Research Department
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Bank of
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FRBSF Weekly Letter

Return to Gold?

A Congressional commission has met several times in Washington this fall to consider U.S. policy toward gold, including whether the U.S. should return to a gold standard. That this question is being debated seriously in official circles is striking testimony to public frustration with inflation and the policies responsible for it. Until recently, conventional wisdom held that the gold standard is an economic antique lacking the flexibility required in an age of big business, big labor, and OPEC cartels. But to its proponents, gold's strictures are necessary if Americans are ever to be freed of their preoccupation with inflation. As the Gold Commission weighs these and other arguments, it will have to consider a more basic question: is the gold standard the best practical way to restore and preserve monetary stability?

How it would work

Proposals to return the U.S. to gold generally involve two related but distinct measures. The first would establish a domestic gold standard by fixing the price in dollars of an ounce of gold, and require the Federal Reserve to convert its currency and other liabilities (mainly bank reserves) into gold at this price. In effect, the U.S. government would have to maintain the price of gold by purchasing and selling it on the open market.

Almost certainly, resumption of gold convertibility would *not* return gold coins to circulation, nor would a dollar's worth of gold directly back every dollar in the U.S. money supply. The U.S. money stock, even narrowly defined, exceeds $400 billion—most in checkable deposits at banks and thrift institutions—while the current value of our gold holdings is about $115 billion. More likely, official gold backing probably would apply only to "high-powered" money, that is to the direct liabilities of the U.S. government, in the form of the currency and bank reserves it has issued. For this reason, a return to gold probably would not visibly alter the way that individuals and businesses make payments for their transactions.

But such a gold standard would drastically alter the way the U.S. money stock is *regulated*. The amount of U.S. money now is limited by the amount of backing provided by Federal Reserve liabilities in the form of currency and bank reserves. At present, the Federal Reserve can vary the level of its liabilities at its discretion, literally "at the stroke of a pen." Under a gold standard, however, these liabilities would have to be backed by gold, so their amount would be limited by the gold holdings of the U.S. government. In effect, all U.S. money would then be backed *indirectly* by gold, so that the U.S. gold stock would regulate the U.S. money supply.

Although the U.S. could, in principle, go it alone in returning to gold, many proposals also envisage the establishment of an *international* gold standard. This would require all major industrial countries, not simply the U.S., to fix the gold prices of their individual currencies. The official gold prices for various national monies would then determine the rates at which they could be exchanged for one another. For example, if an ounce of gold were pegged at 100 U.S. dollars and at 50 British pounds, 2 dollars would be the price of a pound. Thus exchange rates among national currencies would be fixed—as they were before 1973—under an international gold standard and would no longer vary with market conditions as they do now.

Why Gold?

Gold's advocates and critics have the same basic objective—restoration of stability and predictability to the purchasing-power of the U.S. dollar. This is necessary if the dollar is to serve efficiently as a medium of exchange, allowing individuals and businesses to make purchases and sales without having to go to the considerable time and expense that direct barter would entail. The dollar's use as a medium of exchange thus saves scarce resources for society as a whole. But any uncertainty about the dollar's future purchasing-power discourages individuals from holding it for this purpose, and so impairs this function. People then conduct their transactions in other, more cumbersome, ways at significantly greater cost to the economy.

Stability in a money's value, though, generally requires stability in its supply and demand. Unfortunately the U.S. money stock has been highly unstable in recent years, fluctuating substantially about a rising trend. Money demand also has been highly unstable. Indeed the growth of NOW accounts, money-market funds, and other substitutes for traditional checking accounts—spurred in large part by U.S. inflation—has reduced the demand for money, and indeed has rendered its very definition ambiguous.

Gold's proponents argue persuasively that a gold standard could restore long-term stability to the *supply* of money. Again, the amount of U.S. dollars outstanding under a gold standard would be limited by the amount of gold owned by the U.S. government. Since the world gold supply has been growing fairly slowly, strict U.S. adherence to a gold standard would mean relatively slow growth in the supply of U.S. money. Thus individuals and businesses would be able to make long-term commitments in dollars, safe in the knowledge that future inflation due to too rapid money growth had been banished.

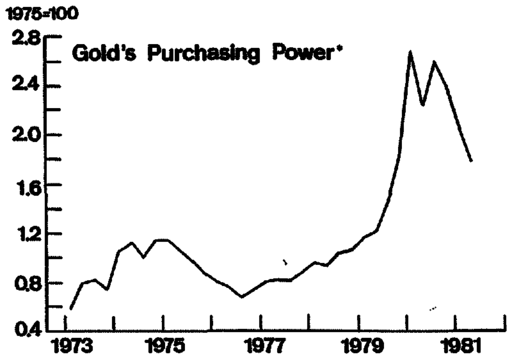
Many advocates also believe that gold would help alleviate some problems caused by short-term fluctuations in the demand for money. In their view, the historical record, as well as gold's intrinsic usefulness for decorative and industrial purposes, suggest that its value in terms of other goods and services is apt to remain fairly constant. If so, fixing the price of money in terms of gold could substantially stabilize its purchasing power in terms of goods generally. For example, if the demand for money should decline, individuals and businesses would tend to push up gold's price as they sold their excess money balances. But then U.S. officials would have to sell gold to maintain its official price, reducing the amount of dollars in circulation in the process. In this way, it is argued, a gold standard could provide an automatic regulator that tailors money's supply to its demand.

Why not

Few would deny the desirability of strictly limiting the money supply over the long-term, or would dispute gold's power to achieve this goal. But critics fear that a gold standard would unduly hamper the authorities' ability to deal with short-term economic problems—and that speculation in gold could add substantially to these problems. Perhaps their greatest worry arises from the fact that gold's purchasing power in terms of commodities generally has not been very stable in recent years (see chart). True, this instability may be due in part to changing expectations about inflation, which have frequently prompted investors to shift between monies and gold. (Indeed, gold's advocates believe that its purchasing power will stabilize once a gold standard is firmly in place). But wars, coups, invasion, or fears of them have also led to significant fluctuations in gold's value. Gold's critics suggest that some upheaval leading to a run on gold could force authorities to reduce domestic money supplies sharply in order to maintain the official price. The resulting deflation, they believe, could be quite severe.

Many critics also argue that a gold standard will deny officials necessary policy-discretion to deal with changing economic conditions. They point out that strict adherence to gold in the face of sharp oil-price increases, comparable to those imposed in 1974, would leave officials with very little freedom to use domestic monetary policy to combat the resulting downturn in economic activity.

Future oil price increases, moreover, could lead to particularly severe problems under an *international* gold standard. When oil prices rise in the face of fixed exchange rates, coun-



*Index of ratio of dollar price of gold to U.S. consumer price index.

tries that are heavily dependent on oil imports inevitably incur large trade-and-payments imbalances. Under a gold standard, these countries normally would suffer substantial gold outflows, and hence potentially severe deflation. Countries that export oil (as well as some that import relatively little) meanwhile would receive gold inflows, resulting in domestic money increases and (hence) inflation. Adherence to an international gold standard thus may actually add to price instability when supplies of basic commodities change with disproportionate impacts across countries. Unfortunately, such changes have been unusually prevalent and severe in recent years.

Admittedly, such difficulties could be significantly alleviated if the U.S. *alone* were to restore gold, while other industrial countries continued to allow their dollar-exchange rates to fluctuate freely, as presently. Then, exchange rates would vary to restore balance in nations' international payments, largely avoiding the need for domestic money and price-level adjustments to oil price increases. But, of course, if foreign countries were to maintain flexible exchange rates, they would *not* be able to adopt gold backing for their own currencies. And, then, with no guaranteed limitation of foreign money supplies, fears about inflation abroad could seriously aggravate speculative pressures on gold.

Verdict

Ultimately, the Gold Commission's verdict is apt to come down to two fundamental questions: 1) is short-term discretion in monetary policy politically compatible with monetary stability? and 2) can other alternatives ensure this stability without gold's drawbacks? Gold's advocates believe that, allowed discretion, policy-makers will inevitably fail to resist political pressures to alleviate short-term economic ills at the expense of longer-term goals. They advise officials to follow the ancient example set by Odysseus, who had himself lashed to his ship's mast so that he might resist the calls of the Sirens. "Tie your hands with gold," they counsel, "lest the Sirens of Special Interests entice you onto the shoals of inflation and stagnation." Gold's critics counter that Odysseus did not, after all, attempt to steer his ship all the way home while lashed to the mast. While conceding that discretionary monetary policy has not always worked well in the past, many argue that the remedy is better money management in the future—not an economic straitjacket made of gold. And they are not sanguine, as many gold advocates are, that short-term economic problems will be banished once an aura of gold shines through the world economy.

In the end, the availability of alternative routes to monetary stability may well tip the scales against gold. After all, gold's promise of stability for the dollar's purchasing power lies mainly in its ability to strictly limit growth in the dollar's supply. But there are other ways to limit the money supply, and they do not share gold's vulnerability to speculative pressures. For example, the U.S. Congress could legislatively mandate a steady, predetermined, increase in the money stock that was compatible with price stability—as Milton Friedman proposed some years ago. Alternatively, the dollar's value might be fixed in terms of a basket of several basic products (perhaps including gold, perhaps not) whose value in terms of commodities might be more stable than that of gold alone. All these proposals are based on the plausible presumption that gold's basic "secret"—money-supply control—is not possessed by it alone.

To this, gold's advocates might reply: "Such devices are merely promises and laws made by politicians; without gold's mystique, such pledges will be broken as they have repeatedly been in the past." Still, a commitment to gold is like any other legal commitment, and it too has been repudiated often in the past. In the last analysis, monetary stability must be secured by prudent, disciplined policies that are well understood and believed by those they serve. And where such qualities reside, is there a need for gold?

Charles Pigott

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 11/4/81	Change from 10/28/81	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	153,471	161	9,644	6.7
Loans (gross, adjusted) — total#	132,626	160	10,943	9.0
Commercial and industrial	40,125	387	4,224	11.8
Real estate	55,010	31	5,587	11.3
Loans to individuals	23,252	44	− 672	− 2.8
Securities loans	1,837	415	665	56.7
U.S. Treasury securities*	5,575	− 31	− 1,136	− 16.9
Other securities*	15,270	32	− 159	− 1.0
Demand deposits — total#	41,336	2,524	− 7,213	− 14.9
Demand deposits — adjusted	28,140	236	− 6,460	− 18.7
Savings deposits — total	29,751	537	− 328	− 1.1
Time deposits — total#	85,065	− 511	18,787	28.3
Individuals, part. & corp.	77,176	− 447	19,843	34.6
(Large negotiable CD's)	32,545	− 564	6,994	27.4

Weekly Averages of Daily Figures	Week ended 11/4/81	Week ended 10/28/81	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (−)	N.A.	72	96
Borrowings	N.A.	13	167
Net free reserves (+)/Net borrowed(−)	N.A.	59	− 71

* Excludes trading account securities.
# Includes items not shown separately.

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