Charles Kahn
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A week when the price of gold is at record highs would hardly seem to be the time to argue against gold as an individual investment or as a currency backing. So that's just what I'll do.

A year when other countries have been talking up the possibility of replacing the dollar as the world's reserve currency with something else--another currency, maybe, or a basket of currencies--would hardly seem the time to be complacent about the perceived weakness of the dollar. And again, that's just what I'll be.

Actually my argument against gold as an individual investment is simply that there's no reason to include gold in an investment portfolio in any greater proportions than any other commodity, and no reason to include commodities in any greater amount than warranted by the basic arguments for diversification. Commodities, including gold, are useful as a component of a portfolio as a hedge against financial crises; so are US Treasuries. Commodities, including gold, are useful as a hedge against inflation; so are common stocks. Is gold useful as a hedge against meltdown of the world economic order?--Certainly not if held as financial claims, and probably not if held as bars under the bed: hardtack and distilled water will end up more valuable. As for speculation on future directions of the price of gold--your guess is as good as mine, and I wish you the best of luck.

Largely the same people who would rather hold gold than cash would also rather make cash more gold-like. Partly the belief is that re-tying the dollar to gold is the only effective way to make it "stronger" and that making it stronger is a good thing.

But had the dollar been tied to gold over the recent run-up, that would have been a very bad thing. During the past past year, the run up in gold prices has nearly 20%, and inflation has been minuscule. If dollars had been priced by gold, then there would either have been a massive deflation, or there would have been serious dislocations, as prices of goods and services in the US economy became way-too-high, and businesses struggled to adjust.

I've heard it argued that the US should strengthen the dollar to protect its position as the world's reserve currency. The Chinese, for example, would like to be able to use some other currency than the dollar as a basis for world trading, and have been attempting to make their own currency more acceptable as a reserve for their trading partners. Imagine the effect if they were to peg the yuan to gold--wouldn't everybody flock to this stronger currency, to the detriment of the US economy?

Well, probably not. I don't claim to understand the psychology of international currency dealers and speculators, but I do know that they'll be concerned by the stability of the promise: a country that goes on the gold standard can go off it as well--and the same people that flock to the currency at the initial announcement will run away from it whenever there is a sign that the government cannot commit to continue the peg. We've seen such swings in sentiment for currencies pegged to the dollar; they'd be even more dramatic when pegged to a fluctuating commodity price. As a result it seems to me that smart money will still hedge with a basket of currencies, just as they do now.

What about the more moderate version of this argument, that the US should strengthen the dollar in less drastic ways to keep its reserve currency status secure? It's probably true that prospects of further depreciation of the dollar discourage some holders of dollars, and tightening US monetary policy would make the dollar more attractive as a reserve (although the mechanism through which this happens is actually pretty murky).

But why would the US want to continue to be the reserve currency country in the first place? There are two reasons why the dollar's ceasing to be the reserve currency would be bad:

1. Loss of seignorage. Because payment assets are useful, others are willing to hold them even if they don't generate as high a return. That's how kings made money minting money. It would be expensive for the US to lose this seignorage, but by no means devastating for the US economy.

2. Loss of status as unit of account. Lots of transactions are denominated in dollars even if the payment is actually accomplished in yen or euros. In ancient times when it was expensive to hire scribes to multiply and divide for you, there would be lots benefit from having other people make their pricing decisions based on the unit of account you used for your own day-to-day operations. With electronic calculators, this is now trivial. There is still a little bit of risk reduction provided by the decision by others to use the unit of account most convenient for you. But again, the disappearance of this advantage wouldn't be devastating.

So the reserve currency role is a nice perk. But if the only way to keep it is to use monetary policy to keep the currency strong, even when the domestic economic situation demands loose monetary policy then that it way too high a price to pay. When inflation is low and unemployment is high, monetary policy should be easy, even if it's detrimental to our reserve currency status.