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Would a Gold Standard Brighten Economic Outcomes?

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“It gets dug out of the ground in Africa, or some place. Then we melt it down, dig another hole, bury it again and pay people to stand around guarding it. It has no utility. Anyone watching from Mars would be scratching their head.”

—Attributed to Warren Buffett

For much of human history money was made of either valuable commodities such as gold or silver coins or pieces of paper (bills) that represented these commodities. For many economies, gold served as the foundation of the money supply. The United States used a gold-based money supply but cut some of its ties to gold during the Great Depression and then severed its last official monetary link to gold in 1971. Some believe the United States should return to a gold standard to protect against the potential for runaway inflation. However, most economists disagree with the idea that a gold standard would improve economic outcomes for the average American.¹

The Gold Standard

With a **gold standard**, the value of a country’s money is tied to its stock of gold reserves. That is, each unit of currency (e.g., a dollar) is tied to a specific amount of gold and is redeemable for that specific amount of gold.² The government’s ability to increase the money supply is then restrained by its gold reserves.³ And since gold is naturally limited and the global gold supply grows relatively slowly, this system seemingly protects against high rates of inflation. However, a gold standard does not provide absolute protection against inflation. For example, a government that wants to increase the money supply can simply change the gold-to-money ratio. The U.S. government did just this in 1933 when it changed the exchange value of an ounce of gold from \$20.67 to \$35. Other countries have taken similar actions; they created money (and inflation) by repricing gold—or even departing from the gold standard entirely—during times of crisis or war.⁴

While it is often argued that a gold standard can effectively provide price stability, at least over long periods of time, the **stock** of gold can fluctuate dramatically over shorter periods, causing financial instability.⁵ Historically, these shifts occurred because the money supply within specific countries was influenced by the flow of gold between countries, which could fluctuate even when global gold supplies were relatively fixed. For example, investors seeking higher investment returns might invest their gold in another country—effectively reducing the supply

of gold (and money) in their own country and increasing the supply of gold (and money) in another country. As a result, individual countries under a gold standard had little control over their money supply. From a global perspective, the money supply was determined by the *total* gold supply, which was influenced by the rate of discovery and production of gold. Economic historians hold the slow pace of global gold production in the 1870s largely responsible for the deflation and economic depression in the United States during the 1870s—a period known as the “Long Depression.” Then, new discoveries of gold in Alaska and South Africa in the 1890s led to a large expansion of the global money supply, and inflation, in the 1890s.⁶

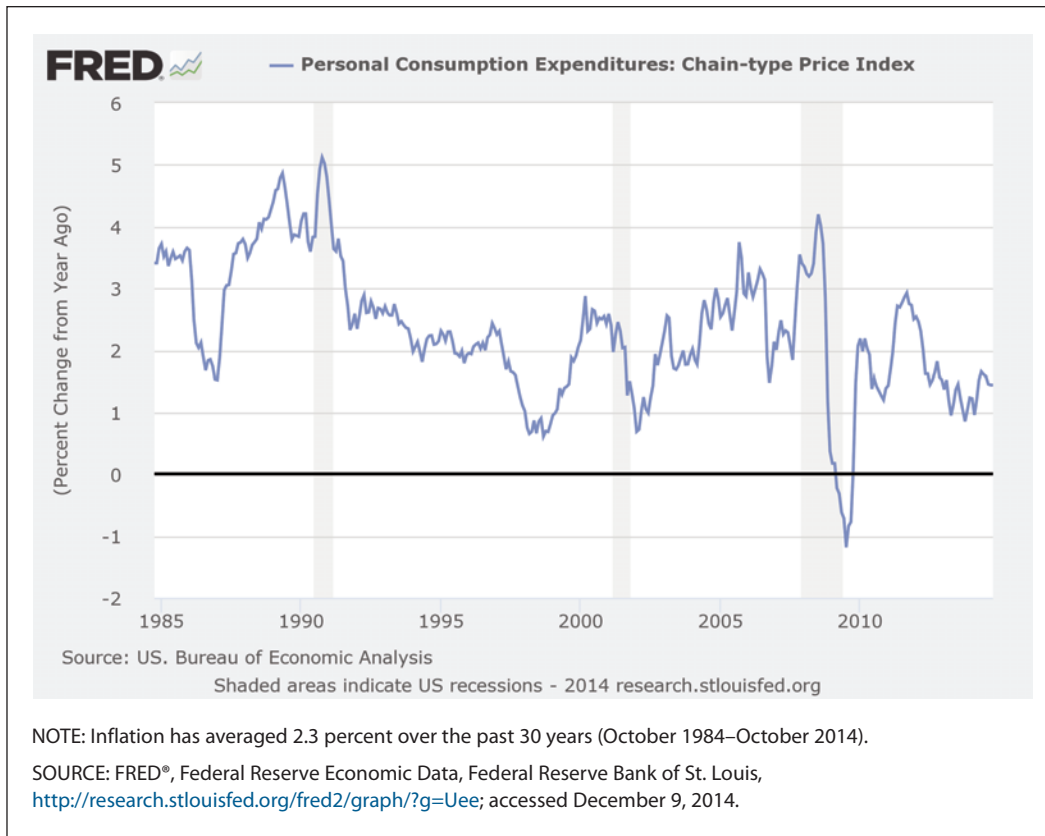
Fiat Money

Nearly every modern economy has adopted a monetary system based on **fiat money**. Fiat money has no intrinsic value (no value of its own) or representational value (not representing anything of value, such as gold). As the name suggests, fiat money is created by a government decree—an official government order that the money is legal tender for carrying out transactions or paying taxes. A fiat money system gives the central bank the flexibility it needs to expand or contract the money supply to provide economic stability—in other words, it is an “elastic” money supply. An **elastic currency** gives a central bank the flexibility to use **monetary policy** to smooth the business cycle and maintain economic conditions conducive to a healthy economy. For example, in a fiat system the central bank can increase **bank reserves** during a recession, which effectively increases the money supply and results in lower interest rates. The lower rates, in turn, encourage consumer spending and business investment. During periods of high and rising inflation, the central bank can use policy to reduce the level of reserves in the banking system, effectively decreasing the money supply and thereby increasing interest rates, which reduces inflationary pressures over time. During periods of crisis when the demand for money is very high, an elastic fiat money system enables a central bank to increase the supply of money quickly; this was effectively done by the Fed during the Y2K scare, in the aftermath of 9/11, and more regionally during and after Hurricane Katrina. Finally, during financial crises the central bank can provide liquidity to financial markets to quell fears, runs, and panics. In this way, emergency lending can serve as a “safety valve” to relieve pressure.

Would “Printing Money” Lead to Inflation?

There is a danger that governments might use the money-creation process (“printing money”) to finance government projects to excess, resulting in inflation that gets out of hand. The government might also purposely attempt to “inflate away” government debt.⁷ There are several historical examples of governments that have expanded the money supply to achieve their own goals—to the detriment of the country’s economy (e.g., hyperinflation in Germany in the 1920s⁸ and the experience of Zimbabwe from 2007 to 2009).⁹

Central bank independence is an important protection against the tendency of governments to generate inflation to achieve short-term goals for electoral purposes.¹⁰ As such, the Federal Reserve System was created with a degree of political independence to insulate it from the political pressures that might push it to create too much money. Even though the Fed has such independence, it is still accountable to Congress—it has a congressional mandate to promote both



price stability and maximum employment. **Price stability** is characterized by a low and stable rate of inflation maintained over an extended period. In other words, money holds its value in terms of purchasing power (the amount of goods and services that a unit of currency can buy). More specifically, the Federal Reserve has identified an inflation rate of 2 percent as most consistent with its longer-run goal of price stability. The Fed started to specify a numeric goal in 2012 to increase transparency and accountability.¹¹

Conclusion

A gold standard ties the value of money to a country's stock of gold reserves. While some argue that a gold standard can effectively maintain price stability over long periods, governments still have the ability to change their money supply and price level simply by changing the official gold-to-money ratio. Moreover, a gold standard can be problematic because of sudden gold inflows and outflows that cause the supply of money, and therefore prices, to fluctuate. In the end, a gold standard is not needed to preserve price stability as long as a country's central bank is independent and has a clear mandate to achieve price stability. ■

NOTES

- ¹ In a 2012 poll of academic research economists from leading U.S. universities, 93 percent disagreed or strongly disagreed with the following statement: "If the US replaced its discretionary monetary policy regime with a gold standard, defining a 'dollar' as a specific number of ounces of gold, the price-stability and employment outcomes would be better for the average American." See the Chicago Booth IGM Forum (http://www.igmchicago.org/igm-economic-experts-panel/poll-results?SurveyID=SV_cw1nNUYOXSAKwrq).
- ² The gold standard is based on promises by a government to exchange gold for its currency at a fixed price. If the public brings gold to a country's treasurer to purchase dollars, then more dollars enter into circulation. Similarly, the public can bring dollars to the treasurer, who is obligated to buy them back with gold, which reduces the dollars in circulation.
- ³ A central bank could increase the money stock without an increase in its gold reserves if its reserves already exceed the legally required minimum.
- ⁴ Bordo, Michael D. and Kydland, Finn E. "The Gold Standard as a Rule: An Essay in Exploration." *Explorations in Economic History*, October 1995, 32(4), pp. 423-64.
- ⁵ Bernanke, Ben S. *The Federal Reserve and the Financial Crisis*. Princeton, NJ: Princeton University Press, 2013.
- ⁶ Walton, Gary M. and Rockoff, Hugh. *History of the American Economy*. Twelfth Edition. Independence, KY: Cengage Learning, 2013.
- ⁷ A country might attempt to use inflation to reduce the real value of government debt. Stated differently, inflation reduces the real value of money, which means a high rate of inflation allows the government to pay for debts using money whose purchasing power has been eroded by inflation—that is, it has less real value than the money it borrowed.
- ⁸ See Polleit, Thorsten. "90 Years Ago: The End of German Hyperinflation." *Mises Daily*, Mises Institute, November 15, 2013; <http://mises.org/library/90-years-ago-end-german-hyperinflation>.
- ⁹ Koech, Janet. "Hyperinflation in Zimbabwe." Federal Reserve Bank of Dallas *Globalization and Monetary Policy Institute 2011 Annual Report*, pp. 2-12; <https://www.dallasfed.org/assets/documents/institute/annual/2011/annual11b.pdf>.
- ¹⁰ Waller, Christopher J. "Independence + Accountability: Why the Fed Is a Well-Designed Central Bank." Federal Reserve Bank of St. Louis *Review*, September/October 2011, 93(5), pp. 293-301; <http://research.stlouisfed.org/publications/review/11/09/293-302Waller.pdf>.
- ¹¹ Federal Open Market Committee. "Press Release." January 25, 2012; <http://www.federalreserve.gov/newsevents/press/monetary/20120125c.htm>.

GLOSSARY

Bank reserves: The sum of cash that banks hold in their vaults and the deposits they maintain with Federal Reserve Banks.

Elastic currency: Currency whose supply can be increased or decreased to meet the demands of the economy and used by a central bank to provide financial stability and achieve economic goals.

Fiat money: A substance or device used as money, having no intrinsic value (no value of its own) or representational value (not representing anything of value, such as gold).

Gold standard: The ability to exchange dollars for gold at a fixed price.

Monetary policy: Central bank actions involving the use of interest rate or money supply tools to achieve such goals as maximum employment and stable prices.

Price stability: A low and stable rate of inflation maintained over an extended period of time.

Stock: A quantity that is measurable at a particular point in time.

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