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# Consequences of a Dollar Standard

By Christopher Mayer

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Since the end of the Bretton Woods agreement in 1971, the dollar has been an irredeemable currency, no longer defined or measured in terms of gold. Nonetheless, in an ironic twist, it has become the world's dominant currency and the core reserve asset of central banks all over the world. It has replaced gold as an international currency.

The transformation has not happened without consequences. One of these is that the discipline imposed by the gold standard is no longer operative. Another consequence, related to the first, is the profound effect this has had on international trade.

## The Discipline of Gold

In the words of Benjamin M. Anderson, gold was "an unimaginative taskmaster." A taskmaster it was in an older age, when money was judged not on faith, but on the dependability of exchanging it for the yellow metal. Faith that paper money itself was of any lasting value would have struck our forebears as patently absurd.

Anderson commented on the nature of gold in his financial history of the United States that covered the years 1914–1946, titled *Economics and the Public Welfare*. In a chapter dubbed "The Tyranny of Gold," he offered the view of a wizened hard-money proponent who had glimpsed the essence of money and noticed irredeemable paper was not part of it. "Gold needs no endorsement," Anderson wrote. "It can be tested with scales and acids. The recipient of gold does not have to trust the government stamp upon it, if he does not trust the government that stamped it. No act of faith is called for when gold is used in payments, and no compulsion is required."

In such a world, the value of the dollar was measured in terms of gold and its value fluctuated accordingly, based in large part on the public's estimation of its ability to convert the paper into gold. If they suspected that suspension of the gold standard was imminent or their convertibility was at risk, the dollar would be sold and the market would reflect a discount to its face value in gold.

Anderson used the seventeen years between 1862 and 1879 as illustrative of this principle at work. A digression into this example may further demonstrate the point. This period was the infamous greenback period, where an irredeemable paper currency circulated in competition with an active gold market and a gold-based foreign exchange market. The greenbacks were legal tender notes issued at par with notes backed by specie. The value of the greenback bounced around continuously as the public digested



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and interpreted news and events that might impact the probability that they would be able to redeem greenbacks for gold (eventually). Of great importance during this time, as one might imagine, was the success or failure of the Northern armies during the Civil War.

For example, the Battle of Chickamauga in the fall of 1863 produced a Confederate victory when the Army of Tennessee drove the Army of Cumberland from the field. News of the battle caused the greenbacks to drop 4%. Since the greenbacks were issued by the North to pay for the war, Confederate progress was inimical to redeemable greenbacks. However, as the Northern Armies achieved victories at Gettysburg, Vicksburg and Port Hudson, the greenback grew progressively stronger. A stunning reversal occurred in the summer of 1864, when the greenback would fall dramatically to only 35 cents as Congress closed the gold window. The market's reaction to Congress's theft led to the legislature reconvening within two weeks of their initial declaration. A swift repeal of the measure followed, "passed without debate" as Anderson reported.

The passage of the Resumption Act in 1875 mandated that greenbacks would be redeemable in specie beginning in January of 1879. As the date neared, the discount grew smaller and completely disappeared in late 1878 as gold payments resumed, as scheduled, in 1879.

Such was gold a taskmaster to the folly of governments. Issue too much paper and doubt is seeded in the market. Doubt did not then—and does not now—sustain the value of fiat currencies and the market's reaction, when it comes, can be swift and powerful as dramatically illustrated by the plunge in the greenback in the summer of 1864.

This is the discipline that is missing from money today, where growth in the money supply has far exceeded what would have been possible with a gold standard and where the steady dwindling of purchasing power has become accepted as normal.

### **Consequences in International Trade**

The consequences of being able to inflate without having the stern disciplinarian of gold rapping one's knuckles are also profoundly illustrated by looking at what has happened to international trade.

When the gold standard existed, if the U.S. inflated its currency the effect would be to stimulate imports as newly released purchasing power made them relatively cheaper than products at home. Conversely, exports tended to dwindle. Foreigners shipped us goods and we gave them paper in exchange. The result was a deficit in the so-called balance of payments, which was paid for by foreigners cashing in those dollars for gold.

The resulting gold outflow from U.S. would force the U.S. to contract in order to prevent the loss of gold. By not adhering to its promise to redeem dollars in gold, the U.S. would essentially have defaulted on its debts, (which is eventually what happened). The subsequent contraction in the money supply would reverse the process, lowering prices at home and reversing the flow of gold.

All of this is generalized, of course. Governments routinely went off the gold standard for periods of time, usually during wartime, but public outcry and the market's reaction often forced them back to it. Gold was the adjustment mechanism in the market, the self-correcting force that kept trade imbalances from persisting.

Without this anchor, large trade imbalances have been able to persist for long periods of time, facilitating a tremendous increase in money and credit worldwide. As documented in Richard Duncan's new book. *The Dollar Crisis*, central banks around the

world have built up large reserves of dollars. Those dollars flow back into the U.S. banking system in the form of investments in U.S. dollar-denominated assets—the dollars themselves cannot be exchanged for gold, and hence they remain as debts never paid. The inflow of dollars undoubtedly helped contribute to the stock market boom, the surge in property prices and has also helped keep U.S. interest rates artificially low. All of this results in massive malinvestment or misallocation of capital—setting in motion the perpetual sequence of boom-bust, not only domestically, but internationally as well.

These imbalances cannot be expected to grow indefinitely. As Bill Bonner and Addison Wiggin write in their book, *Financial Reckoning Day*, "From the truth that foreigners are generally willing to accept U.S. dollars in exchange for valuable goods and services came the lie that they must always do so."

It has been said that every bubble has its pin—foreigners, then, hold a very sharp pin capable of throttling the dollar should they suddenly tire of holding 4% Treasury debt. Collectively, foreigners hold \$9 trillion in U.S. assets, according to *Financial Reckoning Day*. Bernanke has already reminded them that the U.S. has a ready printing press. Bonner and Wiggin note, "In the sixty days following Bernanke's speech (on November 21, 2002), the dollar fell 6.4 percent against the euro and 10.1 percent against gold." Coincidence? Or a taste of things to come?

Self-evidently, the large, sustained, current-account deficits of the U.S. would not have been possible under the classical gold standard, because U.S. gold reserves would have been depleted. Sustainable economic growth will be possible only when the international monetary system returns to a kind that does not generate rampant credit creation.

### The Best Money

Gold is the best money, because for centuries, as a result of countless individual choices, it has evolved as such. It was not imposed on the market by force, but was cultivated in the soil of the market itself. It grew naturally in the open air of voluntary exchange, not in a cloistered greenhouse of government fiat.

Though the old classical gold standard was not perfect, it was, in [Rothbard's words](#) "by far the best monetary order the world has ever known, an order which worked, which kept business cycles from getting out of hand, and which enabled the development of free international trade, exchange and investment."

There is not much more one can ask from a currency.

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