Implementing a Twenty-first Century Gold Standard

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How would we redesign our monetary system if we had to do it? That question is more relevant now than any time since the early 1980s, the last major inflection point for the U.S. dollar. The financial crisis of 2007-08 and the concurrent recession are rooted in a monetary system that came unhinged after decades of turbulence. The weakness of the current economic recovery represents the risk that this kind of catastrophe could reappear – perhaps again in housing or another sector loaded with debt. This absence of closure with the meltdown means that we may not have the luxury of redesigning our monetary system as an academic exercise: the job could be put to us. What will American leaders and policymakers do?

This paper offers a blueprint for one way to fix our monetary system: the gold standard. Today that system is reflexively dismissed by most of the economics profession as archaic; perhaps a functional system in its own day but not one suited for modern times (see the work of Michael Bordo and Harold James). They are right in one sense. It *is* dated. But that hasn't stopped American economic policy from improving before. John F. Kennedy advocated (and posthumously achieved) income tax cuts to counteract three decades of tax policy in which the top rate had increased from 25 to 91 percent. A generation later, Ronald Reagan lowered the top rate even further to near where it had been under his hero Calvin Coolidge in the 1920s. Both reversions to lower taxes spurred economic revival. Progress often means going back to what worked before.

Reagan, not surprisingly, had a phrase for this: “I do not want to go back to the past; I want to go back to the past way of facing the future.” Time-tested ideas are not meant to take us backward, they are meant to get us where we need to go.

As will be described in a later section, the gold standard is in fact better suited to function in today’s economy than it was when it last operated, thanks to advances in technology that can more closely relate paper money with gold. Furthermore, after a 20th century of ill-conceived re-implementations and false starts, there is the benefit of experience at our disposal to craft a gold-based monetary system that is sturdy against external pressures and accountable to the people.

This paper is not meant to document the gold standard’s superiority (see Brian Domitrovic’s “The Gold Standard: the Foundation of Our Economy’s Greatness”) but rather focus on the features of a near-future domestic implementation. It is not meant as substitute for the work that’s been done in this field (see Lewis Lehrman in his comprehensive *The True Gold Standard*, which masterfully describes the workings of the international gold standard), but rather as a layman’s roadmap to supplement and highlight an intellectual foundation stretching from Lehrman back to his teacher, the French economist Jacques Rueff. As monetary advisor to Charles de Gaulle, Rueff linked the franc to gold at an exchange rate based on market conditions, a transition that seems like common sense today but was unconventional in 1959. Rueff’s essential lesson – that the gold standard means living in the now – is a theme that permeates its operation as a monetary system.

Money of Intrinsic Value

At its core the gold standard is about the meaning of money. It establishes an intrinsic value of a nation’s currency by a fixed weight of gold. Money therefore is not an uncollateralized promise by the issuing government (fiat money), it is an actual *thing* of independent worth. Money equals wealth not just as a means of exchange or unit of account, but in the literal sense as well. When this is achieved, trust in currency is not a fluctuating hope but an innate principle. It puts the marketplace participant in the best possible position to create and protect wealth.

Gold is the basis for this trust because it is money *par excellence*. Gold is universally recognized as wealth. It is homogeneous, indestructible, and limited in supply. It is simple in form yet requires resources and effort to monetize. Together these features give gold a stable long-run purchasing power unrivaled by any other commodity.

The American attempt to experiment with a metal other than gold was tried for an extended period of time at the beginning of the nation's history (1792-1834) and briefly again (1890-1893) when both gold and silver were used in a bimetallic monetary standard. The early experience fixed the price of gold to silver at 15 to 1 in the Coinage Act of 1792. This ratio could not be supported in the silver market, causing gold to be bought up at a suppressed price in silver terms and putting the country on a de facto silver standard[1]. The Sherman Silver Purchase Act of 1890 also sucked gold out of the monetary system by undervaluing it against silver[2].

Both cases showed that the standard of value had to be gold alone because silver (or any other commodity) cannot match gold's unique steady supply growth that the two metals would have to share to be monetary equivalents. Furthermore, silver lacked the range and degree of gold's intrinsic properties listed above to stand the test of time as a single monetary standard.

Gold as Money and Money as Gold

How is the bond between gold and money formed? What promises and policies is the government responsible for in making its currency as good as gold?

At the core is the principle of gold itself as functional money. If gold is to form the basis of a monetary system, it cannot be restricted in usage as money or demonetized as property. Otherwise, the promise of a paper currency's redemption in gold will be hollow. In short, gold needs to have the same legal tender status as the U.S. dollar. This is the commitment mechanism that allows the marketplace participant to choose between gold and the dollar, a choice in currency that provides for market (rather than government) control of the money supply.

A dollar as good as gold must be redeemable in monetary gold. The government has the responsibility of converting on demand and at minimal cost its dollar-denominated claims into gold at the value established by law. To ensure a legitimate *market* control of the money supply, it must offer such redemption as far and wide as possible so that private citizens in addition to financial institutions have the capability of redeeming their dollars in gold.

Consider how the gold standard works from the perspective of a single worker in the American economy. That worker walks around with dollars in his wallet and dollar-denominated demand and savings deposits at the bank, just like today. He also has gold coins at home and perhaps more gold at a vault. Those dollars and demand deposits are exchangeable into gold in coin or bar form at the bank, and when he does this the supply of dollars in the economy shrinks. Likewise, he can exchange gold for dollars and the dollar money supply in the economy grows. Both gold and the dollar function as currency, one being the epitome of money and the other being its derivative in convenient paper form.

Our worker's choice between holding more dollars or gold depends on which currency he desires to hold more of at the time. We have not incorporated electronic payment systems into this narrative yet, but it shows how the duality of money is the foundation of the gold standard. Convertibility is the mechanism by which the gold standard automatically matches money supply with demand, down to the most basic unit of the economy, the individual.

How do we implement this system?

Making Gold Legal Tender

As stated above, for gold to be a functional currency it has to be accorded the same legal tender status as the dollar. Otherwise gold remains what it is now in the American economy: a demonetized commodity treated as property for tax purposes by the federal government. Fortunately, there is recent progress in technology *and* law that is changing this.

For most of the 20th century, there were just two widely used payment methods: cash and check. In the 1970s, automatic teller machines and credit cards became widely adopted and made consumer finance exponentially more fluid. The spread of swipeable debit cards and e-commerce transactions in the 1990s brought cashless transactions much closer to real time. The debit card in particular emerged as the convenient substitute for cash at the point of sale: for a nominal transaction fee, money could be spent from a checking account without having to be withdrawn in physical form first.

These electronic payment systems hold the same potential for using gold as money as they have fulfilled for the dollar. They mean that gold no longer needs to be in physical form to be acquired or liquidated and that gold, like dollars in a checking account, can serve as the asset-backing for debit card transactions.

An example of a company in this space is GoldMoney, a firm based in the English Channel island of Jersey. It has emerged in the last decade as one of the larger services for transacting in gold and other precious metals online. Customers can use its vaulting service or take physical delivery. Until this year it also offered its own electronically-based currency, the one-ounce *goldgram*, for use among customers.

That system was restricted to local customers on Jersey in January 2012 due to what GoldMoney describes as the "relatively low use of this service and increasing regulatory burdens."

One place where the regulatory burden has been reversed is Utah. In 2011 its legislature passed a law making gold and silver coin issued by the federal government legal tender in the state. A follow-up law this year expands the potential scope of monetization by giving the state's executive and judicial branch the authority to make other classes of gold and silver coin legal tender. This instantly made Utah the safest place in the U.S. to hold gold currency. Similar legislation was under consideration in 2012 in nine other state legislatures, and the House chambers in South Carolina and Missouri passed their bills.

What does gold-backed monetary reform have to do with the states? The Constitution in Article I Section 10 says that no state shall "make any thing but gold and silver coin a tender in payment of debts." This is one of a handful of exceptions to a list of prohibitions put on the states in the section. Prior to the ratification the states had been notorious in going wild with their own paper money, and this was written to eliminate that embarrassment from happening again. The only currency the states could recognize independently of the federal government was the kind that was recognized universally as money, specie tender.

The legal tender law implements two important changes. First, the designation of legal tender confers the legal status of money on the coins. The government acknowledges them as money and they are immune from regulation that would treat them otherwise. Second, it removes taxes on the coins in their exchange for dollars. No sales, property, capital gains or any other tax that would discourage such an exchange can be applied. The power to tax is the power to destroy, the U.S. Supreme Court said in *McCullough v. Maryland* (1819). Larry Hilton, leading advocate of the Utah Legal Tender Act, observes the consequences on specie: "The taxation of money essentially demonetizes it, altering its fundamental character from being a medium of exchange to being merely another form of property"[3].

Gold holdings in Utah have increased by 50 percent since the law's passage, according to people in the industry, and two vaulting companies are working on a gold-backed debit card product. Such a card would come with the imprint of a major issuer and be tied to the holder's gold and silver assets on deposit. The swipe of the card at a retailer would follow the same way it does now, with the only difference being that the customer's precious metals, rather than dollar deposits, would be debited after processing. From the retailer's point of view, the transaction would still be denominated and closed in dollars. Another concern is working to develop a similar product using a money transmitter license that would keep the transaction in gold for both the consumer and retailer using the same kind of electronic payment system.

The Utah model shows how the compatibility of the law and technology could allow for gold currency to be used in a method palatable to the common consumer. An electronic payment system like the debit card eliminates the inconvenience of carrying coins and determining their fair market value in dollar terms. This feature is in a way more prudent than a bank debit card because the assets behind it are hard money rather than checkable deposits. The depository institution is responsible for vaulting the coins, limiting debits to a reasonable cap to account for market swings during the transaction, and handling exchanges and payments.

But there is still a *federal* tax that hampers the Utah model and prospects for state-based monetary reform to make gold legal tender. Gold is taxed at the ordinary income rate that applies to short-term capital gains (sold within one year) and at the 28 percent long-term rate that applies to collectibles. Besides specie coin, other collectibles the Internal Revenue Service designates are art, rugs, antiques, and stamps. Unlike securities, dividends, and real estate, the appreciation on gold is not even considered investment income. It is taxed at a premium rate (28 versus 15 percent) and essentially classified as a niche asset by the IRS.

The federal tax is the largest impediment to gold being used as money alongside the dollar. The tax liability on its exchange for dollars or goods and services encourages gold to be hoarded like other "collectibles." This is why gold and silver coins have been in the purview of collectors and dealers— out of monetary circulation and as far from the taxing authorities as possible.

This tax wedge could be cleared out by federal legislation. Such legislation would be written so that no tax or other duty could be imposed on the exchange of gold for dollars, of gold for any other official U.S. currency, on the exchange of one form of gold for another form of gold, or for goods and services. Gold could be acquired or exchanged in the economy completely free of taxation.

A legal challenge based upon state legal tender power could be also be a viable solution to the problem. *McCullough v. Maryland*, in finding that the Bank of the United States could not be taxed by the states, developed the concept of intergovernmental tax immunity. Legal scholar Jane Robbins writes, "The idea was that the federal and the state governments operate in their own spheres of authority, and neither should have to submit to a tax by the other that would inhibit the proper exercise of their authority"[4].

The only instance in which the federal government taxed money and was backed by the Supreme Court appears to be during the Civil War when Congress passed the National Bank Act and imposed a 10 percent tax on state bank notes to drive them out of existence. The court upheld this tax in 1869 as a way for Congress to implement a national currency. But it did not intrude on the states' specie legal tender power. That same year, it ruled in *Lane County v. Oregon* that the state could require taxes be paid exclusively in gold and silver coin rather than the federal notes that had been declared legal tender during the war. A state, the court said, got to decide by its own authority how it collected taxes.

The U.S. Treasury today points out that the legal tender designation does not mean notes or coins must be accepted by anyone. This is from its website section on legal tender status.

> There is, however, no Federal statute mandating that a private business, a person or an organization must accept currency or coins as for payment for goods and/or services. Private businesses are free to develop their own policies on whether or not to accept cash unless there is a State law which says otherwise[5].

This squares with the idea that acceptance of legal tender is voluntary. This can be, as the Treasury goes on to explain, out of practical concern: some merchants may elect not to accept pennies while other may refuse bills over a certain denomination. In the case of Utah, the state specified in its Legal Tender Act that a person may not compel another person to tender or accept gold and silver coin. The legal tender designation adds a monetary *choice*, not a mandate, over what to accept as money. All federal and state legislation should reflect this with language that allows individuals, businesses, and other entities to accept in payment for goods and services only gold, only paper currency, or any combination of gold and paper currency.

To encourage the usage of gold as legal tender, federal agencies starting with the IRS and Securities and Exchange Commission should recognize gold as an acceptable denomination for financial reporting. Individuals and businesses should have the right to report income and file taxes in terms of gold. This would also put pressure on the International Accounting Standards Board to list gold as a "functional currency," enabling auditing firms to audit gold-denominated books and classify gold as cash on the balance sheet. This would complete the status upgrade for gold as money in the American economy.

Availability of Gold

In order to use gold as money, Americans must be able to acquire it in physical form, either directly or through financial institutions. For much of the 20th century, gold was outlawed by the U.S. government as currency or even a privately-held asset. The Gold Reserve Act of 1934 culminated a series of executive orders by President Franklin Roosevelt to completely demonetize gold. Americans were prohibited from owning monetary gold and the government melted the coins it bought or confiscated them into bars to ensure they could not leak back into circulation. The law also expressly prohibited the redemption of the dollar for gold, officially finishing off the domestic gold standard[6].

Forty years later in 1974 Congress passed a law sponsored by Rep. Phil Crane (R-IL) that permitted Americans to own, buy, and sell gold again. A follow-up law introduced by Sen. Jesse Helms (R-NC) three years later legalized the use of gold contracts. In 1980, the year inflation was raging at a postwar high of 13.5 percent, Helms won another breakthrough. The U.S. Gold Commission was set up in 1981 to study the role of gold in domestic and international monetary policy.

Despite the potential for the new Reagan administration to sway the commission in favor of gold, it did not intervene and allowed staff director Anna Schwartz (Milton Freidman's collaborator) to guide its conclusions. The official report made a single recommendation in favor of gold: the minting of new gold coinage, without dollar denomination or legal tender status and exempt from taxes. Four years later Congress acted on this idea and Reagan signed the Gold Bullion Coin Act of 1985, which created the American Gold Eagle. Contrary to the Commission's recommendation, the four coin sizes (1/10th, 1/4th, 1/2th, and 1 oz) came with dollar denominations ($5, $10, $25, $50), legal tender status, and were taxable. The application of taxes demonetized the coins at issuance and made them into an investment, which is what Schwartz says the majority on the commission wanted in the first place[7].

Since 1986, approximately 15.5 million 1 oz. pieces, 2.6 million half-ounce pieces, 3.5 million quarter-ounce pieces, and 11.9 million tenth-ounce pieces of the American Eagle Gold Bullion series have been sold by the U.S. Mint. They represent a cumulative value of approximately $30 billion in monetary gold specie tender[8] (there is an approximate total of $1.08 trillion in Federal Reserve Notes in circulation[9]).

American Eagles can be expected to be monetized fairly seamlessly under a new convertible gold standard. Financial institutions could simply handle them according to the new gold-dollar parity, either in physical form or via electronic payment systems. But this would still leave the vacuum that the Gold Commission attempted to fill – U.S. gold coinage denominated solely by weight unit, not dollar amount. South African Krugerrands, minted since the late 1960s, have proven popular with gold coin holders around the world in part because they have this feature – there is no defunct paper currency denomination to confuse the intrinsic value. It would make sense for the U.S. Mint to offer for sale the same kind of coin, even if only in 1 oz form. To ensure gold's maximum reach as money throughout the market, it should be offered in unlimited quantity based on the statutory gold-dollar price. The Mint would be allowed to charge a nominal fee on the exchange to pay for this service.

A new gold standard could not just rely on coins for currency redemptions. The government's gold stock would need to be monetized in bar form to meet the scale of redemptions from financial institutions. This could be done in 400 oz standard bars at 99.5 percent purity, meeting the London Bullion Market Association's specification for *Good Delivery*. The U.S. Treasury would be responsible for buying and selling these bars at the statutory gold definition of the dollar, with a nominal redemption fee and smaller monetization fee allowed to compensate for market-making costs.

Currency notes have historically been the preferred form of money under the gold standard because of their convenience, and this would be expected to remain the case under a new gold standard. But the steps to make gold available in physical form would ingrain it as money in the economy, which is essential for a fully-functioning gold standard. Every marketplace participant from the low-wage earner to the big bank would be able to acquire gold in efficient form and at nominal cost. Whether it means coins in a home or bars stored in a vault, gold would be accessible and liquid – with government recognition as money *par excellence*.

Convertibility

The linkage between gold and the dollar, or the dollar's definition in gold, hinges on the government making the dollar a convertible currency. Convertibility is the feature of the gold standard that makes it go – the automatic, self-regulating mechanism that gives the currency issuer credibility and puts the people in charge of the money supply. It is also a touchstone for this monetary system. The dissatisfactory twentieth century experience with the gold standard is in part the story of the taking away of convertibility at the domestic and international levels. When a paper currency is no longer redeemable in gold, the government has control of the money supply because it can foist as much of it on the market as it wants.

Surefire convertibility is as close to the workings of the marketplace as possible. It provides an accessible and convenient way to redeem the government's paper currency promise with gold. In the summary of his monetary reform plan presented in *The True Gold Standard*, Lewis Lehrman boils it down to one sentence: "All financial claims on banks and government agencies, chartered or supervised under federal law, that are payable in dollars shall be redeemable in gold at the statutory rate without restriction – demand deposits (e.g. checking accounts) to be redeemed upon demand but other dollars claims at maturity"[10]. In other words, gold is dispensable all the way through the banking system, from commercial banks up to the Federal Reserve System.

This will enable individuals to redeem dollar claims for gold at the local bank and financial institutions to redeem at the central bank, i.e. their regional Fed branch. There will be nominal restrictions in the form of the range of coins and associated redemption fees described earlier. But this sets up the process where the market asserts its demand for money on the government, not the other way around. Each redemption of dollars for gold – whether it is in coin or bar form – adjusts the money supply to the market's will. It puts the exchanged dollar back on the Fed's balance sheet and out of use from the economy. When money demand increases this process is reversed and gold is redeemed for the dollars on the Fed's balance sheet. It is a nonstop adjustment in the level of outstanding dollars and dollar claims in the economy to fulfill its demand for money, one conversion at a time.

The Parity

A government's promise to redeem its notes for gold turns on the question of value – what are they worth in gold? In the abstract, the question is simple. Paper currency in a gold standard is a derivative of gold, and the monetary authority has to determine a set relationship between the two forms of money and honor it through convertibility. But in most of the twentieth century, attempts to determine this parity caused pain rather than prosperity for national economies as governments reached back in time and attempted to restore currency values that had become obsolete.

Consider the American experience coming out of World War I. When it entered the conflict in 1917 the U.S. shut down exports of gold and stifled domestic convertibility. The rest of the industrial world had already done the same thing, either formally or informally. This was chaotic but completely predictable considering the circumstances. War put the gold standard, like many other financial arrangements, on hold as governments used all available tactics (e.g. money printing) to pay for it[11]. The Union had done the same thing during the Civil War when it issued greenbacks.

The issue following war was never whether or not to return to the gold standard. It had already proven itself and there was a consensus each time to reestablish hard money. The conundrum was about how to reconcile the inflation injected into the economy with the old gold parity. Both could not hold. The government either had to accept the inflation and establish the requisite lower gold value of the dollar or reinstitute the same terms and drive the price level down. It was a choice between acquiescing to market conditions and honoring past promises.

The worst experience through this crucible was the aftermath of World War I, where a faulty return to the gold standard tormented the economy up to the Great Depression. By the war's end the general price level in the U.S. had doubled. A few years later in 1920, prices were down to 40 percent above the prewar equilibrium. But the dollar value of gold remained at the longstanding parity of $20.67 per ounce, as if the war and resulting inflation had never happened. This undervaluation of gold encouraged it to seep out of circulation and led the Federal Reserve, which had opened its doors in 1913, to use the general price level as its monetary indicator. Meanwhile, after the Genoa Conference of 1922 the major industrial powers moved toward using national currencies rather than gold to settle international payments and restricted convertibility from specie to bullion. This wasn't the gold standard; it was a bastardized version of it. The attempt by critics to disparage the gold standard because of the interwar monetary experience led James Grant to observe that this is analogous to saying "I detest music because I don't like Lady Gaga"[12].

The monetary problems that snowballed into the wreckage of the Great Depression started with the continuance of the defunct prewar dollar/gold parity. It is what led citizens to hoard gold, foreign central banks to economize on it, and the Fed to use the crude measure of wholesale prices as the replacement lodestar. Gold drifted away from the global monetary system because the national banknotes, particularly of the United States, no longer held a functional relationship with the metal. Prior to relinking, the U.S. should have doubled the gold price from $20.67 to approximately $40 an ounce following World War I to account for the wartime inflation. Gold would have remained relevant.

The post-World War I monetary meltdown shows that a critical element in transitioning to the gold standard is *getting the price right*. This means setting the dollar/gold parity based on market conditions where the currency is neither undervalued nor overvalued in terms of gold. An overvaluation can lead to deflation, as the above example shows. Undervaluation likewise necessitates inflation as the general price level catches up to higher gold price. In setting a policy for returning the dollar to a gold peg, it is critical that the government protect the economy from both of these risks.

The last official federal proposal to reintroduce the gold standard, H.R. 3794 sponsored by Rep. William Dannemeyer in 1985, leaned on the market to determine the price. It instructed the Treasury to post a daily bid and ask price for gold for one year, and at the end establish the official parity between the dollar and gold (or American Gold Eagle coin) based on the last day's average of the two. In other words, it gave the market a one-year period to discover the gold value of the dollar and communicate that to the government.

Is one year sufficient? The last complete restart of the gold standard was in the aftermath of the Civil War and took four years. The Specie Payment Resumption Act of 1875 made convertibility effective on January 1, 1879, spanning the presidencies of Ulysses Grant and Rutherford Hayes. This also overlapped with the tail end of Reconstruction. Economic devastation and inflation generated by the war formed the backdrop.

The circumstances today come with their own challenge. Gold has been demonetized for four decades, and the swings in the price through those years reflect that status. Furthermore, unlike 1985 there is no living institutional memory of operating under a gold-based monetary program. A coming to terms with the new dollar/gold parity will require the government to proceed with an abundance of caution. The market deserves a fair amount of time to match the dollar money supply with monetary gold and determine the price relationship between them.

In addition to market considerations, there are also political dynamics for which to account. Monetary policy has traditionally been dictated by presidents. It was Nixon who closed down the Bretton Woods system, Franklin Roosevelt who clamped down on private gold ownership and Grover Cleveland who demanded that Congress repeal the Sherman Silver Purchase Act to keep the gold standard pure. Likewise, William McKinley's victories over William Jennings Bryan in the presidential elections of 1896 and 1900 were electoral mandates for the gold standard over bimetallism.

A market discovery period sufficient for the gold/dollar parity would seem to be longer than one year but fewer than four. The time span within these parameters is arbitrary, but 30 months from the law's passage to full effect is a prudent policy. This not only assures the market sufficient time to determine the parity, but also gives the government a lengthy period in which to audit its gold holdings and adjust them accordingly.

How much gold does the U.S. government need to run a gold standard? Adam Smith observed in *The Wealth of Nations* that gold specie equal to 20 percent of the paper money supply worked well in 18^{th} century Scotland. In his seminal *Lombard Street* a century later, Walter Bagehot opines that the central bank should keep no less than one-third of a gold reserve ratio as the Bank of England did at the time. The Federal Reserve Act of 1913 required that 40 percent of circulating notes had to be backed by gold, later amended by Congress in 1945 to 25 percent[13]. Today, the U.S. government's gold holdings of 260 million ounces at market value are equal to approximately 15 percent of base money (coins, currency, and commercial bank reserves with the Fed).

There is no explicit gold reserve rule in the gold standard, only the obligation of the government to redeem gold for paper money at its statutory value. No matter how much gold happens to be on hand with the monetary authority at any given time, the currency is still 100 percent backed by gold. Thus it is the government's job to determine how much gold it needs to enable redemptions. This is why the 30-month period used to arrive at the gold/dollar parity should also be used by the monetary authority to adjust its gold holdings. The parity is actually likely to be found *before* the government finishes determining its gold stock, given the efficiency which the market works. Therefore the parity will be observable, if not set in place, and the government will be able to buy and sell gold at this value with a certain reserve guideline in mind.

The Gold Standard and the Federal Reserve

Contrary to the popular idea of the two being antithetical to each other, the Federal Reserve was organized under the gold standard. A 2012 monetary study by the Republican staff of the congressional Joint Economic Committee notes that the Fed came with "a monetary policy mandate to provide an 'elastic currency' *within the context of a gold standard* to combat the form-seasonal elasticity problem"[14] (italics added). Before its inception the U.S. did not have a central bank, a bank to the banks, to provide sufficient liquidity. Banks sometimes simply did not have the cash on hand to convert deposits into notes and could not meet the shifting demands for money from their customers.

The Panic of 1907 – triggered by a series of events ranging from the San Francisco earthquake that wiped out West Coast finance to the Knickbocker bank meltdown in New York – revealed the fragility of the U.S. banking system. J.P. Morgan's integral role in bailing out Wall Street after he had already helped replenish the government's gold stock during the Panic of 1893 convinced Congress that the financial system could not be held together by one man much longer. It organized the National Monetary Commission in 1908 to design a central bank and at the end of 1913 the Federal Reserve opened its doors.

The Fed was organized by law for two purposes: to furnish an elastic currency and serve as a lender of last resort during times of liquidity crises. Neither of these contradicts the gold standard;

rather, they do for the banking system what the gold standard alone could not, as the classical gold standard of 1879-1913 showed. In this model, gold is the basis for the definition and value of money while the Fed is in charge of administering the money supply. In other words, the Fed is subordinate to the gold standard, a self-operating monetary regime where the supply of money is dictated by the economic participants rather than a central bank.

Consider the contrast between an interest rate environment determined by committee and one determined by the marketplace.

Today, the Federal Open Market Committee led by Chairman Ben Bernanke meets once every six-and-a-half weeks and picks a target federal funds rate, or the price at which its member depository institutions lend reserves to one another. This is its key monetary policy lever, because it affects interest rate levels on all further types of lending across the risk spectrum. The FOMC executes its decision by instructing its traders at the New York Fed to buy and sell government securities with banks to increase or decrease their reserves with the Fed. When reserves grow, the fed funds rate sinks as the demand for interbank lending falls. When they fall, the rate increases as banks scramble to borrow to meet the reserve requirement. Since December 2008 the FOMC has kept the target fed funds at the band of zero to 0.25 percent and stated in its outlook that it expects to maintain that goal until late 2014. What was conceived of as an emergency response to a meltdown of the lending market during the financial crisis has since been made into a long-term policy that is the backbone of the Fed's monetary stimulus.

Under the gold standard, there would be no reason to interfere with interbank lending in this way. The overall money supply and reserve levels would be shaped by gold flows rather than the Fed's intervention via government securities. The Fed would redeem claims for gold or dollars by financial institutions (furnishing an elastic currency), leaving the banks to borrow or lend with one another without prodding from the Fed. The resulting fed funds rate, like the money supply itself, would be a function of market demand rather than Fed policy. Open market operations would be comprised of the automatic workings of gold convertibility, not the central bank's trading activity.

In his book *The True Gold Standard*, Lewis Lehrman describes how the Fed can reinvigorate its discount window, the tool used to provide short-term credit to banks. He advocates that such emergency lending be restricted to "solvent banks at above-market rates, secured by short-duration, high-quality, liquid collateral"[15]. For a bank to be the recipient of the Fed's help, it must be structurally sound, have a secure footing in sight (within six months), and hold commercial securities acceptable to the Fed to back the loan. These are purposefully tough and prudent standards.

If the Fed were to remove itself from the government debt market, Lehrman points to the benefit for the real economy. Commercial banks would follow the Fed in gradually replacing their portfolios of Treasuries with business loans. This would redirect massive flows of credit from the government to the private sector. The principal beneficiary would be small businesses which historically have struggled to obtain commercial bank loans, particularly since the Fed's zero interest rate policy took effect.

Lehrman believes that fixing the Fed for the gold standard also requires fixing the banking system as a whole, a topic on which he has written and spoken extensively. As he sees it, this involves strengthening banks' capital ratios, reserve requirements, and accounting standards. It also means increasing the liability on bank stockholders, directors and managers in order to make banks behave like fiduciaries (an idea that James Grant, another preeminent gold standard proponent, has advocated). Such comprehensive banking reform would need to be written and passed as separate legislation from monetary reform, as would a repeal of the Humphrey-Hawkins Act which formally provided the Fed with control over monetary policy in the paper dollar system.

Lehrman's model is akin to Bagehot's in *Lombard Street*. Here the Fed is playing the classic lender of last resort role, not that of a bailout artist. It embodies the larger theme of the central bank under the gold standard guided by rules, not its own discretion. There would be no fed funds target, only an actual fed funds rate determined by the money market. Emergency funding through the discount window would be available only to credit-worthy institutions should the money market freeze. Bernanke and the open market committee would no longer conduct monetary policy, but administer it. The arbitrariness of the current system would be removed. Money would be derived from an actual asset, not by a committee. What Grant dubs a "Ph.D. Standard" would be replaced by the gold standard and the Fed would be returned to its original mission of supporting, not managing, the nation's monetary regime.

Conclusion

The gold standard is a monetary system that means living in the now rather than the past. Money is based on an asset (gold) rather than a debt (government promise) whose presence in the economy reflects the market's real-time demand rather than the central bank's latest policy stance. On the global level it means the settling of international payments in gold rather than government debt obligations, a concept extolled in detail by Rueff in the past and Lehrman and his colleague John Mueller today. The gold standard provides closure to an exchange because it leaves real wealth in the hands of the recipient, not a paper currency of uncertain value. It provides for a neutral, non-national means of financial interaction which cannot be gamed by money printing, interest rate suppression, or other tactics of financial repression. It is a monetary policy for the future, not just the past.

If the classical gold standard showed how well it could work for the economy in the 19th century, the debased 20th century experience of half-hearted gold-backed monetary policy showed how it could sabotage itself. There was no popular outcry for paper money in 1971; only a frustration with a dysfunctional system wherein gold was merely a passenger, as economist Robert Mundell put it in his 1999 Nobel Prize acceptance speech. The essential components of a true gold standard (convertibility, gold legal tender, central bank compatibility) were missing.

The United States now has the opportunity to reinstitute a gold standard with the benefit of experience, the advancement of technology, and a clear absence of functional paper-based monetary policy. After decades of turmoil and confusion, it is in a position to improve upon what worked before and lay the groundwork for an enduring reform. This requires a fidelity to the ideas behind the gold standard and the political will to see them through to implementation.

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[1] Davis
[2] Grant
[3] Hilton
[4] Robbins
[5] U.S. Treasury
[6] Davis
[7] Schwartz
[8] U.S. Mint
[9] Federal Reserve
[10] Lehrman *i*
[11] Crabbe
[12] Pietrusz
[13] Davis
[14] Joint Economic Committee
[15] Lehrman 71

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