet he yearned for a universal, real, non-government gold standard where money is produced by the private market. Long after the gold standard was abandoned, Friedman felt that, notwithstanding his ideal system, it would be impractical and impossible to return to the gold standard for several reasons – the most compelling one being that no governing authority would give up their control over monetary policy. There is just too much of a universal belief in a central authority handling monetary policy.

Friedman believed that if the money supply was to be centrally controlled (which he considered inevitable), that the preferable way to do it would be with a mechanical system that would keep the quantity of money increasing at a steady rate. Instead of this being managed by the Federal Reserve, it should be determined by a private market. His ideal was to "reestablish a world in which government's budget accounted for 10% of the national income, in which laissez-faire reigned, in which governments did not interfere with economic activities and in which full employment policies had been relegated to the dustbin ……"

As I read on, I realized Friedman was identified by many with a determined move away from the gold standard. One reason for this general impression was that he blamed the monetary policy during the Great Depression with prolonging and worsening the economic conditions in the U.S. Too much adherence to old fashioned economic theories and strict adherence to the gold standard was the culprit. He felt those in power should have had the power and/or inclination to provide more money to the economy.

And get this! In 1997 he wrote in the WSJ: "The surest road to a healthy economic recovery is to increase the rate of monetary growth, to shift from tight money to easier money." If Friedman were alive today, would he be a harsh critic of the GOP attack on the Fed and the push for returning to the gold standard among many in the conservative ranks. Perhaps he would be!

I didn't find a definitive answer from "Uncle Milty", that's for sure!

More on the Great Depression – Why Blame the Gold Standard?

According to Friedman and Bernanke, among others, adherence to the gold standard, and tightening monetary policy, prevented the Federal Reserve from expanding the money supply in order to stimulate the economy, fund insolvent banks and fund government deficits which could "prime the pump" for an expansion. An inability to control the money supply also prevented any influence over interest rates. The gold reserves in the vaults at Fr. Knox put a cap on what the government could do.

My Last Word

I'm just not convinced of the practicalities of a return to the gold standard. Perhaps, it is just too inflexible as a system (the desire of some), or maybe we are just too long removed from any such system. Another development that, like it or not, makes it more difficult to return to the gold standard is that in 1976, the International Monetary Fund established a permanent system of floating exchange rates. That's not going to go away. Like it or not, we are in an international economy, and what would there be the international advantage of a U.S. return to the gold standard – all by themselves?

I accept many of the advantages suggested for having a gold standard. However, I also can see that the disadvantages are not just an invention of radical economic theorists. And unfortunately, the words I have listened to and read refuting these disadvantages require way too much reliance on faith and finger-crossing. There is no level of certainty, which I feel must be present before we actually make such a huge change. I must rely heavily on the words of that obscure (but wise) economics scholar, Stephano Bachovich, whose quote opened this report. Here's another wise comment:

> *I keep coming back to the concepts that **gold flows should NOT be the best guide to how much money the economy needs**; and **the size and health of a country's economy should be dependent on the resourcefulness of its people and business, NOT on its coincidental supply of gold.***

Return to the gold standard? I just can't get there – not yet anyway.