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Against the Gold Standard

A lot of simplistic ideas for solving complex problems become popular during economic crises. One such proposal is for Russia to adopt the gold standard -- that is, to print only as much money as the Central Bank holds in its gold reserves. Such talk is fraught with serious risks. Recall the 1930s, when countries that tied their currencies to gold quickly yielded to the ruinous temptation of protectionism. Nonetheless, the same idea has now grabbed the attention not only of the Russian media, but of top government advisers as well.

There are two basic economic arguments against the gold standard. The first holds that monetary policy is too important a tool for smoothing fluctuations in the aggregate demand. Easing monetary policy cannot affect "real" economic variables, such as the level of industrial output and unemployment in the long term. But it can have an impact in the short term as long as firms and individuals that have not yet adapted their expectations to the reality of rising prices. If monetary authorities are certain that they can stop printing money after a while, such a move can indeed help in a recession. But adhering to a gold standard does not allow for conducting countercyclical monetary policies. The overall volume of currency is determined by the amount of gold held by the Central Bank, and the ruble-to-gold exchange rate is permanently fixed at the moment when the gold standard is first adopted. At the same time, the inflexibility of the gold standard -- that is, the inability to arbitrarily print money and thereby conduct an active monetary policy -- is also its greatest advantage. As long ago as the 1960s, U.S. economists (and future Nobel laureates) Milton Friedman and Edmund Phelps argued in their works that when an economic entity is expecting high inflation, monetary policy loses almost all of its meaning since issuing more money only leads to higher prices. The gold standard might help in putting a halt to inflation by not allowing the monetary base to grow.

In one sense, the second argument against implementing the gold standard is only a continuation of the first. But it also took the work of a number of outstanding minds, including economists Finn Kydland and Edward Prescott (also Nobel prize winners) and their followers in modern political economy and macroeconomics, regarding stagflation of the 1970s to enunciate the argument clearly. The usefulness of the gold standard is limited by the fact that no government in the world can make a commitment not to abandon it in the future. This is especially true because it often requires not only a firm commitment from a politician or political party, but also from a future government. But if this were possible in principle, a commitment to many other forms of monetary policy would work as well.

Of course, the gold standard does have its charm. The classic article "The Gold Standard and the Great Depression" by Barry Eichengreen and Peter Temin describes how difficult it was for state leaders prior to the Great Depression to reject the "gold mentality" -- even when it became obvious that the gold standard itself was creating problems. Nonetheless, the question of monetary policy is really an issue of the people's faith in the government, and there is no magical elixir that can help create this.

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