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Let's go back to good old gold

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Given the uncertain global currency environment, there is a genuine need for a proactive gold reserves policy.

With the advent of World War I, the international community went off the gold standard. While the US kept some sort of gold standard, the world had a link to the US dollar. With President Nixon breaking the link between the dollar and gold in August 1971, there was a total delinking of currencies from gold.

A small band of dedicated advocates of gold has continued to persevere in their attempt to restore the gold standard. Following Keynes' celebrated statement that gold is a barbaric relic, the bulk of central bankers, government officials, politicians and economists dismiss, outright, the gold standard. The minority still committed to gold carry the cross, as the insecure majority hurls insults, calling gold advocates atavistic cranks and madmen.

Unbridled Currency

In the last 100 years, there has been unbridled recourse to fiat currency. This column draws heavily on a benchmark address by Lewis E. Lehrman on "The Federal Reserve and the Dollar" at the 31st Annual Monetary Conference at the Cato Institute, Washington DC.,US (November 14, 2013).

Lehrman quotes Keynes in "Indian Currency and Finance", to say that whether a central bank holds its reserves in gold or in foreign exchange "is a matter of comparative indifference …India, in her Gold-Exchange Standard… far from being anomalous, is in the forefront of monetary progress …(heading towards) "the ideal currency of the future". What glory for India!

French economist and adviser to the French Government Jacques Rueff pointed out that when a monetary authority accepts dollar claims for its official reserves, instead of settling its balance of payments deficit in gold, purchasing power is duplicated. For example, the US market is in a position to buy in Europe and in the US at the same time, causing asset or price inflation. Rueff inspired two vital restorations of franc convertibility to gold in 1926 and 1959 even as Great Britain failed in 1926 and the US in 1971. Rueff's success was due to his being a gifted monetary economist as also a successful practitioner.

Rueff believed that no central bank can determine the quantity of money in circulation; this contrasts with the dominant view that the quantity of money and credit in circulation, the level of interest rates, economic growth, the level of employment and the rate of interest can be co-ordinated at optimum levels by the central bank credit policy.

If the central bank's goal is to avoid sustained inflation or deflation, then the target should be to influence the supply of cash to the economy to equal the level of desired cash balances. To attain this, the central bank has to abandon hyperactive open market operations and activate the discount rate. The central bank should set the discount rate above the market rate when the price level is rising. (Monetary policymakers in India would do well to take note of this.)

The global approach to the 2008 financial crisis has been to resort to unbridled pump priming. It is amazing how much support there is for pump priming in both the industrial and emerging market economies. The view is that sooner or later there will be green shoots of economic growth and employment. The strong possibility of an international financial crash of unprecedented intensity is summarily dismissed.

Way Out of crisis

Lehrman's way out of the crisis is to avail of the historic regime tested for centuries in the market place, namely,the classical gold standard. The opposition to the gold standard is that it is too costly in economic and social terms, estimated at 2.5 per cent of output. Professor Lawrence White has calculated that the cost is as small as 0.05 per cent of output. Lehrman argues that the classical true gold standard is the least imperfect monetary regime and the restoration of the true gold standard will foster rapid growth, world trade and investment.

Professor Alan Meltzer, an arch critic of the gold standard, says "I don't say it is wrong. I say it is possible. I mean it is a plausible system. There are a lot of things that are better than our fiat system" (See Ralph Benko, The Gold Standard Now, November 19, 2013).

A number of countries have a very high proportion of gold reserves and some others are slowly, but surely, increasing the proportion. The longer unbridled fiat currency expansion continues, the greater will be the incentive to move to gold. Opponents of gold highlight that central banks have lost $545 billion since 2011 because of falling gold prices, but nobody calculates how much more central banks have lost in real terms because of the loss in value of reserve currencies.

RBI's strategy

In India, gold accounts for 7.5 per cent of total reserves. In the context of the extremely uncertain global currency environment, there is an imperative need for a proactive gold reserves policy. The US dollar moves inversely with gold and with other reserve currencies. As such, the best loss minimisation strategy would be to deploy one-third of the reserves in gold and one-third each in dollars and non-dollar currencies. As a first step, the RBI should undertake small purchases of gold, taking into account swings in prices. There is a strong anti-gold reserves lobby in India. Would this lobby prefer to hold a part of the reserves in onions!