Restoring Confidence: Five Approaches

Confidence in a currency, or any liquid asset, is always relative, namely, compared with some alternative asset; the problem is the likelihood of massive switches between alternative assets held. Economists have long known that a currency system with two moneys, such as gold and silver coins, with fixed rates of conversion is very unstable and should not be tolerated (Gresham's law).

The problem of increased or reduced confidence in the dollar lies in its convertibility into gold. Changes in expectations regarding the relative scarcity of the two assets lead to massive switches, which in turn may result in major disturbances of world monetary affairs. Switches from dollars to gold may, if convertibility is maintained, destroy large amounts of monetary reserves and induce deflation and unemployment in several countries. Switches from gold into dollars would increase monetary reserves, as the disgorging of private gold hoards creates additional reserves of commercial banks as well as additional cash balances of individuals and firms, which induces inflation of prices and incomes everywhere.

Traditionalists are fond of repeating that confidence is lost only when governments have misbehaved, and that convertibility into gold enforces discipline. Both statements are, to put it mildly, exaggerated. Expectations of lower production and rising industrial use of gold may lead to a large speculative demand for gold even if the creation of dollars has not been excessive by any traditional standards. And the fear of losing reserves of gold has rarely in modern times kept monetary authorities from engaging in monetary expansion when they wanted to promote employment and growth. The allegiance to gold exerts no discipline, it merely creates guilt feelings.

The traditional advice to the monetary authorities anxious to restore confidence in the dollar is that they make the dollar scarce. However, when popular belief in a future scarcity of gold is widespread, it would take severe deflationary measures by the United States to achieve a matching scarcity of the dollar. It would be downright madness to accept the prescription of a stiff dose of deflation.