

Trump's Cross of Gold

BARRY EICHENGREEN

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US President Donald Trump wants to compress the United States trade deficit and enhance the competitiveness of domestic manufacturers by using tariffs to raise the price of imported goods. And the fixed exchange rates he needs to achieve that goal are the real reason behind his nomination of Judy Shelton to the Federal Reserve Board.

SINGAPORE – There are now scores of efforts to psychoanalyze US President Donald Trump's nomination of Judy Shelton to the Federal Reserve Board. Some emphasize Shelton's fidelity as an early adviser to the Trump campaign. Others point to her conversion into "a low-interest-rate person." Still others highlight her advocacy of the gold standard as insulating US monetary policy from an unreliable Fed.

These interpretations all miss the point, which is that Shelton is a proponent of fixed exchange rates. Her belief in fixed rates is catnip to an administration that sees currency manipulation as a threat to winning its trade war.

Team Trump wants to compress the United States trade deficit and enhance the competitiveness of domestic manufactures by using tariffs to raise the price of imported goods. But a 10% tariff that is offset by a 10% depreciation of foreign currencies against the dollar leaves the relative prices of US imports unchanged.

Countries seeking to maintain the competitiveness of their exports have an obvious interest in encouraging such currency adjustments, or at least in not resisting them. In fact, they don't actually have to do anything in order for their currencies to fall when the US applies tariffs. The US current-account deficit is just the difference between US investment and US saving, which tariffs do nothing to change. If the current account doesn't change, then neither can the relative price of domestic and foreign goods. So the exchange rate must move, of its own accord, to offset the tariff.

Thus, the challenge for Team Trump is to get other countries to change their policies to *prevent* their currencies from moving. That's what the demand for stable exchange rates and an end to "currency manipulation" is all about.

Consider Shelton's call last year for a new Bretton Woods system. The goal, as she described it, would be to establish a "coherent mechanism for maintaining exchange-rate stability among national currencies," the same goal as the one that was set at the original 1944 Bretton Woods Conference.

But in the absence of a global conference – something that would be anathema to Trump – the way to get there is the same as under the nineteenth-century gold standard. Then, the leading power, Great Britain, unilaterally fixed the domestic currency price of gold. Other countries, seeing the advantages accruing to Britain, followed its example. Once multiple countries had pegged the domestic price of gold, the exchange rates between their currencies were effectively fixed. Today, the idea evidently is that if the US moves first, "preemptively" as Shelton puts it, other countries will follow.

Behind this presumption, however, lie a number of logical non-sequiturs. First, other countries show little desire to stabilize their exchange rates, restored gold standard or not. They understand that different economic conditions justify the adoption of different monetary policies, which in turn requires exchange rates to move.

Second, gold is no longer a stable anchor. The dollar price of gold has fluctuated from \$900 in 2009 to \$1,900 in 2011 and back to \$1,500 today. Having the Fed peg the price of gold in dollars would do nothing to peg its *relative* price – that is, the price of gold relative to the prices of other goods and services. For the relative price of gold to double, as it did between 2009 and 2011, consumer prices would have to fall by half, in a catastrophic deflation.

The price of gold relative to CPI inflation was less volatile in the nineteenth century, but this reflected the importance of gold mining. When the price of gold rose relative to the prices of other commodities, more resources were allocated to mining. Additional gold was extracted as a result, causing its relative price to fall. More precisely, other prices rose, as that additional gold backed an inflationary increase in money supplies.

Today, after a century-long increase in the production of other goods and services, gold mining accounts for a much smaller share of global GDP. The stabilizing capacity of the mining industry is weaker, rendering the price of gold more volatile.

It might be argued that the volatility of the gold price reflects financial instability, which induces investors to rush into gold as a safe haven, and that the gold standard will produce a more stable financial environment. But there is no historical basis for this notion. Financial crises were a recurrent phenomenon under the gold standard. That is no mystery: having to stabilize the price of gold severely limited the ability of central banks to act as lenders of last resort to distressed financial systems. Instability regularly followed.

In short, arguments for a gold standard and pegged exchange rates are deeply flawed. But there is a silver lining, as it were: nothing along these lines is going to happen, Governor Shelton or not.