Will Gold Plating the Fed Provide a Sound Dollar?

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Every period of economic crisis or turmoil in the U.S. since 1971 has invariably elicited an outbreak of nostalgia for the "gold standard" among assorted financial journalists, investment gurus, policy wonks, politicians, and even a few economists. Generally the proposals that these reformers present take the form of a greatly watered-down version of the genuine, classical gold standard. For example, the monetary disorder attending the Great Inflation of the 1970s brought forth a public clamor for a return to gold that rose to a crescendo by 1980. Congress enacted a law in October of that year establishing what came to be called the Gold Commission to study the role that gold should play in the U.S. and international monetary systems. In June 1981, President Ronald Reagan appointed 17 members of the commission, which submitted its report to Congress in March 1982.[1]

Although the Gold Commission considered plans for a variety of gold standard regimes, the one that received by far the most exposure in the mainstream media was the proposal of supply–side economists and journalists including Robert Mundell, Arthur Laffer, and Jude Wanniski for the implementation of a system very much like the Bretton Woods System.[2] This proposal formed the basis for the

[1] Anna Schwartz (2004), author of the Commission's majority report, frankly questions whether the establishment of the Gold Commission was a "serious attempt to study what a gold standard could contribute to the public welfare." Judging by the make-up of the Commission it is difficult to disagree with her assessment. Aside from U.S. Representative Ron Paul and entrepreneur Lewis E. Lehrman, the politicians, businessmen, Federal Reserve Board Governors, and economists composing the Commission had no sympathy for the gold standard. Paul and Lehrman's position can be found in the minority report of the Commission (Paul and Lehrman 2007).

[2] The proposal is presented in detail in Laffer (1980). Also see: Laffer and Miles (1982, pp. 399–401); Mundell (1981); and Wanniski (1981). See Welker (1980) and Salerno ([1982] 2010) for a discussion and critique of the various proposals for a gold standard in circulation at the time.

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Gold Reserve Act introduced as a bill into the U.S. Senate in 1981 by Senator Jesse Helms (R-NC).[3]

The financial crisis of 2007–2008 and the ensuing recession and stagnant recovery have raised recent calls for the restoration of the gold standard. And once again, the plan that has received the most support and media attention is one that calls for the establishment of an attenuated version of the Bretton Woods system in which the Fed is legally mandated to target the price of gold. And it, too, is the basis of a Congressional bill. H.R. 1576 (2013) entitled "The Dollar Bill Act of 2013" was introduced into the U.S House of Representatives on April 16, 2013 by U.S. Representative Ted Poe (R-Texas).[4]

In the first section of the paper, I will describe the nature and operation of the gold standard that is envisioned in Ted Poe's bill. I will analyze the chief flaws in Poe's proposed "Dollar Bill system" in the second section. I argue that it is not really a gold standard in any meaningful sense. The third section will be devoted to an analysis and critique of the main arguments presented by the advocates of Poe's bill. I will try to demonstrate that the arguments of the contemporary pro-gold reformers are built on the same fundamental fallacies that are espoused by mainstream macroeconomists and Fed policy makers whose doctrines and policies they so roundly condemn. I will conclude with some observations on the path back to sound money in the final section.

The Dollar Bill System

Representative Poe's bill begins grandly with a list of "findings" that constitutes a blistering indictment of the performance of the Federal Reserve System ever since Congress delegated to it the power to regulate the dollar in 1913.

According to these findings, the U.S. dollar has declined "dramatically" relative to real commodities including gold and crude oil and to foreign currencies while its value has become "unstable and uncertain." The Fed "has not produced a stable and reliable value" for the U.S., nor can it "be reasonably expected" to do so. The findings then go on to detail the deleterious effects of the unstable dollar on: economic growth; the cost of capital and risks of long-term investment; real earnings of American workers; the value of financial assets held by the American public; the real value of pension plans and retirement accounts; the economic and political standing of the U.S. in the world; and the level of anxiety and uncertainty in financial markets and among the public at large.

To prevent further instability in the value of the U.S. dollar caused by the Fed, Poe's bill would mandate the Fed to fix the price of gold within a narrow band. The first step in instituting this gold price-targeting regime would be for the Board of

[3] Helms's bill is reprinted in Welker (1980, pp. 7–9).

[4] For Poe's bill, see H.R. 1575 (2013).

Governors of the Fed to designate a "Target Week" that would start no earlier than 90 days and end no later than 120 days from the enactment of the bill. Using an unspecified "random process" the Board would then designate during the Target Week a precise day, hour, minute and second as the "Target Moment," which it would not publicly disclose. The dollar price of gold would be fixed at the price prevailing on the exchange operated by Commodities Exchange, Inc. (COMEX) of the New York Mercantile Exchange precisely at the Target Moment and maintained within a range of plus or minus 2 % of this price (the "Target Range") from that time onward.[5]

The Fed would maintain the gold price within the Target Range "directly" by open market operations. Furthermore, the Fed would be barred from using indirect methods, for instance, targeting the Fed Funds rate as it does now, to carry out the bill's mandate. In the same vein, the bill would prohibit the recent practice of paying interest on bank reserves deposited at the Fed.

While the bill lays out the basic policy framework for the "Dollar Bill system," it does not describe how it actually might operate to "stabilize" the dollar.[6] Details of its operation, however, may be gleaned from the writings of the bill's major proponents, namely *Forbes* magazine publisher and long-time supply-sider Steve Forbes (2013a, b), *Forbes* economic journalist Louis Woodhill (2011, 2013a, b) and investor and columnist Nathan K. Lewis (2007, 2013), author of two books on the gold standard.

To begin with, gold would not play a direct monetary role under the Dollar Bill system. The U.S. dollar would continue as a pure fiat money, inconvertible into gold. The monetary base would be, as it is now, composed exclusively of fiat dollars, that is, Federal Reserve notes held by the public and by the banks in their vaults and ATM machines plus reserves held by the banks on deposit at the Fed.

Thus the Fed would continue to control the monetary base, but it would do so by buying or selling bonds depending on whether the price of gold was falling or rising relative to its target price within the Target Range. Suppose for simplicity that the target gold price was established at $1,300 per ounce in accordance with the process specified in the Dollar Bill Act. This means that the Fed would be legally compelled to conduct open market sales thereby reducing the monetary base whenever the price of gold rose to $1,326, which at 2 % above the target price of $1,300 defines the upper limit of the Target Range. Similarly, a movement of the price of gold to $1,274 at the lower end of the Target Range would oblige the Fed to expand the monetary base via open market purchases.

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[5] The language in the bill refers to making "the value of the U.S. dollar equal to the price of gold," which is nonsensical and empty rhetoric. One could just as easily declare the value of the dollar equal to the price of IPads, soybeans or any good or service whatever, because the dollar's value or purchasing power always consists of (the reciprocal of) the prices of all the alternative goods, including gold, that it exchanges for on the market. "Fixing the dollar price of gold" is the correct and honest description of what the Fed would actually be doing.

[6] Woodhill (2011) uses the term "Dollar Bill system" to designate the monetary system that would emerge from Poe's bill in order to distinguish it from the Bretton Woods system.

The "Goldless" Gold Standard

There are numerous problems with this blueprint for a new gold standard. Most important, however, is that it is a pseudo-gold standard, a gold standard *in name only*. It has been described as a "goldless gold standard" (Benko 2013). There would be no gold dollars coined and in circulation among the public, nor would the Fed be required to maintain convertibility between dollars and gold or to hold any gold reserves at all. Thus Poe's Dollar Bill Act would leave the fiat dollar fully intact and the supply of dollars subject to continued absolute control by the Fed via open market operations. In effect, the Dollar Bill system is nothing but monetarism with a price rule rather than a quantity rule governing the Fed's operating procedure.

As I argued in a critique of the earlier Laffer proposal for a gold standard (Salerno [1982] 2010, pp. 282–283):

> When we strip away the gold plating, Laffer's price rule appears as a technique designed to control inflation under the current fiat-money standard. It thus differs only in technical detail from the quantity rule advocated by the monetarists.. . . Laffer's plan turns out to be, in essence, a kind of "price rule monetarism," the references to gold notwithstanding. The most serious defect in both variants of monetarism is that they fail to address the underlying cause of inflation, namely, the government monopoly of money.

In fact the Poe bill places even fewer restraints on the Fed than did Laffer's proposal, which, as noted above, served as the blueprint for Senator Jesse Helms's Gold Reserve Act of 1981. At least in the Helms bill, the dollar and gold would be freely convertible into one another at the official price. In addition the Fed would be obliged to pay out gold coins and to hold gold reserves as a certain percentage of its dollar liabilities, although these reserves could vary within a wide range and dollar convertibility would be legally suspended if the level of reserves sank far enough below the lower limit of the range. After a period of inconvertibility and free fluctuation of the gold price, the official gold price would then be reset below its previous level.

The supporters of the Poe bill clearly recognize that the dollar would remain a fiat currency subject to monopoly control by the Fed and that gold would have no monetary role whatsoever. Indeed they tout this as a major virtue of the Dollar Bill system. For example, Steve Forbes (2013b) refers to "countless varieties" of gold standards and describes the "common characteristic" of real gold standards in the following terms: "Theoretically . . . you don't need an ounce of the yellow metal to operate a gold standard; all you need is to refer to the price in the open market." Louis Woodhill (2013a) explicitly rejects the use of gold as money in an article revealingly entitled "Gold Isn't Money, but It Should Be Used to Define the Value of the Dollar."

But why would self-proclaimed supporters of the gold standard be willing to leave in place the inflationist Federal Reserve and the ever depreciating fiat dollar, while relegating gold to the status of an ordinary market commodity whose price is used as a target to guide the Fed in manipulating the money supply? In order to answer this question we need to examine their fundamental views on the nature and function of money.

Erroneous Monetary Doctrines

Underlying the arguments of those who advocate the "goldless" gold standard are three erroneous doctrines regarding money. These errors can be traced back to the writings of the first influential fiat-money inflationist, John Law ([1705] 1966) at the beginning of the eighteenth century and have been exposed and refuted time and again during the past three centuries by sound-money theorists in the classical-Austrian tradition.[7] In analyzing these doctrines, it will become apparent that the advocates of the Dollar Bill system share these fallacies in common with central bankers, macroeconomists and other supporters of the current fiat-dollar regime whom they criticize so vehemently.

A. Money as a Policy Tool

Proponents of the classical gold standard have generally viewed money, and the gold standard in particular, as a social institution that is the outcome of a market process involving millions of individuals and evolving over millennia. In their view, the primary function of money is to serve as a general medium of exchange that is used by the multitude of autonomous participants in the market to carry out their diverse transaction plans in the most economical manner. Money also serves at the same time to provide entrepreneurs with a reliable means of calculating the prospective costs and revenues of their investment and production plans, which guide them in efficiently allocating productive resources to those uses anticipated to be most valuable to consumers.[8]

The adherents of the Dollar Bill system reject this account of the origin and function of money. Rather than an organically grown social institution, they consider money to be a policy instrument deliberately constructed and wielded by government and its central bank to achieve specific macroeconomic goals, such as an adequate supply of money, low interest rates, a stable price level, the avoidance of deflation and depression, and so on. In this "constructivist" narrative of money, the gold standard like all monetary regimes is purely a contrivance of government *policy* and has always been so historically.

In his book on the gold standard, Nathan Lewis (2013) elaborates the argument that the gold standard is a policy tool. For Lewis (2013, pp. 28–29) all forms of the gold

[7] For a review and critique of Law's doctrines in their ancient and modern forms, see Salerno ([1991] 2010).

[8] For a historical overview of this approach to money, see Salerno ([1991] 2010).

standard are "a subcategory of a broader class of fixed-value policies" which may or may not involve the use of gold as the "standard of value." In this subclass of policies, the gold standard refers to a variety of systems that have existed or can be conceived in which the value of the currency is linked to the value of gold bullion via a fixed or "parity" price at which bank notes exchange for gold. All historical gold standards—even the 100 %-reserve banknotes issued by the Bank of Amsterdam in the seventeenth and eighteenth centuries—therefore have been an invention of government policy, "a fixed-value system with gold as the policy target." Indeed in his analysis of the operation of a gold standard, Lewis (2013, pp. 159–169) does not treat the 100 %-reserve gold standard as fundamentally different than his preferred "no gold" gold standard in which the money manager does not hold any gold reserves and does not buy or sell gold at the parity price but instead targets the gold price by buying or selling bonds or even fine art.[9]

Furthermore, according to Lewis (2013, pp. 30–31), gold itself does not function as money in any kind of gold standard. Rather, fixing the price of gold is simply an effective policy for constraining the "currency manager" to ensure that the supply of currency, consisting of "banknotes with no intrinsic value," remains artificially scarce and therefore valuable. Thus by establishing a fixed price of gold, the "worthless paper chits" can be given a specific value, i.e., the same value as a specific weight of gold bullion. The startling implication of Lewis's analysis is that somehow money originated as a paper fiat currency without a determinate supply or purchasing power over goods and services, *and then* governments had to invent a method of keeping it scarce and giving it a market value. Needless to say, this is preposterous. Even if a clever monarch, politician, or central banker were able to devise a policy rule to ensure that paper currency remained scarce, its initial introduction into the barter economy would fail because economic agents would not be able to value the currency in the absence of a pre-existing set of exchange ratios between the new currency and real goods and services.[10]

Lewis's ideas on money do not differ in the least from the position of most mainstream economists, who maintain that all historical and thinkable monetary regimes must involve an implicit or explicit "policy rule." Where supporters of the current monetary regime differ from the advocates of the Dollar Bill system is in their belief that targeting the price of gold is a "suboptimal policy rule," which can be improved upon by targeting either a short-term interest-rate or the inflation rate.

B. Money Is a Measure of Value

According to mainstream economics textbooks, one of the primary functions of money is to "measure" the value of goods and services exchanged on the market. A

[9] For a critique of earlier advocates of the gold standard who viewed the gold standard as a creation of government policy, see Salerno (1992, pp. 102–107).

[10] As early as 1912, Ludwig von Mises demonstrated, via his "regression theorem," that money must originate as a commodity with a pre-existing market value under barter. See Mises (1981, pp. 129–44, 1998, pp. 405–408).

typical statement of this view is given by Frederic Mishkin (2010, p. 55) in his textbook on money and banking:

> [M]oney . . . is used to measure value in the economy. We measure the value of goods and services in terms of money, just as we measure weight in terms of pounds and distance in terms of miles.

When money is conceived as a measure of value, the policy implication is that one of the primary objectives of the central bank should be to maintain a stable price level. This will supposedly remove inflationary noise from the economy and ensure that any changes in money prices that do occur will tend to reflect a change in the relative values of goods and services to consumers. Thus, for mainstream economists, stabilizing a price index based on a basket of arbitrarily selected and weighted consumer goods, e.g., the CPI, the core CPI, the PCE, etc. is a prerequisite for rendering money a more or less fixed yardstick for measuring value.

Now the idea that a series of acts involving interpersonal exchange of certain sums of money for quantities of various goods by diverse agents over a given period of time somehow yields a measure of value is another ancient fallacy that can be traced back to John Law. Law ([1705] 1966, pp. 52, 61, 92, 102) repeatedly referred to money as “the measure by which goods are valued.” This fallacy has been refuted elsewhere. Suffice it to say that the act of measurement involves the comparison of one thing to another thing that has an objective existence and whose relevant physical dimensions and causal relationships with other physical phenomena are absolutely fixed and invariant to the passage of time, e.g., a yardstick or a column of mercury. In contrast, the value an individual attaches to a given sum of money or to any kind of good is based on a subjective judgment and is a purely intensive quality without physical dimensions. As such the value of money varies from moment to moment and between different individuals. The price paid for a good in a concrete act of exchange does not measure the good’s value; rather it expresses the fact that the buyer and the seller value the money and the price paid in inverse order. For this reason neither money nor any other good can ever serve as a measure of value.[11]

Unfortunately, advocates of a gold-price target wholeheartedly embrace this mainstream doctrine while giving it an odd twist. They begin with the wholly unsupported assumption that one commodity, gold, is stable in value and that, therefore it can serve as the lone guiding star—or “The Monetary Polaris” as Lewis (2013) terms it—for Fed monetary policy. According to Steve Forbes (2013b) real gold standards have one thing in common: “They use gold as a measuring rod to keep the value of money stable. Why? Because the yellow metal keeps its intrinsic value better than anything on the planet.”

Woodhill (2013a, b) writes in a similar vein:

> The fundamental validity of the gold standard rests upon the premise that the real value of gold remains constant over time.. . . The most fundamental thing about a unit of measure is

[11] For a critique of the idea that money is or can be made to measure value see Rothbard (2009, pp. 843–851) and Mises (1981, pp. 51–62; 1998, pp. 220–229).

> that it be constant.... Gold is not money, and it should not be money. However we can and should use gold to define the value of the dollar.

These passages reflect an almost mystical belief that the "intrinsic" or "real" value of gold is, for all practical purposes, eternally unchanging, unaffected by the continual flux of human valuations, stocks of resources (including gold itself), technology, and entrepreneurial judgments that defines the essence of the dynamic market economy. Furthermore no definition is ever given of what exactly the concept of "intrinsic value" means or in what units it is expressed.

Historical experience clearly shows that the value of gold vis-a-vis other commodities has fluctuated over the centuries, even when gold has served as the monetary standard. This was certainly the case, for example, when the U.S. returned to the gold standard after the Civil War. From 1880 to 1896, U.S. wholesale prices fell by about 30 %. From 1897 to 1914 wholesale prices rose by about 2.5 % per year or by nearly 50 %. This rise came about mainly as the result of a nearly doubling of the global stock of gold between 1890 and 1914 due to discoveries of new gold deposits in Alaska, Colorado, and South Africa and improvements in the technology of mining and refining gold (Friedman and Schwartz 1971, pp. 135–137).

Proponents of a gold-price target thus seem to ignore both theory and history in assuming that once the dollar price of gold has been fixed, the value of money itself becomes forever stable and immune to the influence of market forces of supply and demand. Inflation and deflation are, therefore, *ipso facto* banished from the economy. This implies that any changes occurring in the quantity of money under a fixed-gold price regime are to be construed as benign and stabilizing adjustments of the supply of money to changes in the demand for money. As Forbes (2013a) argues:

> [T]he yellow metal is merely a means of measuring the value of the dollar. The fact that a foot has 12 inches doesn't restrict the number of square feet you have in a house. The fact that a pound has 16 ounces doesn't restrict your weight, alas—it's a simple measurement.... The virtue of a properly constructed gold standard is that it's both stable and flexible—stable in value and flexible in meeting the marketplace's natural need for money. If an economy is growing rapidly such a gold-based system would allow for rapid expansion of the money supply.

In other words Forbes's "stable and flexible" gold standard would facilitate and camouflage an inflationary expansion of the money supply that would, according to Austrians, derange capital markets and lead to asset bubbles.[12] The motto of our current gold-price fixers seems to be: "We want sound money—and plenty of it."[13]

Lewis takes the idea that gold is an absolutely fixed measure of value to its logical—and absurd—conclusion. If gold is intrinsically constant in value, he reasons, then the "equivalent gold value" of labor income computed at the current dollar price of gold will give us a truer picture of the trend of real wages than

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[12] See, for example, Salerno (2012) and Woods (2009).

[13] I have heard economist Roger Garrison of Auburn University use this phrase to characterize the monetary program of the 1980s supply-siders.

calculations using the fiat dollar adjusted for inflation. Thus Lewis constructs a chart of "U.S. Median Male Full-Time Income in Gold Oz." According to this chart, income rises from 125 gold oz. per year in 1955 to an all-time postwar high of 250 oz. in 1970. Real income then falls precipitously to around 25 gold oz. in 1980. Over the next 20 years it climbs steadily punctuated with a few minor downturns, eventually reaching a local peak of 125 oz. and finally re-attaining the level of 1955. From there it is all downhill to 2010 where real income settles at 35 oz.

It is hard to imagine that Lewis is actually claiming that median annual wage income measured in an alleged unit of constant value, that is, real wages, was 14 % and 28 % in 2010 of what it was in 1970 and 2001, respectively. Yet how else is one to interpret the conclusion Lewis (p. 23) derives from his chart?

> The equivalent gold value of the income of the full-time working male in the United States has fallen drastically since the beginning of the Mercantilist monetary era [i.e., 1971]. The decline in the dollar value since 2001 has of course accelerated this trend downward; as the dollar's value declines, the value of wages paid in dollars declines also.

Of course the chart shows no such thing. What it does show is that paper fiat money that is progressively inflated and arouses inflationary expectations changes the value of inflation hedges like gold *relative* to the value of other goods and services. For the same reason one would find a similar movement over time of labor incomes expressed in terms of units of art, antiques, and other collectibles.

C. Deflationphobia

The last fallacy may be summed up as "deflationphobia." [14] The supporters of Poe's bill live in constant dread of falling prices, which they fear will result in a financial meltdown and a downward spiral of the real economy into ruinous depression. In this respect, too, they are no different than the mainstream economists that they criticize and the inflationist Fed policymakers they seek to rein in.[15]

Woodhill exemplifies the extreme deflationphobia that animates the typical supporter of a gold price-targeting regime. Woodhill (2013a) bluntly asserts:

> The most fundamental issue that determines the workability of a gold standard is whether it attempts to use gold *as* money. Any gold standard system where the size of the monetary base is determined by the physical supply of gold will eventually suffer a deflationary collapse.

[14] On the nature of deflationphobia and the causes of its most recent outbreak, see Salerno ([2003] 2010, pp. 267–269; and [2004a, b] 2010. Other economists who have recognized the phenomenon are Mark Thornton (2003) and Brendan Brown (2013, pp. 58–63).

[15] See Woodhill 2013b for a bitter critique of Fed policy and the monetary economists who are apologists for it, which is aptly entitled "America Doesn't Need Monetary Policy, and It Doesn't Need Economists." And yet, as we shall see, Woodhill's deflationphobia is even more blind and frenzied than Bernanke's.

Woodhill then points to the economic collapse of 1930 as "inevitable" because of the way the gold standard was designed at the time. Curiously, while he admits that there are various kinds of gold standards, some workable and some not, he does not specify that the gold standard that was in place in 1930 was the gold exchange standard. This was a greatly attenuated form of the classical gold standard. Indeed the gold exchange standard was, practically speaking, very similar to the goldless gold standard that he prefers. The gold exchange standard was deliberately designed to "economize" on gold so that there was very little gold coin held by the public, gold reserves were centralized in the Fed and a few other important central banks, and central banks, especially the Fed and the Bank of England, "cooperated" in order to expand their national money supplies while maintaining the legal parities between their currencies and gold.[16] In contrast, the classical gold standard, a genuine gold standard that involved the use of gold coins as currency, performed remarkably well for a century until it was deliberately destroyed in 1914 by revenue-hungry governments gearing up to fight World War I.[17]

Woodhill also conveniently ignores the fact that under the classical gold standard there were periods of deflation that coincided with vigorous economic growth. For example, in the U.S. between 1880 and 1896, wholesale prices declined by about 1.75 % or by nearly 30 % overall. During the same period, real income rose by 85 %, or approximately 5 % per year (Friedman and Schwartz 1971, pp. 94–95; Salerno [2003] 2010, pp. 273–274). In fact real income in the deflationary 1880s expanded at the highest decadal rate of growth in U.S. history. Even some Fed economists have come to recognize this type of deflation as a "benign" or "good" deflation caused by technological improvements and an accumulation of capital that lowers the costs of production and expands the supplies of goods and services (Federal Reserve Bank of Cleveland 2002; Bullard and Hokayem 2003, p. 1). This is the same benign process that in the last several decades has caused precipitous drops in the prices of computers, video game systems, HDTVs, Lasik eye surgery, and so on to the great benefit of consumers. Another recent example is China from 1998 to 2001. During that period, real income grew at an annual average rate of 7.6 % while retail prices declined in every year, with the annual deflation rate ranging from 0.8 to percent to 3.0 % (Federal Reserve Bank of Cleveland 2002, p. 10).

This process of "growth deflation" is the natural outcome of the free functioning of a healthy capitalist economy under market-supplied commodity money like gold. The secular decline of prices reflects the equilibrating adjustment between rapidly increasing labor productivity, falling production costs, and an ever expanding volume of goods, on the one hand, and a fixed or slowly increasing money supply on the other.[18]

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[16] For a thorough history, analysis, and critique of the gold exchange standard, see Rothbard (2005, pp. 351–433).

[17] Within two weeks of the outbreak of World War 1, every belligerent government suspended the gold standard. On why war leads inevitably to the abolition of the gold standard, see Salerno (1995).

[18] On "growth deflation," see Salerno ([2003] 2010, pp. 272–274).

Woodhill's lack of comprehension of this monetary adjustment process leads him to present a highly distorted picture of the true gold standard. According to Woodhill if money were gold, the slowly growing supply of gold would be confronted with a "new and potentially unlimited demand." Eventually the monetary demand for gold would cause an increase in the real price of gold and therefore in the dollar, i.e., deflation, "precipitating a financial and economic crisis." The financial crisis would in turn cause a further increase in the demand for money as everyone scrambled to become more liquid. This would raise the demand for gold even further and intensify the crisis "leading to a complete meltdown of the whole financial system and real economy. This is exactly what happened in 1930."

This is deflationphobia run riot. Nowhere in this nightmare scenario does Woodhill advert to the operation of the venerable mechanism of supply and demand which would adjust prices in goods' markets permitting monetary transactions to continue smoothly without crises or depressions. Indeed, Woodhill's reference to 1930 is not an indictment of gold money and deflation, as he believes. Quite the contrary: it is an admission that the gold exchange standard failed to restrain the Fed from expanding the money supply and manipulating interest rates from 1922 to 1928, creating massive stock and real estate bubbles that burst in 1929 ushering in the financial crisis of 1930. The monetary disorder of the 1920s and 1930s occurred despite—or rather because of—the fact that the Fed, while fixing the price of gold at its legal parity, manipulated the money supply to "stabilize" the domestic price level and to bail out Great Britain in its attempt to avoid the deflation required by its flawed decision to return to gold at the overvalued prewar parity for the pound. Fed policy thus prevented goods' prices from adjusting downward naturally in the face of rapid economic growth.[19] In addition, contrary to Woodhill's hysterical claim to the contrary, recent empirical research has shown no statistically significant link between deflation and depression (Atkeson and Kehoe 2004; Salerno [2004a, b] 2010).[20]

Finally, let us look at deflationary episodes involving large contractions of the money supply as a result of either a financial crisis or the restoration of the genuine

[19] For a detailed account of how the international gold exchange standard facilitated the inflationary asset boom of the 1920s that resulted in depression and the breakdown of the standard in the early 1930s, see Rothbard (2005 pp. 351–433). Rothbard (2000) focuses more narrowly on how the Federal Reserve manipulated the gold standard and generated the 1920s inflationary boom and Great Depression in the U.S.

[20] Summing up their study that used raw, unadjusted panel data from 16 countries over at least a 100-year period covering 73 deflation episodes and 29 depression episodes, Atkeson and Kehoe (2004) conclude:

> "The data suggest that deflation is not closely related to depressions. A broad historical look finds more periods of deflation with reasonable growth than with depression, and many more periods of depression with inflation than with deflation. Overall the data show virtually no link between deflation and depression."

gold standard following an enormous expansion of fiat money.[21] Even in these cases, as long as there existed reasonable flexibility of prices, there was either no accompanying depression of the real economy or the depression was sharp but brief. In U.S. history, the financial crisis and monetary deflation of 1839–1843 and the deliberate contraction of the stock of fiat money during 1876–1879 to restore the gold standard did not provoke a decline in real growth but merely a fall in prices. The sharp monetary contraction in the U.S after World War 1 also did not plunge the U.S. economy into a downward spiral of depression.[22] In fact the 1920–1921 depression was remarkably brief and ended before Congress was able to pass a public works bill.[23]

Concluding Remarks on the Path Back to Gold Money

Now one might infer from the argument in this paper that the problem with the monetary reform under consideration is that it does not immediately result in a genuine gold standard, but this is not necessarily the case. This is not to deny that a monetary regime like the nineteenth-century classical gold standard would be far superior to both the proposed Dollar Bill Standard discussed above and the current regime of national fiat currencies under managed exchange rates. But in the short run under current politicized monetary institutions, the formal restoration of the classical gold standard may not be a practical possibility.

Let us take as an example the recent proposal of Lewis Lehrman (2012) to restore the "true" gold standard. Lehrman's book makes a thoughtful and compelling case for reconstituting the U.S. dollar as a genuine gold currency. Under Lehrman's "Monetary Reform Plan" the dollar would be legally defined once again as a specific weight of gold and there would be unrestricted convertibility between gold on the one hand and dollar notes and deposits on the other. Gold coin would thus be minted and in circulation among the public. Lehrman also presents a detailed plan for transition from the current system back to the gold standard either by the U.S. unilaterally or via a multilateral international conference. Now any plan for a government-managed national or international transition from the current fiat-money regime to the classical gold standard would inevitably involve interested central bankers and bureaucrats. And this is true of Lehrman's plan.

[21] It should be noted that a monetary deflation that is caused by a financial panic can only be the result of a previous expansion of the money supply via the fractional reserve banking system. On this point, see Howden 2012.

[22] On the depression of 1839–1843, see Temin (1969, pp. 155–65). For a brief discussion of the monetary contraction of 1876–1879, see Kindahl (1971) and Bullard and Hokayem (2003).

[23] The depression of 1920–1921 is discussed in Weiher 1992 (pp. 26–27); Degen 1987 (pp. 30–40); Anderson 1979 (pp. 61–89); and Gordon 1974 (pp. 21–22).

Such a plan confronts an insurmountable problem, however. For example, in the U.S., the Fed and the U.S Treasury, their academic advisers, and their political and financial constituencies are steeped in the erroneous monetary doctrines criticized above. They all accept without question that money is a policy tool consciously designed to achieve aggregative statistical targets, including and especially stability of some arbitrarily constructed index of prices. They are also ardent deflationphobes who consider generally falling prices, even in the face of productivity growth, as the road to economic ruination and to be avoided at all costs. These attitudes have been deeply entrenched among monetary policymakers and the vast majority of monetary economists since at least the 1960s. Indeed Murray Rothbard (2000, pp. 169–181) argued that such attitudes were prevalent among Anglo-American economists and policymakers in the 1920s. Given that such attitudes have long been embedded in the intellectual culture of the political institutions that are called upon to manage the resumption of the gold-convertible dollar, even the most carefully conceived transition program will come to grief.

Consider that the transition from the current chaotic and unstable monetary and financial regime to the gold standard could not take place in one fell swoop but would require a lengthy period of time. For example, Lehrman's plan stipulates that the transition would not be more than 4 years from the date of the announcement of the resumption of convertibility. During this period, which may be less than 4 years, the Fed and Treasury policymakers would need to make a number of radical policy changes in preparation for resumption. Not only would these changes cut against their ingrained attitudes and inclinations, but the unforeseen emergence of cyclical phenomena or instabilities in the financial sector would provide them with strong reasons to suspend or reverse the implementation of such policies until the crisis had passed. We also should not discount the possibility that the Fed and Treasury bureaucrats, many of whose jobs will be obsolescent after resumption, will readily respond to pressure from their political and private sector constituencies to sabotage the transition. In sum there is a strong case to be made that a transition to a genuine gold dollar may be practically impossible under existing political institutions.

A simpler and less encumbered path to sound money and the gold standard would be to permit the fiat dollar to face competition from alternative currencies. In other words, give U.S. citizens the unrestricted right to choose to contract and make payments in gold, silver, yen, euro, etc. This proposal for currency competition was first advanced by F.A. Hayek (2009) in 1974 and has been since advocated by many others, including Henry Hazlitt (2009) and Hans Sennholz (1985). This reform would not directly involve the Fed and the U.S. Treasury, nor would it require a complicated and time-consuming plan susceptible to bureaucratic obstruction. All it would involve is the abolition of legal tender laws that privileges the fiat dollar as a general medium of exchange and the removal of all excise, sales, and capital gains taxes on the trading and holding of gold, silver, and foreign currency deposits. Any legislative impediments to private firms minting gold and silver coins denominated strictly by purity and weight would also have to be repealed. U.S. banks would be freed from all regulatory and legislative restraints in accepting and holding deposits of any kind of metallic coins or foreign currency, while being exempted from mandatory membership in the Federal Reserve System, the Federal Deposit Insurance Corporation, etc. Legal barriers to entry and interstate branching in banking would also be eliminated.

This program would severely restrict the inflationary propensity of the Fed, because U.S. citizens would be now free to replace a rapidly depreciating dollar in their transactions and cash holdings with whatever they perceived to be a more stable medium of exchange. The Fed's monopoly of the money supply would effectively be eliminated and monetary policy in any meaningful sense would be abolished. In the worst case scenario if the Fed continued its inflationary monetary policy, there would be a rapid run from the dollar into competing currencies and conditions would then be ripe for a hard-money gold standard (or parallel gold/silver standards) to naturally emerge on the market.

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