A Chinese Gold Standard?

By KWASI KWARTENG  JULY 24, 2014

LONDON — While the 70th anniversary of D-Day last month received a lot of attention, another event, in July 1944 — the Bretton Woods conference, named for the mountain resort in New Hampshire where it was held — was perhaps even more significant in shaping the modern world. It not only led to the creation of what are now the International Monetary Fund and the World Bank, but it also confirmed the central position of the United States dollar in the international monetary system.

Why does this matter for us now? Just as America displaced Britain as the world’s pre-eminent economic power in the interwar period, so, too, the large debts and fiscal pressures confronting the West, and the rise of China and other economic powers, challenge us to think about the future of finance.

For most of the 19th century the British pound had been the world’s “reserve currency,” the currency in which trade and finance were denominated. “As sound as a pound” became a widely used expression. The pound was pegged to gold at a fixed rate of just under £4 per ounce.

At the outbreak of World War I, Britain abandoned the gold standard. You could no longer exchange pounds for gold. The gold standard was reintroduced in 1925, but this, as John Maynard Keynes observed, proved to be an economic mistake.

British prices and, more crucially, wages, would have to be forced down by 10 percent to maintain the competitiveness of British exports. As American agricultural and industrial exports soared in the 1920s and 1930s, the dollar effectively replaced the pound. It was American bankers who helped out the financially strapped Weimar Republic in the 1920s. The British, as exporters of capital, were a diminished force.
By the time of Bretton Woods, the United States held roughly 60 percent of the world’s gold supply. “Think of the gold in Fort Knox,” America’s chief negotiator at Bretton Woods, Harry Dexter White, said. “That is why we are in a powerful position.” He added, “We have the wherewithal to buy any currency we want.”

Bretton Woods fixed the dollar price of gold at $35 per ounce, and all the other major currencies — the pound, the franc, the mark, the yen — were subsequently pegged to the dollar, even though they could not be exchanged directly for gold. This system lasted until 1971. By then, America was under the financial strain of the Vietnam War and Lyndon B. Johnson’s Great Society. With mounting deficits and an adverse balance of trade, America struggled to maintain gold convertibility at the old rate of $35 an ounce. So President Richard M. Nixon abandoned the fixed dollar price of gold established at Bretton Woods (over the objections of the Federal Reserve chairman, Arthur F. Burns).

International critics said that the United States, by ending the dollar link to gold, was turning its back on its responsibilities as the guarantor of the international monetary system. Over the decades, the situation has gotten worse. The United States is $17.6 trillion in debt owed to the public, and large trade deficits are the norm. Yet there is no scope for revisiting the international monetary system, despite great dissatisfaction by countries like China and the Persian Gulf states, which hold large foreign currency reserves. Americans themselves question the security of the dollar when their country faces such large trade and budget deficits.

China’s nearly $4 trillion in reserves — accumulated through its mercantilist trade policies — give it plenty of ammunition to claim leadership in the creation of a new monetary order. The Chinese, however, are most unlikely to bid for monetary hegemony in the near future. For the past 25 years they have pursued a policy of aggressive export growth to drive their economy. China successively devalued its currency, from 1.50 renminbi to the dollar in 1980, to 8.72 in 1994. (Today the renminbi trades at 6.20 to the dollar, which the United States still considers artificially low.)

Could China someday peg its currency to gold, as Britain did in 1821? China has the reserves to do this, and it could have the political will, if the dollar proved to be unreliable as a store of value in the future.
Of course, Britain’s earlier adoption of the gold standard, in 1821, worsened a sharp deflationary period, during which, according to one calculation, consumer prices fell nearly 50 percent, between 1818 and 1822.

Nevertheless, to its supporters the gold standard ensured British fiscal and monetary dominance during the rest of the 19th century. As the British historian A.J.P. Taylor observed, 19th-century Britons believed that “a country could not flourish without a balanced budget and a gold currency.” Since Keynes, the West has tried to deny this proposition, with our reliance on deficit spending and “fiat” money, backed mainly by the expectation that a government will not default on its debts.

China is not as indebted as the West, but it is looking to “rebalance” its economy by raising demand by consumers, who want to enjoy the standard of living enjoyed across the Western world. Since 2010, the renminbi has appreciated 14 percent without drastically hurting Chinese exports.

Having expanded its manufacturing base and captured international markets, China may well find a world hooked on its products. It could eventually — in, say, 20 years — peg the renminbi to gold, considering it preferable to the dollar as a store of value, because of its permanence and longevity. With a balanced budget and a gold-backed currency, China’s economy could be even more formidable than it is today. Such a move would truly mark its return as the “Middle Kingdom.”

Hard as it may be to contemplate today, this scenario would, in many ways, be a more secure basis for an international monetary regime system than the system of floating exchange rates that Nixon inadvertently created in 1971, one that forever overturned the Bretton Woods order.

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