

RETURN OF THE GOLD STANDARD?

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Any move in the gold-standard direction must be guided by pragmatism, not dogmatism.

Category: [Analysis](#)

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The greatest problem with economics is the bridge from theory to reality. Nowhere is this proven with more clarity than in countries that are subjected to socialism: its economic theory is proven wrong time and time again with misery in place of prosperity, with chronic shortages, quality problems, and a depressing lack of economic and social progress.

Socialist economics, or Marxism, is not the only economic theory that fails in the face of reality. Keynesian economics, especially in its politicized contemporary format, is in large part responsible for the unending fiscal problems associated with the modern welfare state.

Austrian economics, embraced by conservatives and libertarians, also struggles when put to work. It is fundamentally a sound theory, which emphasizes the intertemporal nature of economic decisions and the role that uncertainty plays in shaping those decisions. This theoretical base is a good launch pad for explanations of how government negatively affects the economy.

Monetary policy is a case in point: by distorting the money supply, the central bank corrupts the most essential of all intertemporal prices: the interest rate. As a result, private sector decision-makers on free markets misallocate resources in both time and space.

Austrian economists often promote the gold standard as a remedy for such distortions. In his book *Human Action*, Ludwig von Mises describes the gold standard as an essential component of Western civilization. It is so powerful, he explains, that it eliminates the need for government regulations on the banking industry.

Unfortunately, it is difficult to implement the gold standard, more difficult than the theory may suggest. That does not mean we should dismiss it, but any reform to move a modern fiat currency onto a commodity base will have to be exceptionally carefully executed. To illustrate these difficulties, I will do a small experiment.

First, though, a quick overview of the gold standard itself. One of the best overviews of it was penned by British economist Ralph Hawtrey. Titled simply "The Gold Standard", it was published in *The Economic Journal* in December 1919. Hawtrey explains:

In order to make the gold standard effective, it is ordained that every debt above a certain limit shall be payable, if the creditor wishes, in gold. This system can only work if the debtor, when so required, can readily obtain the necessary quantity of gold.

This, Hawtrey says, has far-reaching consequences for commercial banks:

And with a banking system, of course, the banker makes it his business to supply so much gold as his customers require for their daily business, and keeps a stock in hand for the purpose.

Technically, this is called 'full-reserve banking' and contrasts with the widespread modern practice of 'fractional-reserve banking.' The latter, which means that banks only keep a

small portion of their liabilities in reserves, is often blamed for causing speculative bubbles in equity markets.

When fractional-reserve banking works as intended, it is smooth and efficient. Joe goes to his bank to borrow \$1,000. The bank does not have \$1,000 in reserves, so it asks the central bank for a loan of \$1,000. The central bank prints the money and lends it to Joe's bank. His bank, in turn, opens a line of credit on his checking account.

This is an illustrative example only; the relationship between credit expansion and the growth of the fiat money supply is relatively complex. With that in mind, let us see what happens next.

Joe buys a motorcycle from Jack and pays with a check for \$1,000. Jack deposits the check and buys a computer from Jane, using his debit card. Jane, in turn, buys a lifelong subscription to *The European Conservative*.

By now, the same \$1,000 worth of reserves—the original cash that the bank used to fund Joe's credit line—has created \$3,000 worth of economic activity. At every turn, \$1,000 is deposited into a checking account, tripling the supply of money without increasing the cash floating around. All that has happened is that the economy uses the same amount of money three times.

This is possible when commercial banks *de facto* can create money. That is impossible under the gold standard. As Ralph Hawtrey points out, we can still use paper money under the gold standard, but the supply of cash would be tied strictly to the amount of gold in the central bank's possession.

The practical meaning of this is very important: a fixed price per ounce of gold.

At this point, the gold standard runs into its greatest challenge. To see why, let us do the aforementioned experiment. We use annual data on global gold mining—courtesy of the

[World Gold Council](#)—and on the gross domestic product, GDP, from the [United Nations economic database](#).

For simplicity, we apply the gold standard globally; every central bank has a fixed per-ounce gold price in its own local currency. This creates a fixed exchange rate system across the world, which means that we can use the dollar-to-gold price as an international proxy.

Gold effectively becomes the global currency.

With a global gold standard, there is no longer a need for investors to keep gold in their portfolios. If the gold standard works as theory intends for it to do, namely to guarantee price stability, there will be no upward trends in the price of gold. This eliminates the speculative reason for investors to keep gold (unless they deliberately wish to disrupt the gold standard). Furthermore, since inflation is eliminated, private investors no longer need to own gold *qua* gold for inflation-hedging purposes. All they have to do is hold money, which, thanks to the gold standard, represents the value of gold just as well as the metal itself.

But does this not mean that there is no longer any meaningful reason for people to mine gold around the world? No, it does not. Central banks are still interested in buying new gold, for reasons that our little experiment will show.

To give us the best possible contrast between theory and reality, we go back in time and launch it in 2009. We can then monitor its effects over a decade, through 2019, and compare it to how the economy actually performed during that time period.

Given that the gold standard is worldwide, we can use the whole world's economy as our laboratory. Using the dollar as our denomination, in 2009 the entire planet produced a GDP of \$62 trillion. All the transactions that take place in this economy are guaranteed by an amount of gold at the price of \$1,405.50 per ounce.

We use this price because it was the global, average price at the end of 2010; for data quality reasons, we do not track the gold price further back in time.

At our selected price, in 2009 the world's central banks would have had to own 44.1 billion ounces of gold, or 1.7 million tons. They could then print a supply of paper money proportionate to that amount of gold—for simplicity, we assume that the cash-to-gold ratio is the same as the GDP-to-gold ratio. This means that the total global supply of money is \$62 trillion (and, as all you monetary nerds quickly realize, the velocity of money is one).

Now we have a GDP, a stack of gold, and a supply of money in the economy. So far so good.

We now set time in motion, and suddenly things get a bit complicated.

If we look at [UN national accounts data](#), in 2010 the global economy grew by 4.5%, adjusted for inflation. This comes out to an extra \$2.8 trillion in economic activity. How do we finance this increase? There is not enough money in the economy to bankroll those activities. This is no small problem. We have an extra \$2.8 trillion of capital formation, private consumption, paychecks, and other transactions that we need money for.

The central banks of the world cannot just print another \$2.8 trillion: if they did, the price of money vs. gold would increase—in other words, the value of money would decline. The whole point of the gold standard is to strictly limit money supply to a fixed price vs. gold.

At the same time, if we do nothing, the so-called transactions demand for money will increase. This will push interest rates up; since money supply is strictly limited, higher interest rates will reverse the expansion of economic activity. The world's GDP in 2010 will be exactly equal to where it was in 2009.

The only way to increase the amount of gold in the world's central bank vaults is for them to buy up all the gold that miners can extract. In 2010, the world's gold mines produced

2,831 tons of new gold. At the aforementioned dollar-per-ounce price, this comes out to \$127.3 billion worth of new gold.

This means that the world economy can now grow, but only by 0.17%.

But wait—did we not just report that the actual, inflation-adjusted growth of the world economy in 2010 was \$2.8 trillion? Yes, we did, which means that the growth allowed under the gold standard is a tiny fraction of what the actual growth was.

In other words, even if all the central banks in the world buy up the entire annual production of new gold, the gold-standard economy still runs into some serious, practical problems. The most pressing among them is the virtual elimination of economic growth—which happens to be something we need more of, not less. A lot of the world's economic expansion benefits poorer countries. The African continent has seen a remarkable economic upswing in the past 20 years, in some ways comparable to what the Asian 'tiger economies' experienced in the latter half of the last century.

Billions of people ride the tides of economic growth from abject poverty into relative prosperity. This means better housing and food, higher-quality health care, more education opportunities, and a financially safer future. It means access to more expensive, yet more environmentally friendly technological solutions to production, investment, and consumption.

Do we really want to deprive the world's poor of a path to prosperity? Clearly, they themselves want it: in 2010, there was demand for 22 times more economic activity than the gold standard would have allowed. This means 22 times more capital formation, private consumption, government investments, labor income, and entrepreneurial profits.

This problem can be sliced in many different ways. Should, e.g., the world's central banks decide what countries can have economic growth, and which ones can't, by simply allocating the newly mined gold between them? Africa produced more than one-fifth of the

world's new gold supply in 2010—does that mean they should get more than one-fifth of the world's economic growth? Should only three European countries, with their own gold mines, be allotted economic growth?

These are tricky questions, and they are inevitably in the way of any project to rebase any currency from fiat to gold. However, the difficulties in answering them do not suggest that the gold standard is a bad idea. What they do tell us, though, is that any move in the gold-standard direction must be guided by pragmatism, not dogmatism.

With all this in mind, I encourage gold-standard proponents to continue their work. A limited, practical commodity base can improve the solidity of a currency. More than anything, it can help highlight the prominent role that deficit-spending governments play in eroding the value of money. Once the commodity base is in place, those spending-happy politicians cannot monetize their deficits without manipulating their currency's gold price.

The political barrier that this creates may be the most important contribution that the gold standard can make in terms of strengthening our economy and opening a more prosperous future for all of us.