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Restoring an International Gold Standard – A Viable Alternative?

by Wulfdiether Zippel, Munich*

The Gold Commission, whose 17 members were appointed by President Reagan in June 1981, has been conferring since autumn last year. The task of this commission is to discuss the pros and cons of restoring some gold backing for the dollar and to study the role of gold in the international economy. Prof. Zippel analyses whether an international gold standard would at all be able to operate trouble-free under present conditions.

Since the second half of the sixties international monetary relations have been characterised by a successive demonetisation of gold. This trend culminated, at least for the time being, in the "Second Amendment to the IMF Agreement", which came into force on April 1, 1978. Due to experiences made with "overshooting" exchange rates, and the fact that since the transition to a substantially greater exchange rate flexibility several problems for national and international policies have been aggravated, it is hardly surprising that the question is increasingly raised as to whether fixed exchange rates or a reassessment of the monetary function of gold can lead to a turn for the better.

During the last months of the Carter Administration, Congress passed legislation calling upon the Treasury to install a commission to analyse the possible future role of gold in international economic relations. The 17 members of this commission were appointed by President Reagan in June 1981. In particular, the consultations carried out by the commission in September 1981 have shown that the views of its members are split in many respects. The scope ranges from the demand for a "gold-free" national and international monetary system to the propagation of an international gold standard¹. The latter is implicitly supported by advocates² of a supply-side economic policy.

Discussions up to date within the Gold Commission have – at least as far as has been made known to the public – generally concentrated on the question of restoring a certain degree of gold backing for the dollar and the ensuing implications regarding the approach to domestic economic objectives. Besides this, various

proposals have already been presented which deal with the technical details³ involved in such a step.

The discussion on the domestic economic effects of tying the American bank notes in circulation to gold must not mislead one's view of the numerous and close interdependencies between the national and international monetary systems. The return to some gold backing and the restoration of gold convertibility for the dollar are therefore to be regarded as a precursor of fundamental changes in the international monetary system. This general intention is underlined by the legal task of the Gold Commission: its mandate is explicitly to analyse the part gold should play in future in international economic relations⁴. The following will consider some of the various aspects of a reintroduction of a gold standard which would at least include the most important Western world trading nations. The analysis will be mainly focused on the problem of whether or not such a standard would operate smoothly under prevailing – and under the most likely future – circumstances. Any assessment of the political practicability of the restoration of the gold standard or of the technical problems of transition has been intentionally omitted in this analysis.

The key argument supporting a return to a monetary system based on the classical gold standard principles

¹ Cf. Morgan Guaranty Trust (ed.): *World Financial Markets*, No. 9/1981, p. 5.

² Cf. Interview with A. B. Laffer, in: *Süddeutsche Zeitung*, Nov. 12, 1981, p. 30.

³ Cf. e. g. R. E. Weintraub: *Restoring the Gold Certificate Reserve*, in: Joint Economic Committee (ed.): *The Gold Standard: Its History and Record against Inflation* (Joint Economic Committee Print No. 83-769-0), Washington 1981, p. 21 ff.

⁴ R. W. Jepsen: *Foreword*, in: Joint Economic Committee (ed.), *op. cit.*, p. V.

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assumes that no matter how plausible readjustment concepts in economic policy may be, they will be only of little use as long as their effectivity depends on the willingness of economic decision-makers to consistently maintain monetary discipline. Considering the many bad experiences made with various forms of discretionary economic policies the advocates of a return to a gold standard are asking for an automatic and efficient adjustment mechanism for economic policy activities. In this respect, they point towards the classical gold standard, which for many decades, if not indeed centuries⁵, proved to be a highly effective monetary system.

Long-term Adequacy of Reserves

Maintaining international economic stability under gold standard conditions entails primarily the securing in all member countries of a continuous growth of monetary gold reserves in accordance with the national development of production potential. It is convenient to consider first of all how far a renaissance of the gold standard would ensure a lasting solution of the liquidity problem.

An important precondition for the transition to an international gold standard is a structurally balanced distribution of the monetary gold reserves amongst the participating countries. Such a situation does not exist at present in the comparatively small group of the most important world trading countries, particularly in the case of Japan and the United Kingdom. In this respect, however, certain attention should be focussed on gold buying by the Japanese central bank, which has been observed for some time now.

An international system of gold-backed currencies would undoubtedly have the advantage that the balance of payments of the USA would no longer exert a decisive influence on the reserve position and on the economic development of the rest of the world. At the same time it must be pointed out that – provided the long-term price of gold and the backing ratio remain unchanged – the growth of official gold stocks would today, as it did in the historic gold standard⁶, depend on factors which have no economic or rational link to the current reserve requirements.

The necessity to determine an “appropriate” price of gold before returning to the gold standard implies many

⁵ R. W. Jastram: *The Gold Standard: Its History and Record against Inflation*, in: Joint Economic Committee (ed.), op. cit., p. 12 f.; interview with A. B. Laffer, in: *Euromoney*, 8/1980, p. 32.

⁶ Cf. B. B. Aghevli: *The Balance of Payments and Money Supply under Gold Standard Regime: U.S. 1879-1914*, in: *American Economic Review*, Vol. 65, 1975, p. 56.

serious problems. One of these is the fact that there is no objective criterion for quantifying the international and national monetary reserve requirements. Besides this, it must be underlined that the efficiency of the gold standard's adjustment mechanism differs fundamentally from that which is immanent to the present international monetary order. This means that future reserve requirements would differ considerably from those within the existing monetary system. On the other hand, data relating to the period before 1914 can only be regarded as a limited point of reference. For due to today's relative lack of downward price flexibility a much greater amount of reserves would be required nowadays to bridge the period until a balance of payments equilibrium were restored.

In addition, it is important to note that not only the official price of gold, but the mere fact that a gold currency exists and, moreover, the confidence in its viability will have a considerable influence both on gold supply and on private gold demand. The suggestion of changing the official gold price or the backing ratio if private gold supply or demand be too great does not present a practical solution⁷. The institutional possibility of changing the price of gold or modifying the backing ratio would prevent the emergence on the markets of an increased confidence in the monetary authorities' commitment to monetary discipline. At the same time this would automatically lead to the latent danger of destabilising speculation occurring.

Regarding the quantitative development of the monetary gold stocks a whole series of long-term uncertainties exists. Worth mentioning in this respect is the fact that gold production has tended to fall⁸ over the past 14 years even though the price of gold has risen tenfold since March 1968⁹. Special factors of uncertainty are the future mining policies and the future gold selling policies of South Africa and the Soviet Union; only vague assumptions can be made about these. The same applies to the long-term behaviour of private persons interested in gold. Up to now the latter have usually reacted in an erratic way to any changes in the international political situation. Long-term forecasts of the amount of gold required for industrial purposes are just as unreliable.

⁷ The model introduced by Weintraub to solve the gold price problem must be reconsidered in many respects. Weintraub explicitly classifies his model as a “prototype proposal”. Cf. R. E. Weintraub, op. cit., p. 21.

⁸ The decline in South African gold production since the end of the sixties was perhaps mainly due to the possibility of using less rich ore the higher the price of gold soared; cf. R. W. Jastram, op. cit., p. 9 f.

⁹ Ceasing of support of the gold price on the free market by the so-called gold pool.

It would therefore seem basically very unlikely that the large number of random factors affecting the development of official gold holdings would in all cases compensate each other so that the long-range growth of the monetary gold holdings would always correspond to the need for additional reserves. Even the historic gold standard period was characterised by repeated substantial fluctuations in the inflow of new monetary gold. These led without exception to considerable disruptions of economic activity¹⁰. Such disruptions could be overcome at that time due not least to the fact that monetary gold reserves increased, on a long-term average, approximately parallel to the real growth path. On top of this, the then internationally dominant role of the British pound and the high degree of efficiency of London's banking system exerted a stabilising influence¹¹ on world-wide financial relations.

Experiences made in connection with the classical gold standard thus reveal that in spite of the decisive influence of random factors a sufficient long-term growth of reserves does not have to be ruled out *a priori*. At the same time it must be stressed that events during the last century do not provide any definite proof as to future developments. On the other hand, some facts can be pointed out which allow a certain degree of optimism with regard to the current and future situation. The quantity of gold produced¹², for example, during the past five decades was well above the level recorded for the last century, despite the already mentioned slight downward trend during the past decade. The market price of gold is also well above last century's figure. More important than this, however, is the fact that economic and monetary theories have in the meantime made enormous progress. In addition, the national money markets have, today, reached a high level of international integration. Finally, a fundamental difference to the situation at that time is to be seen in the fact that there is today close cooperation between the national monetary authorities, based on the certainty that national "solo runs" do not do anybody any good.

¹⁰ R. Triffin: After the Gold Exchange Standard?, in: Weltwirtschaftliches Archiv, No. 87, 1961, p. 189 f; E. Küng: Die Versorgung der Weltwirtschaft mit Währungsreserven (Supplying the International Economy with Monetary Reserves), Tübingen 1974, p. 6.

¹¹ Cf. H. Möller: Möglichkeiten und Grenzen (Possibilities and Limits), in: Kreditwesen, Vol. 8, 1955, p. 26; O. Ising: Reform des internationalen Währungssystems – das Ende einer Illusion? (Reform of the International Monetary System – End of an Illusion?), in: Außenwirtschaft, Vol. 29, 1974, p. 317; H. Weise: Möglichkeiten und Grenzen des Goldes im internationalen Währungssystem (Possibilities and Limits of Gold in the International Monetary System), in: Weltwirtschaftliches Archiv, Vol. 101, 1968, p. 210.

¹² Since the gold standard was dropped at the start of the 1930s more gold has been mined than in the entire period from ancient times up to 1930. Cf. H. Weise: Gold als gewerblicher Rohstoff, Vermögensanlage und Währungsreserve (Gold as an Industrial Raw Material, a Capital Investment and a Monetary Reserve), in: Weltwirtschaftliches Archiv, Vol. 107, 1971, pp. 324, 331.

Bearing this in mind, one must not forget the non-interest-yielding character of gold reserves and the greater simplicity of foreign exchange transactions. Both factors would make it seem doubtful whether national monetary authorities could, following a future return to the gold standard, be prevented from switching over in the long run to a new accumulation of foreign-exchange reserves. Were such a "diversification" of reserves to come about, however, this would mean that the amply well-known "Bretton Woods problems" would return via the back-door.

Efficiency of Adjustment Mechanism

The practical utilisation of the potential advantages offered by an international gold standard first requires a basic change in the hierarchy of economic policy targets. In particular, it would be necessary to sacrifice the precedence given to the state of the domestic economy in the orientation of economic policy, a practice which has become common since the late 1920s. At the same time it would be essential for the member countries to accept a binding commitment to link their economic activities primarily to the development of the balance of payments. This change in emphasis is also acknowledged by the advocates of a reintroduction of the gold standard to be an indispensable prerequisite for its successful implementation. In the following an attempt will be made to assess the chances of such a reorientation taking place.

The fact that there is today no longer a downward flexibility of wages and salaries or commodity prices has important consequences for the viability of any future gold standard. This one-sided rigidity means that to overcome any future balance of payments deficit a much greater drop in domestic incomes and a much higher increase in domestic interest rates would be required than was the case *ceteris paribus* in the previous century. The substantial employment effects associated with such variations would probably lead to an early dropping of the priority given to a balance-of-payments oriented economic policy. That would be due to the fact that nowadays no government will be willing to subject its citizens to large fluctuations in income and employment over a longer period of time. One could also mention the fact that the typical mechanisms which bring about a return to balance of payments equilibrium under the gold standard will be weakened in case of underemployment¹³.

¹³ Cf. E. Küng: Die Selbstregulierung der Zahlungsbilanz (Self-regulation of the Balance of Payments), St. Gall 1948, pp. 199, 234, 242.

The fact that following a return to the gold standard the full brunt of adjustment would have to be borne by output and employment has a further interesting aspect. For it is very unlikely to fit into the concept of the advocates of a supply-oriented economic policy that the supply side should be subject to such a high degree of fluctuation in the utilisation of capacities as would be necessary as a result of the existing one-sided price rigidity to cancel out the arising disequilibria quickly enough.

A discussion as to whether governments under present socio-political circumstances would be willing to subordinate their economic policies unconditionally to the rules associated with the gold standard must take a closer look at the experiences already made under the historic gold standard. In this respect the fact must be underlined that, even during periods in which general conditions were in many respects more favourable than today, those responsible for economic policy often resorted to escaping the constraints of the gold standard. The as yet undisputed view regarding this matter maintains that such violations remained largely harmless due to the fact that the rules associated with the gold standard were only ever broken with utmost caution¹⁴. This restraint was probably due to the fact that economic policy in the last century had nowhere near as many economic and non-economic tasks to fulfil as is the case today.

Several factors indicate that it is very likely that the imbalances in international payments transactions which have been considerable and lasting in past years will continue in future. One reason for such a development lies in the increasing politicisation of world trade. In particular, abrupt increases in the prices of important energy resources and other industrial raw materials must be reckoned with. In addition, considerable regional shifts in progress made in productivity can be expected up until the end of the 20th century. This will inevitably result in rapid swings in the world-wide structure of comparative costs and international demand flows. Moreover, the high degree of sensitivity of monetary transactions to disruptions in the international political situation demands under fixed exchange rate conditions substantially greater flexibility from economic policy-makers than is currently the case.

The fact that there will be considerable shifts in future international payment flows and that these can come

about at very short notice is bound to adversely affect confidence in the long-term workability of a future gold standard. As soon as such fluctuations in international monetary flows become greater, attempts to ease the employment effects and to partially redistribute the adjustment burdens by means of exchange rate changes will be evoked.

The necessity inherent in the system of having to put up with a strong domestic recession and other unpopular effects should a balance of payments deficit occur was already before 1914 the cause of much harsh criticism¹⁵ of the gold standard. The fact that this monetary system was abandoned between the two world wars was purely a result of the increasing disappearance of the socio-economic and political preconditions which had enabled a linking of the domestic money supply to the development of the balance of payments. Above all, the willingness to tolerate passively substantial income and employment fluctuations resulting from the gold standard principles had dwindled more and more. As already explained, such fluctuations would tend to become even more drastic in future. Were the gold standard to be reintroduced this would induce an early return to some discretionary control of the money supply, clearing the way for reinstating a greater degree of national autonomy in economic policy.

Independent of this, not much would point for the present towards Jacques Rueff's forecast coming true. Nearly 10 years ago Rueff predicted¹⁶ that continual monetary crises would finally lead to a rearrangement of the order of economic policy targets, resulting in a general priority in favour of a balance-of-payments oriented behaviour.

Reduction of Inflation

The supporters of a transition to the concept of a gold-backed currency are convinced that the realisation of their proposals is the only reliable way of controlling international inflation. This expectation is based on the belief that a disciplined expansion of the domestic money supply will only succeed if the money in circulation is linked to gold-backing stipulations. Apart from this, the countries adopting the gold standard would be directly virtually forced to implement an immediate contraction of the domestic economy as soon as a national inflationary tendency arises. This constraint, they maintain, proved its efficiency during

¹⁴ Cf. A. I. Bloomfield: *Monetary Policy under the International Gold Standard: 1880-1914*, New York 1959, p. 60; M. Seeger: *Die Politik der Reichsbank von 1876-1914 im Lichte der Spielregeln der Goldwährung (The Policies of the Reichsbank 1876-1914 in the Light of the Rules of Gold Currency)*, Berlin 1968, p. 136.

¹⁵ Cf. A. I. Bloomfield, *op. cit.*, p. 55 f.

¹⁶ Cf. J. Rueff: *Marshall-Plan für den Dollar (Marshall Plan for the Dollar)*, in: *Wirtschaftswoche*, 1973, No. 12, pp. 68, 70.

the heyday of the gold standard, when the commodity price level averaged out to nearly zero¹⁷.

Behind the on the whole and in the long run balanced development of purchasing power during the gold standard period there were, however, at the same time, parallel to the fluctuations in the inflow of new gold, persistent swings in the level of prices. Their intensity before 1914 was in the German case very often above the level recorded in the 1970-1980 decade¹⁸. These major fluctuations in purchasing power are hardly paid any attention to by the advocates of a return to the gold standard. This is all the more surprising considering the fact that since the last century downward price flexibility has evidently lessened. For this reason, not only would the contraction periods probably last considerably longer than in former times, but it is very doubtful whether a compensatory reduction in the price level could be achieved at all.

Another important difference between the current situation and that a century ago is that nowadays the extent of income increases can if necessary be pushed through against the intentions of the national monetary authority. It is in no way certain that a return to the gold standard would succeed in preventing this practice. A further set of problems would result from the fact that any monetary expansion in the gold standard countries would be directly affected by the gold export policies pursued by South Africa and the Soviet Union. Moreover, the increasing importance of the deposit money component, which is continually growing due to new methods of payment, must be taken into account. This development would undoubtedly affect the anti-inflationary effectivity of any future gold backing stipulations.

The various new kinds of stability risks in contemporary economic relations and the probable lack of willingness to accept deflationary developments any longer, or in any greater degree, than is necessary go to confirm the fear that under a future gold standard the member countries would see themselves forced to temporarily suspend the gold convertibility of their currencies. Such interruptions did also take place under the classical gold standard so as to reduce the recession in output and employment due to an automatic monetary concentration¹⁹. For the reasons already given such situations can be expected to occur

more frequently in future. Associated with this, considerable uncertainties as regards the durability of the existing exchange rate structure as well as the maintenance of convertibility and the existing extent of foreign trade liberalisation make it doubtful whether a future reinstatement of the gold standard would be able substantially to stabilise market expectations about inflation. Any legally sanctioned clause allowing the gold backing to be rescinded for an interim period²⁰ would only increase doubts as to the relevant authorities' commitment to monetary discipline.

Conclusions

Irrespective of the question as to whether the reintroduction of an international gold standard is politically feasible, there are other serious reservations concerning the practical expediency of a future application of this monetary concept. The general framework within which a gold standard would have to operate today in many ways does not provide a guarantee for an immediate application and efficient functioning of the adjustment mechanisms characteristic to a system of firmly fixed parities. Very important in this respect is the fact that the existing downward inflexibility of wages and commodity prices together with today's very tight organisation of particularist interests would nowadays, and in future, induce much greater and longer-lasting income and employment fluctuations than was the case during the classical gold standard era. There are, however, many indications that the political will to demand of citizens that they tolerate more than a slight and short-term decline of real income and employment will also be lacking in future. Furthermore, it is not at all clear what could induce governments to relinquish almost totally their scope for influencing domestic economic activity and to commit themselves unconditionally to subordinating their future economic policies to the demands of the balance of payments.

The general socio-economic and political conditions of the present time and of the foreseeable future, which tend to prevent a speedy cushioning of any disequilibria that may occur, would, in case of a reintroduction of the gold standard, become a permanent source of lack of confidence in the long-term maintenance of gold convertibility, in the existing exchange rate structure and in the present extent of liberalisation in trade and payments transactions. These prospects further underline the opinion that a renaissance of a gold standard system cannot, despite its many potential advantages and its generally satisfactory performance in the last century, be recommended as a way out of the current national and international economic problems.

¹⁷ R. W. Jastram, op. cit., p. 12 f.

¹⁸ Cf. Citibank (ed.): Die Entwicklung der Großhandelspreise in Deutschland seit den Napoleonischen Kriegen (The Development of Wholesale Prices in Germany since the Napoleonic Wars), Frankfurt/M. 1979.

¹⁹ For further details cf. R. W. Jastram, op. cit., p. 2 ff.

²⁰ Cf. Interview with A. B. Laffer, op. cit., p. 30.