1 What is a gold standard?

- A monetary system where the government links its supply of paper money to a stock of gold reserves (visual)

- Under a GS, the government defines a dollar to be a specific weight of gold

- A dollar bill is a paper note made redeemable in a dollar weight of gold

- So, if a dollar is defined to be 1/20th of an ounce of gold—as it was for many years in the U.S.—then it would take twenty dollar bills to purchase one ounce of gold
2 Do we currently operate under a gold standard?

- No: the United States, like most countries in the world, currently operates under a *fiat money* system

- Under a fiat money system, a dollar is just an accounting unit
  - a dollar bill is not redeemable in gold, or any other asset

- Paper money is stipulated as legal tender
  - people can legally pay their debts (including taxes) using paper money
3 What do proponents of a gold standard view as its primary benefits?

- Governments cannot finance their expenditures by printing money
  - new expenditure must be financed by borrowing or by raising taxes
  - inflation finance is not possible
  - hence high (and hyper) inflation avoided

- Also, because gold is costly to mine, the world supply of gold has natural limitations
  - provides a “nominal anchor” for the price-level (visual)
4 What do opponents of a gold standard view as its primary costs?

- A desirable property of any monetary instrument is that it holds its value over short periods of time

- A gold standard may deliver a stable price-level in the long-run, but not necessarily in the short-run
  
  - the price of gold (and most other assets) can be quite volatile in the short run
  
  - just recently, for example, after a run-up in value, the purchasing power of gold dropped by 10% in a single day
– imagine having gone to work for gold one day, and then watching the value of your wages plummet by 10% the next day

– imagine purchasing a good for gold one day, only to see the value of your spent gold rise by 10% the next day

– it would be frustrating

• The demand for money (whatever its form) can fluctuate a lot in the short run

• Under a gold standard, the supply of money remains relatively fixed

  – these two facts imply that the purchasing power of monetary gold fluctuates in the short-run
• This is especially harmful when there are large and persistent unexpected increases in the demand for gold

  – results in sharp downward movements in the price level (unexpected deflation) can lead to depression

• Moreover, under a fractional reserve banking system, a gold standard permits bank runs

  – as people rush to redeem their bank money for gold (or dollar bills)

  – causes an interruption in the payments system

• Inefficiency of commodity money
5  Does a gold standard eliminate the possibility of inflation?

- No: old rushes and “natural” inflations

- No: Remember: under a gold standard, the government chooses the definition of a dollar

- A government can lower the purchasing power of a dollar bill by making it worth less gold

- In the United States prior to 1933, one dollar meant 1/20th of an ounce of gold
• In 1933, President Roosevelt redefined one dollar to mean 1/35th of an ounce of gold

  – a one dollar bill was now worth less gold (60% less)

  – the government was able to expand its supply of bills by 60%, without any change in its gold reserves

• This act resulted in a significant decline in the purchasing power of paper money

• Moreover, note that there is little to prevent a government from abandoning a gold standard

  – e.g., President Nixon, in 1971
- the link between paper and gold (alluded to in 1st bullet) breaks (visual)
6 What do proponents of a fiat money system view as its primary benefits?

• Because money can be created quickly, the supply of money can be expanded and contracted to accommodate short-run fluctuations in money demand
  
  – an “elastic” monetary policy can help stabilize the price-level in the short-run
  
  – can mitigate the bad consequences of deflation

• Likewise, it is possible for a central bank to serve as a lender-of-last-resort
— reduces the probability of bank runs

• Long-run price-level stability can be achieved by creating a politically independent central bank with a mandate to manage the supply of fiat money over time that targets some measure of price-level stability
7 Conclusion

- At the end of the day, what matters for price-level stability is credibility on the part of the monetary authority to manage the money supply in a socially responsible manner

  - the source of this credibility is not related to the existence of a gold reserve

  - inflation can remain low for long periods of time under a gold standard

  - but this can also be the case for a fiat money system (e.g., the U.S. since the early 1980s), the EMU since its inception