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Let's forget the gold standard

The gold standard downgrades the importance of domestic economic outcomes, ignores distributional equity and is about as practical as a plan to make Monday the third day of the week.

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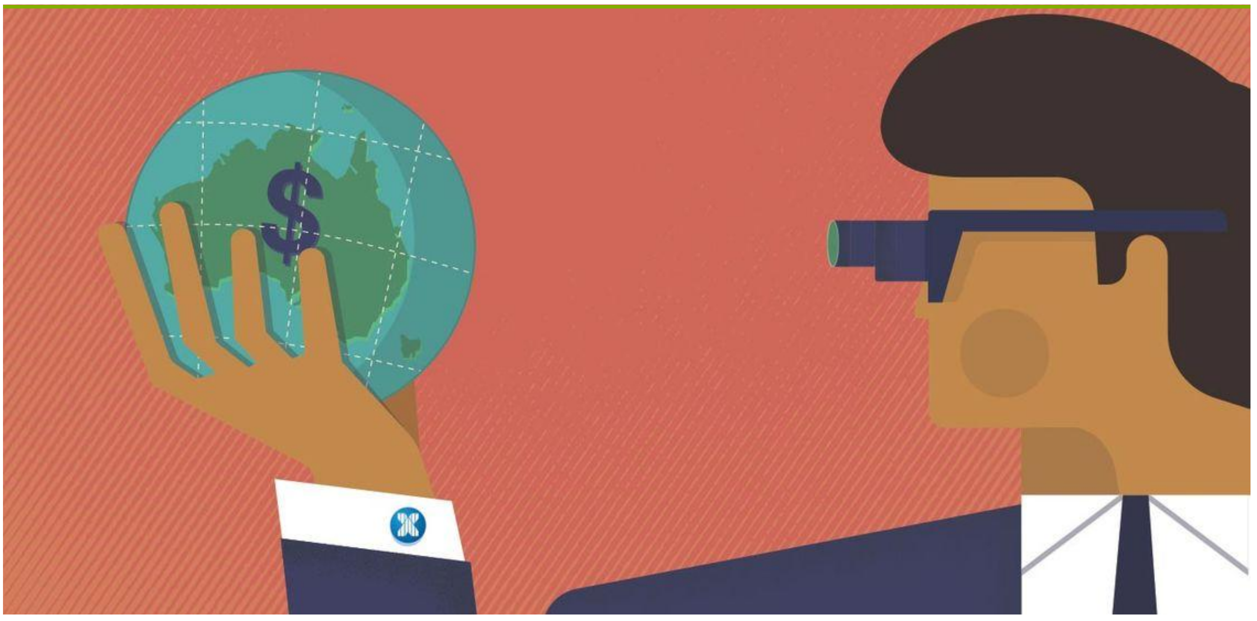

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The potential nomination to the US Federal Reserve board of European Bank for Reconstruction and Development executive director Judy Shelton has rekindled talk of the gold standard.

President Donald Trump tweeted on July 3 that he intends to nominate Shelton to one of two vacancies on the US central bank board of governors. He has proposed filling the other vacancy with Christopher Waller from the St Louis Federal Reserve Bank.

Shelton and Waller are more conventional choices than his first two suggestions, widely seen as short of the needed skills, withdrew their candidacies after their personal behaviour histories began costing too many Senate confirmation votes.

Shelton was one of Trump's advisers on the 2016 presidential campaign trail. She is a forthright advocate for Trump's policy positions but brings enough academic heft to warrant consideration for inclusion in the heavily PhD oriented central bank halls.

Shelton brings some controversy to the role. She has alleged central banks use monetary policy to manipulate trade competitiveness. This would not be allowed, she contends, under a gold standard which would establish a level playing field for trade.

Asked in a CNBC interview on Friday about her views on gold, Shelton criticised use of the money supply to engineer policy outcomes at the expense of safeguarding money as the dependable store of value needed to encourage savings and investment to sustain future economic growth.

Rules, such as a gold standard, designed to guide monetary policy decision making are often portrayed as the best way to keep policymakers on the straight and narrow.

Shelton's comments about the gold standard appear to dovetail neatly with the often stated slogans of the US president about fair trade, his desire to rein in trade deficits with other countries and his increasingly strident critique of Fed tightening as handing a competitive advantage to other countries.

> **The gold standard policy prescriptions for deficit countries have been blamed for the severity of the great depression**

The classic gold standard maintained a fixed exchange rate between national currencies and physical gold and, consequently, between individual currencies. To work, the link could not be adjusted and gold had to flow freely between individuals and between countries. There was no role for an international co-ordinating agency such as the International Monetary Fund to intervene to prevent, modify or compensate for market outcomes.

A gold standard comes with a problematic asymmetry between the treatment of balance of payments surpluses and deficits.

A surplus country could go on accumulating gold indefinitely with a potentially higher rate of inflation being the only penalty.

A deficit country would risk running out of gold. Being unable to abandon the fixed gold value of its currency, it would have to deflate rather than devalue to restore balance. Lowering prices and possibly real incomes would be necessary to reduce imports and increase exports to improve the balance of payments and rebuild gold reserves.

A gold standard is tough medicine, many would say heartless, for a country with a balance of payments deficit. The gold standard policy prescriptions for deficit countries have been blamed for the severity of the great depression.

Balance of payment adjustments have been a bugbear since the first nation states. No entirely satisfactory model has evolved, as current trade disputes attest.

What economists have referred to as a monetary policy trilemma has been an ongoing constraint on the choice of a suitable adjustment model. In short, a country can only pursue two out of the following three desired possible objectives: foreign exchange stability, freedom of cross border payments and the primacy of domestic policy goals.

A choice must always be made. In choosing domestic policy primacy and freely flowing capital, more or less the status quo, exchange rate stability is foregone.

The gold standard opts for foreign exchange stability and an open payments system, leaving domestic policy goals on the outer. It is hard to believe this would be a voluntarily acceptable arrangement within any domestic community presently.

President Trump has come to power advocating the primacy of domestic policy outcomes, a stance at odds with the gold standard outcomes many of his supporters espouse.

The gold standard also faces a devilishly difficult transition problem for which economists have no answer. Economists spend the majority of their time commenting on current conditions. They expend some but considerably less energy on defining improved alternatives. Hardly any time is spent detailing transition paths from the present to a proposed better future.

In moving to adopt the gold standard, some countries would have more than enough and others would have too little gold to avoid an immediate deflationary impact, with job losses and output contraction being a needed preliminary step.

If national and individual wealth is suddenly defined in terms of how much gold is owned, a widening gap between the gold haves and have nots would threaten political instability on a global scale.

No matter how impressed economists are about the elegance of the gold standard as a model describing economic behaviour, their affinity is more nostalgic than practical.

Searching the website of the American Economic Association, the world's largest assembly of economists, for "gold standard" throws up just 10 mentions from the past three decades of digitised journals. Of those, six are primarily articles dissecting the causes of the great depression or earlier instances of gold standard use with only oblique relevance to the future conduct of policy.

The message from the economics profession is "let's move on". Meanwhile, those most enthusiastic about a return to the gold standard as an international monetary model typically have no responsibility for, or care little about, the ensuing distributional inequity. Others have no transition plan with which to facilitate adoption. In short, a currency gold standard is a lost cause. Forget it.

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