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OPINION | COMMENTARY

The Fed Could Use a Golden Rule

Abandon the Ph.D. standard, which brought the era of government bailouts and too big to fail.

By James Grant

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Though money can't talk, people can't stop talking about it. With the nomination of Judy Shelton to the Federal Reserve Board, the discussion has tilted to gold.

Gold is money, or a legacy form of money, Ms. Shelton contends, and the gold standard is a reputable, even superior, form of monetary organization. The economists can hardly believe their ears. The central bankers roll their eyes. How can this obviously intelligent woman be so ignorant? Let us see about that.

America was on one metallic standard or another from the Founding until President Richard Nixon announced the suspension of the Treasury's standing offer to foreign governments to exchange dollars for gold, or vice versa, at the unvarying rate of $35 an ounce. The date was Aug. 15, 1971.

Ever since, the dollar has been undefined in law. Its value against other currencies rises or falls, as the market, sometimes with a nudge from this government or that, determines. The dollar isn't unusual in this respect. With few exceptions, the values of the world's currencies oscillate.

In the long sweep of monetary history, this is a new system. Not until relatively recently did any central bank attempt to promote full employment and what is called price stability (but is really a never-ending inflation) by issuing paper money and manipulating interest rates.

The advance of computer technology has made possible a world-wide monetary system based on the scientifically informed discretion of Ph.D. economists. The Fed alone employs 700 of them.

"Gold standard" means not one system but many. You can think of them as a Broadway hit, the

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roadshow version of the hit, and the high-school drama-club editions. The version Nixon scuttled didn't have the starch, elegance, universality or populist inclusion of the classical gold standard. It was drama club.

The true-blue standard was sweet and simple. Participating nations defined their money as a fixed weight of gold. Citizens could exchange currency for gold, or gold for paper, as they chose. Gold moved freely across national borders. It went where interest rates and business opportunities beckoned. Gold was base money; over it rose the superstructure of credit.

Fixedness was one defining feature of the classical gold standard. Trust in the workings of supply and demand—in the "price mechanism"—was a second. Belief in individual responsibility for financial outcomes was a third.

A central bank's single objective was to assure convertibility of the currency it managed at the fixed and statutory price. The exchange rate, not employment, growth or price stability, was the all in all.

The Bank of England was "very desirous not to exercise any power," as a director of that institution testified before a committee of the House of Commons in 1832. The bank was content to allow the people to regulate the money supply by exercising their right to exchange bank notes for bullion.

A 20th-century scholar, reviewing the record of the gold standard from 1880-1914, was unabashedly admiring of it: "Only a trifling number of countries were forced off the gold standard, once adopted, and devaluations of gold currencies were highly exceptional. Yet all this was achieved in spite of a volume of international reserves that, for many of the countries at least, was amazingly small and in spite of a minimum of international cooperation . . . on monetary matters. This remarkable performance, essentially the product of an unusually favorable combination of historical circumstances, appears all the more striking when

contrasted with the turbulence of post-1914 international financial experience and remains, even today, a source of some measure of fascination and indeed of puzzlement to students of monetary affairs."

Arthur I. Bloomfield wrote those words, and the Federal Reserve Bank of New York published them, in 1959.

The gold standard, "the fly wheel of the Industrial Revolution," as the historian Lewis E. Lehrman puts it, was as imperfect as any other human institution. Prices were stable over the long term but variable in the short run; sometimes—even for years on end—they fell. Sometimes governments interfered with gold movements. There were panics when the bankers overissued their IOUs. And when people ran on the banks to exchange those claims for gold—when stock prices crashed and business activity stopped cold—a central bank would respond by raising its interest rate to defend the exchange rate. It was the exchange rate, one's standing in the international monetary community, that mattered.

Gold-standard central banking concerned itself with the present. Millennial central bankers dare to take a view of the future. The moderns forecast, or attempt to forecast, economic growth, inflation, employment.

It's no fault of theirs that they usually miss, most memorably in 2008, when the biggest event of their professional lives took most of them unawares. The economists are dealing with human beings, not raindrops.

The National Weather Service, which does deal with raindrops, and which marshals enormous computing power and truly big data, has an ordinary forecasting horizon of seven to 10 days. The central bankers inadvisedly cast their predictions into the distant future.

The ideology of the gold standard was laissez-faire; that of the Ph.D. standard (let's call it) is statism. Gold-standard central bankers bought few, if any, government securities. Today's central bankers stuff their balance sheets with them.

In the gold-standard era, the stockholders of a commercial bank were responsible for the solvency of the institution in which they held a fractional interest. The Ph.D. standard brought the age of the government bailout and too big to fail.

While gold-standard central bankers set short-term interest rates, they did not seek to control longer-term rates, much less drive them to zero. In today's monetary regime, some $13 trillion of debt securities world-wide are priced to deliver a yield of less than zero. There's been nothing like it in 4,000 years of recorded interest-rate history.

And if gold could once be brushed aside as an anachronistic form of money, that time is no more, with private companies competing to bring digital gold to the blockchain.

In 1989, Ms. Shelton published "The Coming Soviet Crash," a brilliant and courageous analysis of the weakness of an overrated collectivist economy. She could be just the woman to remind the Fed's doctors of economics how monetary capitalism works.

Mr. Grant is founder and editor of Grant's Interest Rate Observer and author of "Bagehot: The Life and Times of the Greatest Victorian," out July 23.

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