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ECONOMIC BEAT

Restoring Balance: The Case for Gold, Part II

By GENE EPSTEIN

IMAGINE THIS. THE U.S. AND OTHER MAJOR INDUSTRIALIZED nations agree to convert the world's money to a universal gold standard, administered by a system of private banking. Once holders of dollars, yen, euros, pounds and pesos are apportioned the equivalent value in gold, governments retreat to the passive role of legally requiring that all such paper claims on gold receive 100% backing.

Some might ask whether any government would willingly relinquish the power to print money; others might wonder if the logistics of such a radical conversion are manageable. Good questions, both, to which I believe good answers can be given. But in this second of two installments on the case for gold, I argue only that, if such a privatized, 100%-reserve gold standard could be achieved, it would satisfy Alan Greenspan's three main arguments for gold -- the focus of last week's first installment ("[Greenspan Was Right: The Case for Gold, Part 1](#)¹").

Start with Greenspan's first point: "Under a gold standard, a free banking system stands as the protector of an economy's stability and balanced growth." Under the present regime, the banking system's habit of creating money out of thin air has again brought on a feckless expansion of credit, in the present instance creating a huge imbalance in the housing sector and destabilizing the rest of the economy. But where money is gold, and where gold is legally protected by 100% reserve requirements, the great credit-expansion machine will no longer operate. Weekly credit-card solicitations will no longer flood our mail boxes. Fast-buck artists will no longer sell people homes they can't afford. Saving and investing will be carried on through savings accounts, bank CDs, corporate bonds, stocks, reinvested earnings. But because such investment involves scarce funds, it will be allocated according to prudent standards of risk and reward. Irrationally exuberant folks always will be with us, but their chances of starting an Internet bubble will be radically curbed.

One of the abiding monetary myths is that the gold standard got a fair trial in the 19th century, only to be replaced by the Fed's stabilizing hand by the early 20th century. In fact, credit expansion was the norm in the 19th century, almost as much as today. But with a privatized monetary system that holds government at arm's length, and with a 100%-reserve requirement, the chances of credit-cycle abuses would greatly diminish.

Since inflation is a monetary phenomenon, even skeptics probably would agree that a gold standard would satisfy the second of Greenspan's main arguments: A gold standard would curb price inflation. Indeed, Atlantic.com blogger Megan McCardle raised the fear that a gold standard would bring "deflation," which "does rather devastating things to anyone who has debt, since they now have to repay what they borrowed in more expensive dollars."

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But by "deflation," she can only mean the contraction of money -- a risk under the current regime, or even under a gold standard with fractional reserves, where the money supply could indeed rise and fall. However, subject to the proviso that the transition to a gold standard would avoid just such a wrenching deflation, the gold supply probably would increase by 2% to 3% a year, while output would rise by 4% or more. That would still mean rising sales. Business would have no more problem paying its debts than it does now.

That brings us to the third and final argument: A gold standard would prevent government from raising funds through the printing of money. The power of politicians would greatly diminish. That can't be all bad.

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