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What is the gold standard?

Recurrently, and especially during periods of monetary stress, economic debate revisits the reintroduction of the gold standard. In this Focus, we first present the definition, the history and the mechanism of the gold standard and then discuss the advantages and disadvantages of a return to this monetary regime.

Definition

The gold standard is a monetary system in which (1) the value of each country's currency is defined in terms of a fixed weight of gold and (2) domestic currency is freely convertible to gold. To ensure convertibility, the amount of money issued by the central bank is strictly limited by the value of its gold reserves. International payments are settled in terms of gold. As the value of each currency is tied to the value of a fixed weight of gold, the exchange rate between two countries is constant and reflects differences in the respective gold weights.

Where do the origins of this system lie? During centuries, precious metals such as gold or silver had been used as a medium of exchange in domestic and international transactions. Precious metals displayed several desirable properties for such a purpose: they were durable, transportable, rare, and difficult to falsify, as their physical properties were well known and could be easily checked. In the 19th century, notes that could be exchanged into gold or silver started to circulate. These notes were issued by private banks and their value depended on the credibility of the issuer. In practice, the issued notes were not always backed by an equivalent amount of gold or silver and this led to frequent banking crises. The creation of central banks was partly an attempt to resolve this problem. Notes issued by central banks were largely covered by reserves of gold and silver.

The process described above finally led to the creation of an international monetary system centred on gold. The gold standard took shape in the 1870s and lasted until the First World War. It was partially reestablished during the interwar period. The Great Depression of the 1930s brought the gold standard to a final end.

How does the system work?

Under a gold standard, the evolution of monetary aggregates is related to the existing amount of gold. Money supply is independent of the level of economic activity and the amount of economic transactions. Therefore, in the medium run, for a given amount of transactions, changes in the supply of gold have to be transmitted to the general price level. This is the opposite of current monetary policies in large industrial countries where the quantity of money endogenously adjusts to ensure price stability. A smooth functioning of the gold standard thus requires very flexible prices (and therefore nominal wages).

The gold standard also implies specific rules for the system of international payments. Since the value of domestic currencies is defined in terms of gold, exchange rates between currencies are fixed and non adjustable. Monetary policy is entirely constrained to ensure the convertibility to gold and defend the exchange rate peg. Contrary to the Bretton Woods system, where domestic currencies were pegged to the dollar, the gold standard is in principle a fully *symmetric* international monetary system where no single national currency needs to play a specific role. All countries and all currencies are subject to the same rules.

International payments lead to gold transfers between countries. When a country runs a balance of payments deficit (surplus), it has to make (receive) a payment in gold. Domestic gold holdings decrease (increase) and domestic money supply contracts (expands). Domestic money supply is thus determined by the balance of payments. This provides an adjustment mechanism to external imbalances. Suppose for instance that a country runs a trade deficit. This leads to a decrease in gold holdings and a monetary contraction. This contraction generates a decrease in domestic prices. With lower relative prices, the country becomes more competitive and its current account is brought back to balance. This adjustment mechanism was described by David Hume in his famous 1752 essay.

In theory, this adjustment should be symmetrical. Prices should increase in surplus countries, making them less competitive, while the opposite should take place in deficit countries. In practice, however, adjustment was not always symmetrical. Countries with balance of payments surpluses could not be forced to issue more money: they could simply hoard gold without monetising it, thus avoiding the price increases that would erode their competitiveness. The United States and France, which both ran current account surpluses in the interwar period, were thus able to stockpile large amounts of gold, while deficit countries losing gold had no choice but to deflate their economies when their creditors required to be repaid in gold.

The end of the gold standard

The gold standard imposes fixed exchange rates and requires of each country a high degree of discipline. This system can only function well if prices are sufficiently flexible. The big economies left the gold standard one after another in the Great Depression of the 1930s. The exit from the gold standard afforded countries more leeway to stimulate their economies, as it gave them back their monetary autonomy and allowed them to depreciate their exchange rates. But, at the same time, the depreciation in exiting countries increased the difficulties for countries with an exchange rate that was still tied to gold and consequently pushed them towards leaving the gold standard as well.

Great Britain, which had reentered the gold standard at the pre-war parity, notably left the system in 1931. Exiting from the First World War less competitive, Great Britain overvalued its exchange rate which led to large balance of payments deficits. The resulting loss of gold reserves finally forced the authorities to give up the gold parity. The United States followed step in 1933.

After the Second World War, the Bretton Woods system replaced the gold standard. Instead of a gold parity, countries announced a fixed but adjustable parity to the dollar, which in turn was initially fully convertible into gold. Restrictions on capital flows allowed for some degree of monetary autonomy. The system came to an end in 1971 when the United States abandoned the gold parity. The big economies then moved to the current system of floating exchange rates.

Advantages and drawbacks of a return to the gold standard

In the current macroeconomic context, one of the most discussed risks concerns an excessive global monetary expansion along with a high volatility in exchange rates. An alternative consists in a possible return to the gold standard.

The main advantage of the gold standard is that it can serve as a credible anchor for monetary policies, and thus for inflation expectations. In fact, the gold standard may serve as "golden fetters", in the words of Barry Eichengreen,[1] to tie the hands of governments. By adhering to the gold standard, member countries are committed to strictly respect "the rules of the game". Breaking this commitment is still possible, but would be very costly in political terms and would be perceived as a failure.

For this specific reason, some countries have adopted exchange rate regimes very similar to the gold standard. The "currency boards" regime is a system in which the amount of domestic currency issued at every date strictly corresponds to the amount of foreign exchange reserves and the country keeps a fixed exchange rate with the currency of a reference country. As with the gold standard, each domestic currency unit is covered by an equivalent amount of a foreign reserve currency. As with the gold standard, the amount of domestic currency evolves in line with the balance of payments. As with the gold standard, the country deliberately gives up its monetary autonomy, which in turn ensures a high degree of credibility. Examples of countries with currency boards include Argentina in the 1990s and Bulgaria or Estonia today.

The second advantage of the gold standard is that, fixing individual currency's exchange rates with gold helps to eliminate exchange rate volatility and thus creates a favourable environment for the development of international trade, a major driving force of global economic growth.

However, a return to the gold standard would clearly imply several drawbacks, which would probably turn out to be very dangerous and a source of instability for the world economy.

Within the gold standard system, an economy has to absorb the consequences of a monetary contraction without any problems, which in turn implies that all prices and wages should simultaneously decrease. Yet, prices and wages in the economies of the 21st century are much less flexible than those of the 19th century, as social institutions and markets behave differently now. When the supply of gold decreases (especially in the case of a deficit), the golden standard would imply corresponding monetary and output contractions, followed by a surge in unemployment.

Secondly, the gold standard prohibits any exchange rate adjustments, which are necessary and justified in a case where a country is affected by a negative shock dampening its competitiveness. As a result, a country with a current account deficit would rebalance its current account through deflation, rather than devaluation which in turn leads to larger contractions in domestic output and employment. Indeed, the literature on the gold standard and the Great Depression shows that the countries which suffered the most from the 1929 crisis were those which stayed the longest in the interwar period of gold exchange standard.

More generally speaking, the gold standard displays a strong "deflationary bias". This stems from the fact that the world supply of gold, and therefore global money supply, can never keep pace with world GDP growth. Therefore, there would be a constant downward pressure on the general price level. Moreover, according to Martin Wolf,[2] there exists a significant mismatch between the official value of gold holdings and the size of the international monetary system. In fact, the total value of central banks' gold reserves amounted to about $1,300 billion while global bank deposits were at $61,000 billion in 2008. As a consequence, building a new gold standard would imply a slump in the global money supply. To avoid this drawback, an ex ante revaluation of the price of gold would be required, generating significant windfall gains for current gold holders.

1 See Eichengreen (B.) (1992)
2 See Wolf (M.) (2010)

Furthermore, the current volatility of the price of gold constitutes another problem as the sustainability of the gold standard depends heavily on the stability of the gold price. Under a gold standard, any variation in the relative price of gold with respect to other consumer goods would result in a period of inflation or deflation: if the relative price of gold increases, the value of the currency issued would increase accordingly, hence leading to a decrease in consumer prices.

Last but not least, there is no guarantee that the gold standard would alleviate global imbalances. As pointed out above, countries with a current account surplus would not be constrained to issue domestic currency as a counterpart to their gold inflows. They would have incentives not to do so, thus allowing an accumulation of new surpluses – and gold – if they anticipate an increase in the price of gold. As the risk of potential valuation losses of gold is low, countries with a current account surplus would have even less incentives to correct their external imbalances. Gold reserves could end up being concentrated in the hands of countries with trade surpluses and the international monetary system could collapse when some major countries run out of gold reserves.

The correct anchoring of monetary policy is a real problem. But the gold standard does not offer a reasonable solution at this stage. At the country level, institutional frameworks have been put in place over the past twenty years, based on the independence of central banks and a mandate to focus on domestic prices stability. Such a framework has made it possible to anchor monetary policies and to ensure their credibility. How global cooperation can achieve the same result without compromising the independence of domestic monetary policies remains an open question.

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