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GOLD STANDARD

A monetary system in which units are defined in terms of their value to gold.

The gold standard is a monetary system in which gold coins (or other forms of money backed by a fixed quantity of gold) were used as the standard unit of currency. In the domestic context, the government would guarantee the conversion of its currency into a fixed amount of gold. At the international level, gold or a currency backed by gold is used as a means of payments between countries. In such a system, the exchange rate would be fixed, and only small fluctuations are allowed as long as they do not exceed the cost of shipping gold from one country to another.

According to classical economist David Hume's specie-flow mechanism, if the exports of a given country are greater than its imports, an inflow of gold will take place, leading to an increase in the money supply within the country. This would cause domestic prices to go up and exceed foreign prices, which would cause exports to fall and imports to rise up to the point where exports and imports become equal. Similarly, if the imports of a given country are greater than its exports, an outflow of gold will take place, leading to a decrease in the money supply within the country. This would cause domestic prices to fall, which would cause imports to fall and exports to rise up to the point where exports and imports equalize again.

HISTORY OF THE GOLD STANDARD

The gold standard was first established in 1821 by England, followed by major world economies. A bimetallic gold-silver system prevailed throughout the world until France, Germany, and the United States abandoned silver in the 1870s because of discoveries of new gold mines. The gold standard disappeared from 1914 to 1928, when countries restricted gold exports during the war period. The Great Depression also led many countries to opt out of the gold-exchange standard during the 1930s.

After World War II, the United States was able to reestablish an international gold standard by fixing the value of the U.S. dollar in terms of gold and having all other countries peg their currencies to the U.S. dollar. All central banks around the world (except the U.S. Federal Reserve Bank) used U.S. dollars and gold as reserve currencies.

In 1971, the gold standard was finally abandoned for good when the United States declared its currency no longer convertible into gold because of a lack of gold reserves and the increasingly negative U.S. balance of payments. In principle, exchange rates were allowed to float freely. Most central banks, however, have adopted a "dirty-float" policy by intervening in the foreign-exchange market to avoid large appreciations or depreciations of their national currency.

Behind the apparent convenience of the gold standard that many policy makers have admired was a misleading strong belief in its theoretical foundations that dominated the way economists formulated their theoretical positions and policy prescriptions with regard to international trade, employment, inflation, and growth. More than three decades after the demise of the gold standard, many economists still formulate theory and policy as if the world were still operating under an international gold standard.

ARGUMENTS FOR AND AGAINST

The proponents of the gold standard argue that such a system would reduce the amount of risk involved in international trade by providing a stable pattern for exchange rates. At the domestic level, a gold standard system could help in limiting the power of governments (through their central banks) to cause inflation by printing more money than warranted by their gold reserves. Critics of the gold standard,

however, argue that central banks in practice have rarely reduced the level of money supply when their economy experienced an outflow of gold.

The gold standard was an inherently rigid system because of its ultimate reliance on the quantity of gold available in the system. It did not allow for the flexibility necessary to accommodate the needs of a dynamic economy. A fast-growing economy often finds itself in a liquidity crisis because of the mismatch between the quantity of money in circulation and the high demand for money required to keep the economy on a sustainable growth path.

Lack of liquidity is even worse for economies with high unemployment and slow economic growth. These economies need to increase exports to accumulate more gold and be able to expand the quantity of money domestically. But increasing exports often requires an initial expansion of the money supply through bank credit or government spending; both of which would be difficult to achieve under a gold standard system.

It could be argued that the gold standard has continued to overshadow mainstream economic thinking to this day. Many developing countries as well as economies in transition have adopted a currency board arrangement. Under such a system, a country seeks to implement a self-restraining monetary policy by fully backing its national currency by a strong foreign currency such as the U.S. dollar or the euro. The central bank can issue a national currency bill or coin only if it has its U.S. dollar or euro equivalent in reserve.

The so-called dollarization process in many Latin American countries is essentially the same thing as adopting a currency board arrangement, which means that the dollarized country cannot have any effective control over its fiscal and monetary policies. In such a case, during a recession the government cannot increase deficit spending to compensate for social and economic distress. However, many leading economists at the World Bank and the International Monetary Fund do not understand that these policies are remnants from the gold standard system and therefore do not apply to the modern monetary system.

L. Randall Wray has written that, in a nongold standard system, tax payments *do not* and *cannot* finance government spending; at the aggregate level, only the government can be the "net" supplier of fiat money. As a result, after government spends (creates or supplies) fiat money to purchase goods and services, it provides the public with the necessary amount of money to meet tax liabilities.

According to Wray's analysis, the government (theoretically) can have a balanced budget, meaning that the public's net money receipts are equal to tax liabilities. However, if the government attempts to run a surplus, the public's net money receipts would run behind tax liabilities. Therefore, the only way for households to pay their tax liabilities is either to use their hoarded money from previous government deficits or to present government bonds for payment. On the other hand, the government can safely run a deficit up to the point where it has provided the quantity of noninterest-earning fiat money and interest-earning bonds desired by the public.

A nongold standard monetary system with flexible exchange rates is a modern money system in which sovereign governments can issue their currency without any financial constraint. Both full employment and price stability can be achieved if economists and policy makers try to escape the theoretical baggage of the gold standard.

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See also: Exchange Rates.

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GOTHS

A group of Germanic peoples who inhabited the region north of the Black Sea before being driven into the Roman empire by the Huns, after which they established several kingdoms in central and western Europe.