CLIENT EDUCATION

The Gold Standard

By Nathan Lewis

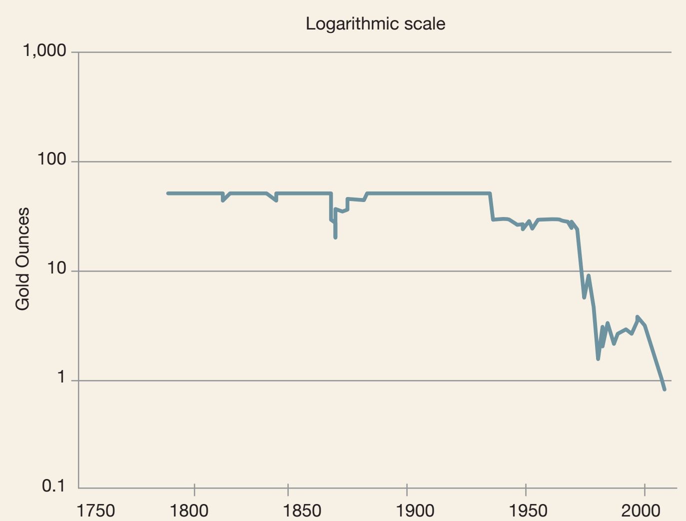
The United States used a gold standard monetary system for 182 years, from its inception in 1789 to 1971. During that time, the United States was the most successful country in the world. The middle class expanded and grew prosperous to an unprecedented degree. The final two decades of this period, the 1950s and 1960s, were some of the most bountiful of the past several centuries.

Since 1971, the United States has had a floating fiat currency. During that time, the value of the dollar has fallen to roughly 1/50th of its value in 1970, from 1/35th ounce of gold to around 1/1750th (see figure 1). Over the past four decades, the U.S. middle class has shrunk, and the underclass has grown. Even by the federal government's own rosy-hued statistics, median male full-time income has been stagnant over that time period, when adjusting for the official inflation rate (see figure 2). If you suspect that the official inflation rate makes things look better than they are, then the conclusion is not one of stagnation but of decline (see figure 3).

Despite this rather clear historical record, we are supposed to believe that the gold standard system causes nothing but problems and hardship, and that today's floating fiat currency system is the only rational option, now and forever into the future.

The likely result of another 40 years of floating fiat money is—at best—that the dollar will be worth perhaps 1/50th of today's value, and it will take 87,500 of them to buy a $20 coin from 1922, which contained about one ounce of gold. The median male full-time income will be higher in nominal terms but after adjusting for the effects of currency devaluation will have stagnated or declined still further.

FIGURE 1: VALUE OF $1,000 IN GOLD OUNCES, 1789–2012



Did the founding fathers insist on a gold standard system—even writing it into the Constitution—because of superstition? Hardly. They had just lived through a hyperinflation. The government had printed banknotes to finance the Revolutionary War. Their value collapsed, throwing the economy into chaos. The government that issued them—the Continental Congress—was replaced. The survivors swore to never let it happen again.

Today, the U.S. government, via the Federal Reserve, is again financing its chronic budget deficits through a contemporary version of printing money. We are told that this will all work out fine in the end.

Maybe not.

Gold Standard System

The gold standard system, such as used by the United States, has a very rational purpose. The purpose is to keep the value of the currency as stable as possible. The capitalist economic system works best that way. A currency that goes up or down in value causes problems. The best practical means of achieving this goal—proven over centuries of experience, by governments around the world—is a gold standard system. Although one could argue that it is not a perfect tool for the job, nevertheless, it is the best tool that anyone has ever been able to find. In practice it works splendidly, and its supposed variations from the perfect ideal of currency stability are small enough to ignore completely.

The United States was not the only country to enjoy success with this

FIGURE 2: U.S. "REAL" MEDIAN FULL-TIME MALE INCOME, 1955–2010

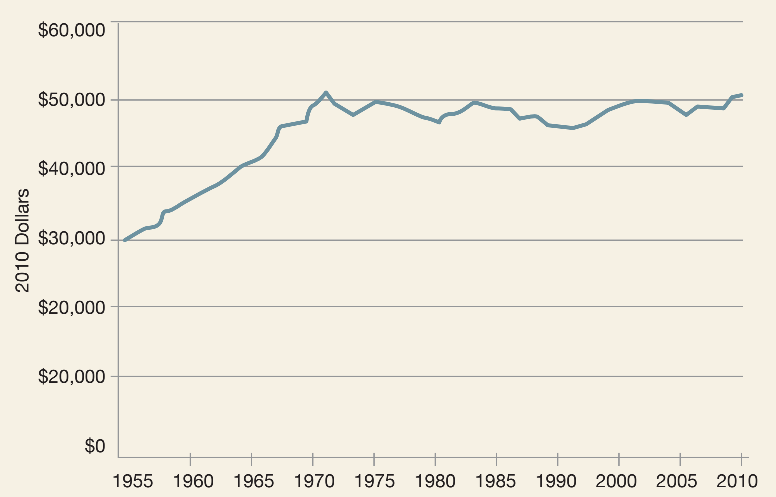
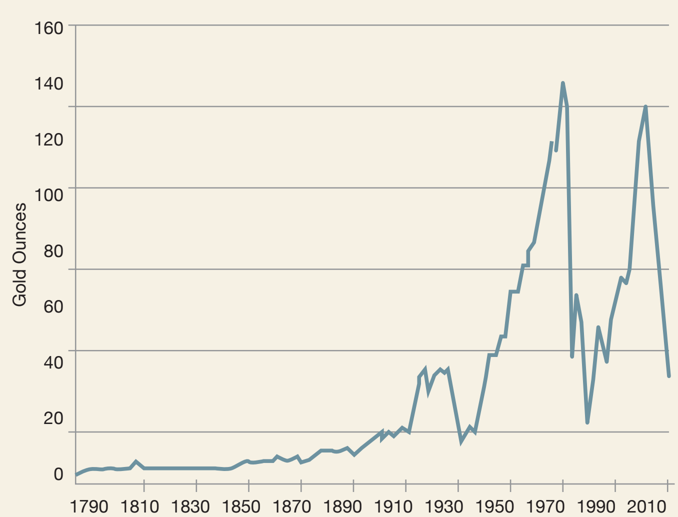


FIGURE 3: U.S. PER CAPITA GDP IN GOLD OUNCES, 1790–2010



strategy. Britain used a gold standard system from 1697 to 1914, a stretch of 217 years.

Certainly, if there was a problem with the system, it would have shown up in 217 years, no?

Britain began that period as a financial backwater, with a moribund economy that was a pale shadow of tiny Holland's. By 1914, Britain was the world's financial center, had the world's premier international currency, and was a shining example of capitalist innovation and prosperity. The British Empire encompassed 458 million people, about 20 percent of the world's population, and more than 13 million square miles of land, about 25 percent of the world's total land area.

The extraordinary monetary and macroeconomic stability that the gold standard produced for Britain is reflected in the record of market yields on British government bonds. These were the famous Consol bonds—bonds of infinite maturity. Between 1822 (following a lapse in the gold standard during the Napoleonic Wars), and 1914, a stretch of 92 years, the average yield on the British Consol was 3.14 percent. Upon this rock-solid foundation, the capitalist economy flourished and the empire grew.

Floating Fiat Currency System

Today, more than 100 central banks in the world manage floating fiat currencies. In the past four decades, not one of them has been able to match the history of British Consol yields. They aren't even in the same universe. Certainly the Federal Reserve hasn't, nor, for that matter, has the Bank of England.

The reason we have a floating fiat system today is not because the gold standard doesn't work. It works splendidly. Rather, our goals changed. We discarded the ideal of a currency that was as stable, predictable, and reliable as possible. Today, we want to manage the economy by way of currency-jiggering. Supposedly, by way of monetary distortion, we can make unemployment go down, make the economy expand, manage interest rates and credit expansion, adjust foreign exchange rates and trade competitiveness, and generally attempt to address an ever-changing agenda of short-term policy goals.

This requires a currency you can manipulate—a floating fiat currency. A gold standard system would prevent all of this. That was one of its purposes.

The actual cause of the emergence of the floating fiat system in 1971–1973 was that U.S. President Richard Nixon wanted to get re-elected. One of his economic advisors was Arthur Burns, who suggested a familiar combination of increased money supply and government spending. When the previous Fed chairman's term ended in February 1970, Nixon appointed Burns to the Federal Reserve. Burns opened the monetary spigots, just as he promised. Burns and his academics calculated that, to resolve the minor recession of the time, U.S. nominal gross domestic product (GDP) should rise by 9 percent. This increase in nominal GDP was to be accomplished with the printing press. (In other words, it was nominal GDP targeting, an idea that also has made a resurgence recently.)

Nixon declared, "I am now a Keynesian in economics."

This was completely contrary to the gold standard system of the time, the Bretton Woods system, causing increasing difficulties. Nixon solved this conflict by effectively ending the U.S. gold standard on August 15, 1971. The strategy worked: Official "real" GDP showed a 5.3-percent increase in 1972 (helped by low-ball inflation estimates), and Nixon was re-elected. However, this was accompanied by a substantial decline in currency value. When Burns entered office, the dollar was worth 1/35th of an ounce of gold, its Bretton Woods parity and the same value it had been since 1934. Its market value in 1970 was 1/35.20th of an ounce of gold. At the end of 1972, the dollar was worth 1/65th of an ounce.

The European central banks, which linked their currencies to the dollar in those days, saw where this was going and wanted no part of it. They severed their dollar links, and currencies floated independently.

The gold standard era didn't end in 1971 because the gold standard didn't work. It wasn't broken and it didn't have to be replaced. The economy was fine. There was no international conference to discuss the introduction of a new world monetary system. The European central banks were opposed to Nixon's funny-money agenda. Even Nixon didn't want to end the Bretton Woods gold standard system, and he attempted to put it back together in the Smithsonian Agreement in December 1971. He didn't understand that it could not co-exist alongside Burns' printing-press strategy.

It was an accident, born of ignorance and confusion.

Printing Press Strategy

This idea, of managing the economy via the printing press is very old. It was popular among the mercantilist economists in the 17th century. In 1650—yes, more than 350 years ago—William Potter argued that, with a little money-printing, Britain could:

> *Enrich the people of the land*
> *Settle a secure and known credit*
> *Extend such credit to any degree needful*
> *Quicken the revolution of money and credit*
> *Diminish the interest for moneys*
> *Fill the land with commodity*
> *Relieve and employ the poor*
> *Augment custom and excise [tax revenue]*

In 1705, John Law asserted that an "addition to the money" would "employ the people that are now idle, and these now employed to more advantage: so the product will be increased, and manufacture advanced."

Even the terminology hasn't changed much.

Law also wanted to lower the rate of interest, naturally by increasing the currency supply:

> *[I]f lowness of interest there the consequences of a greater quantity of money, the stock applied to trade would be greater, and merchants would trade cheaper, from the easiness of borrowing and the lower interest of money, without any inconveniences attending to it.*

Law must have been convincing, because he eventually became the finance minister of France. At first, his financial alchemy made him wildly popular. But it did not go well in the end; after a hyperinflationary bust, he fled the country dressed as a woman and spent the remainder of his days in the gambling dens of Vienna.

For centuries, governments have attempted to attain prosperity with nothing more than a printing press. For centuries, they have failed to do so. For centuries, after yet another funny-money episode not much different than many others in the past, governments have migrated back to some gold-based monetary system. They again embrace the ideal of a currency as stable and reliable as possible.

After the John Law debacle, France returned to a gold-based currency. This persisted until another hyperinflationary episode during the 1790s, when the government again tried to finance itself with a printing press. The consequences were as one might imagine. Napoleon put France back on a gold standard system in 1803.

The classical economists throughout history have warned of the consequences of funny money. In roughly 1375 A.D., Nicholas Oresme described the effects of money that changed value:

> *As time goes on and changes [in the value of money] proceed, it often happens that nobody knows what a particular coin is worth, and money has to be dealt in, bought and sold, or changed from its value, a thing which is against its nature. And so there is no certainty in a thing in which certainty is of the highest importance, but rather uncertain and disordered confusion, to the prince's reproach.*

David Ricardo, one of the 19th century's most eloquent monetary theorists, put it more simply: "A currency, to be perfect, should be absolutely invariable in value."

In practice, a gold standard system operates much like today's currency boards. It is simply a currency board linked to gold rather than a foreign currency. Via automatic adjustment mechanisms, it maintains the value of the

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currency at a specified gold parity. There's nothing more to it than that. It has nothing to do with gold mining, gold imports or exports, the balance of payments, interest rates, GDP, price levels, or any other such thing. Large amounts of gold bullion are not necessary. When the British pound was the premier international currency in 1910, the leader of the world gold standard system, the Bank of England, held only 1.2 percent of total above-ground gold.

Conclusion

Eventually, our goals will change again. Like the founding fathers in 1789, we again will want a currency that is as stable, predictable, and reliable as possible. The idea of a floating fiat currency mismanaged by bureaucrats—now hailed as the solution to all ills—will become abhorrent. Probably this will follow a time of economic distress and currency crisis. At this point (not before) we will look for some way to achieve this goal. Some imaginative proposals may arise, but in the end we will conclude that there is no better system than a gold standard system. Certainly there is none with such a stellar track record over centuries of practical experience. There is no need to try to invent something better.

The only real question is: Who goes first? The country that provides the leadership the world demands likely will become the financial and commercial center of the future—as Britain was in the 18th and 19th centuries, and the United States was in the 20th century. Eventually, other major governments will follow. The world gold standard of the future is likely to be instituted by an alliance of China, Russia, and possibly Germany. These governments today embrace the ideal of a stable and reliable currency, publicly repudiating Ben Bernanke's (and Mario Draghi's) funny money tricks. The United States likely will fade from the world stage, its soft empire dissolving as Britain's did. It may even break up, as that other acronymic, continent-spanning agglomeration without ethnic or geographic coherence—the U.S.S.R.—did when it lost all legitimacy and started to finance government deficits with the printing press.

The future belongs to the resurgent East. But it will be a brighter future, with currencies once again as good as gold.

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