https://www.wsj.com/articles/forget-the-gold-standard-and-make-the-dollar-stable-again-11563404235

OPINION | COMMENTARY

Forget the Gold Standard and Make the Dollar Stable Again

Precious metals no longer make sense as a store of value. Instead, peg money to goods and services.

By John H. Cochrane

July 17, 2019 6:57 pm ET

Gold coins on display in Austin, Texas, July 1, 2016. **PHOTO**: ERIC GAY/ASSOCIATED PRESS

Some of President Trump's potential nominees to the Federal Reserve Board have expressed sympathy for a return to the gold standard. Conventional monetary-policy experts deride the idea—and not wholly without reason. The gold standard won't work for a 21st-century monetary and financial system. It is possible, however, to emulate its best features without actually restoring the gold standard.

The idea behind the gold standard is simple: The government promises that if you bring in, say, $1,000 in cash, you can trade it for one ounce of gold, and vice versa. By pegging the dollar to something of independent value, it promises to solve the problem of inflation or deflation. And we don't need central-bank wizards to run things anymore.

Yet the aim of monetary policy isn't to stabilize the dollar price of gold; it is, rather, to stabilize the prices of all goods and services. The price of gold has varied from $1,000 to $1,800 an ounce in the past 10 years. Had the Fed fixed that price, critics say the price of everything else would have had to vary this much.

Now, it is likely that if the Fed pegged gold, its price relative to other goods likely wouldn't fluctuate as much. But the problem is real. Under the gold standard, the U.S. experienced much more volatile annual inflation and deflation than it does today. The gold standard didn't prevent deflation in the Great Depression and previous panics, a current central concern.

The problem would be worse today. What determines the value of gold relative to all goods and services? In the 19th century, gold coins were used for many transactions. People and businesses had to keep an inventory of gold coins in proportion to their expenditures. If the value of gold rose relative to everything else (deflation), people gained an incentive to spend them, and thereby drive up the prices of everything else. If the value of gold fell (inflation), people needed more of it, so they spent less and drove down other prices. This crucial mechanism linked the price of gold to all other prices.

That link is now completely gone. Other than jewelry and some minor industrial uses, there is nothing special about gold, and little linking the price of gold to all other prices. If the Fed pegged the price of gold today, the price of everything else would just wander away. The Fed might just as effectively peg the price of chewing gum. A monetary anchor is a good thing, but the anchor must be tied to the ship. Gold no longer is.

Broader commodity standards face the same problem. Traded commodities are such a small part of the economy that the relative price of commodities can swing widely with little effect on inflation.

Nor was gold as pure as advertised. Governments didn't back their money and debt fully with gold reserves. So how could they promise always to exchange money for gold? The gold standard was an art, much like fractional reserve banking. Central banks set interest rates as they do today, to manage gold flows. Central bankers' pronouncements rattled markets as they do today. There were occasional sovereign crises, featuring runs on governments' gold promises. Governments couldn't issue more cash when needed. As a result, there were banking crises and cash was seasonally short around harvest time. In response, the Federal Reserve was founded to "furnish an elastic currency," not primarily to set interest rates.

The gold standard was really a fiscal commitment, not a monetary one. If people demanded more gold from the government than it had in reserve, the government had to raise taxes or cut spending to buy more gold. More often, the government would borrow to get gold, but governments must credibly promise to raise taxes or cut spending to borrow. This fiscal commitment ultimately gave money its value, not the sometimes-empty promise to exchange money for gold. Taxes ultimately back all government money. The gold standard made this fiscal commitment visible and testable.

With this understanding, the U.S. could enact a policy today that emulates the good features of the gold standard. I call it the CPI standard. First, Congress and the Fed would agree that "price stability" in the Fed's mandate means precisely that, not perpetual 2% inflation. The Fed's mandate would be to keep the consumer-price index (or a suitably improved index) as close as possible to a stated value.

Second, the CPI target would bind fiscal policy (Congress and the Treasury) as well as monetary policy (the Fed). Inflation would require automatic fiscal tightening and deflation would trigger loosening, just as a gold-standard government trying to defend its currency must tighten fiscally to raise its gold reserves.

Third, the government would emulate the promise to trade gold for notes in modern financial markets. There are many ways to do this, but the simplest is to commit to trade regular debt for inflation-indexed debt at the same price. Under this system, inflation would cost the government money and force a fiscal tightening in the same way gold once did. And vice versa—the system would forestall deflation as well.

Gold-standard advocates offer a cogent critique of current monetary policy, but a return to gold is unfeasible. A stable CPI, immune from both inflation and deflation, backed by the same fiscal commitments that underlay gold, is worth taking seriously.

Mr. Cochrane is a senior fellow at Stanford University's Hoover Institution.

Appeared in the July 18, 2019, print edition.