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The Unending Game of Chicken

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Every once in a while, Alan Greenspan throws a wild card across the table. He concluded a recent address with these remarkable words:

> Although information technology by its very nature has lowered risk, it has also engendered a far more complex international financial system that will doubtless bedevil central bankers and other financial regulators for decades to come. *I am sure that nostalgia for the relative automaticity of the gold standard will rise among those of us engaged to replace it* (my italics).*

Mr. Greenspan came to this conclusion at the end of a cogitation about "the perils of risk management when periodic crises — characterized by sharply rising risk premiums — undermine risk-management structures that fail to address them." A regulatory system requiring financial institutions to hold sufficient capital to protect themselves against hundred-year floods, he emphasized, would reduce the return on capital to a point where the economy would grind to a halt. Nevertheless, he noted, the acceleration of financial technology has greatly increased the difficulty of defining the dividing line between crises in which private risk management systems have to absorb the punishment and crises so severe that central banks have to step in to restore equilibrium.

Quite aside from how rare it is to hear anyone in authority today express "nostalgia" for the gold standard, Mr. Greenspan's observation about the gold standard seems like a *non sequitur*. How would the "relative automaticity" of the gold standard relieve today's central bankers of the responsibility to differentiate between a hundred-year flood and a heavy cloudburst?

In any case, the gold standard era did not lack for major financial crises involving central bank intervention. The entire gold standard system rested on the assumption that central banks would protect a nation's gold stock by pursuing policies designed to discourage a flight from the currency that might drive the gold stock to zero. This assumption tended on many occasions — although by no means all — to make speculation stabilizing rather than destabilizing, because speculators expected the central bank to take appropriate action to restore the currency to equilibrium when it was under pressure, including borrowing foreign exchange from other central banks if necessary. As a result of the stabilizing speculation, central bank intervention was not always required.

But there was nothing automatic in this business for the central bankers. If a currency came under pressure and gold began to flow out, how did the central bankers know whether speculators would step in and reverse the process, or whether the speculators would wait to see how far the gold stock would run down before the central bankers took stabilizing action like raising interest

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rates or searching for foreign credits? It was a constant game of chicken between the central bankers and the speculators. If the central bankers waited too long, speculation would become destabilizing and make matters worse rather than better. What is the difference between that kind of central banker's dilemma and the kind of dilemma that Mr. Greenspan is talking about?

The missing ingredient here is the underlying economic environment. As Benjamin Disraeli told a group of Glasgow merchants in 1895:

> It is the greatest delusion in the world to attribute the commercial preponderance and prosperity of England to our having a gold standard. Our gold standard is not the cause, but the consequence of our commercial prosperity.

The events that followed World War I proved without question the truth of Disraeli's assertion.

The game of chicken between speculators and central bankers is an unending one. If Mr. Greenspan means that watching the signals may have been easier in the old days when the financial system was less complex, I would yield the point. But this is different from distinguishing between the "relative automaticity" of the gold standard and today's system of floating currencies.

Mr. Greenspan's nostalgia for the gold standard is misplaced. As Disraeli reminds us, the job of a central banker is always a cinch when the economy is stable. It is always challenging when instability develops. Mr. Greenspan has no place to hide.

ENDNOTE

*Remarks before the *Journal of Financial Services Research* and the American Enterprise Institute Conference in honor of Anna Schwartz, April 14, 2000.