Module: 6

International Monetary System: Gold Standard

Prepared by: Dr. A.K. Misra
Assistant Professor, Finance
Vinod Gupta School of Management
Indian Institute of Technology
Kharagpur, India
Email: arunmisra@vgsom.iitkgp.ernet.in
Lesson -6
International Monetary System: Gold Standard

Learning Objectives:

In this session, various aspects of international monetary system are discussed in details. The historical development of currency system, particularly the Gold Standard is discussed in details.

Highlights & Motivation:

In this session, the following details about international monetary system are discussed.

- Gold Standard - A Historical Perspective
- The Mint Par Parity Theory
- Operational Aspect of Gold Standard

The session would help readers to understand the historical development of international monetary system, the operational aspects of gold standard and the autonomous paper currency standard.
6.1 Gold Standard

The gold standard is a system in which international currencies are tied to a specific amount of gold. Almost from the dawn of the history gold was considered as the medium of exchange because gold was durable, storable, portable and easily divisible. The foundation of the gold standard is that a currency's value is supported by some weight in gold. Inherently, it makes sense to value currency by some tangible and precious resources; otherwise, currency is just paper bills. Therefore, by tying paper money to an amount of gold, it gives the holder of the paper money the right to exchange the paper bills for actual gold. Ideally, this requires that paper money be readily exchangeable for gold. If a bank does not have gold, then the paper money has no value. But theoretically, actual gold would flow between nations to ensure that all currencies would be supported by gold. Another reason for considering gold as the medium of exchange was that the value of gold remained consistent over short-run due to limited availability of gold. At the turn of the 20th century, many major trading nations used the gold standard to adjust their monetary supply.

Under pure gold standard gold coins were traded freely and their inherent values were considered as their market values. The pure gold standard was used till 1870. Under the pure gold standard system, all participating currencies were convertible based on its gold value. For example, if currency X was equal to 100 grains of gold, and currency Y was equal to 50 grains of gold, then 1X was equal to 2Y.

Under relative gold standard, gold was considered as the currency standard and each currency was convertible into gold as a specified rate. Thus, exchange rate between two currencies was determined by their relative convertible rates.
6.2 The Mint Parity Theory

This theory is associated with the working of the international gold standard. Under this system, the currency in use was made of gold or was convertible into gold at a fixed rate. The value of the currency unit was defined in terms of certain weight of gold, that is, so many grains of gold to the rupee, the dollar, the pound, etc. The central bank of the country was always ready to buy and sell gold at the specified price. **The rate at which the standard money of the country was convertible into gold was called the mint price of gold.** If the official British price of gold was £6 per ounce and of the US price of gold $12 per ounce, they were the mint prices of gold in the respective countries. The exchange rate between dollar and pound would be fixed at $12/£6 = 2, which in other words, one pound is equal to two dollar. This rate is called mint parity rate or mint par of exchange because it was based on the mint price of gold. However, the actual exchange rate between these currencies would vary above or below the mint parity rate by the cost of shipping gold between two countries. To illustrate this, suppose the US has a deficit in its balance of payments with Britain. The difference between the value of imports and exports will have to be paid in gold by the US importers because the demand for pounds exceeds the supply of pounds. But the transshipment of gold involves cost. Suppose the shipping cost of gold from the US to Britain is 5 cents. So the US importers would have to pay $2.05 per £1. This is exchange rate, which is equivalent to US gold.

Because currencies were convertible in gold, then nations could ship gold among themselves to adjust their "balance of payments." **In theory, all nations should have an optimal balance of payments of zero, i.e. they should not have either a trade deficit or trade surplus.** For example, in a bilateral trade relationship between Australia and Brazil, if Brazil had a trade deficit with Australia, then Brazil could pay Australia gold. Now that Australia had more gold, it could issue more paper money since it now had a greater supply of gold to support new bills. With an increase of paper bills in the Australian economy, inflation, i.e. a rise in prices due to an overabundance of money, would occur. The rise in prices would subsequently lead to a drop in exports, because Brazil would not want to buy the more expensive Australian goods. Subsequently, Australia would then return to a zero balance of payments because its trade surplus would disappear. Likewise, when gold leaves Brazil, the price of its goods should decline, making them more attractive for Australia. As a result, Brazil would experience an increase in exports until its balance of payments reached zero. Therefore, the gold standard would ideally create a natural balancing effect to stabilize the money supply of participating nations.
However, the operation of the gold standard in reality caused many problems. When gold left a nation, the ideal balancing effect would not occur immediately. Instead, recessions and unemployment would often occur. This was because nations with a balance of payments deficit often neglected to take appropriate measures to stimulate economic growth. Instead of altering tax rates or increasing expenditures - measures which should stimulate growth - governments opted to not interfere with their nations' economies. Thus, trade deficits would persist, resulting in chronic recessions and unemployment.

With the outbreak of the First World War in 1914, the international trading system broke down and nations valued their currencies by fiat instead, i.e. governments took their currencies off the gold standard and simply dictated the value of their money. Following the war, some nations attempted to reinstate the gold standard at pre-war rates, but drastic changes in the global economy made such attempts futile. Britain, which had previously been the world's financial leader, reinstated the pound at its pre-war gold value, but because its economy was much weaker, the pound was overvalued by approximately 10%. Consequently, gold swept out of Britain, and the public was left with valueless notes, creating a surge in unemployment. By the time of the Second World War, the inherent problems of the gold standard became apparent to governments and economists alike.

Following the second world war, the International Monetary Fund replaced the gold standard as a means for nations to address balance of payments problems with what became a "gold-exchange" standard. Currencies would be exchangeable not in gold but in the predominant post-war currencies of the allied nations: British sterling, or more importantly, the U.S. dollar. Under the new International Monetary Fund approach, governments had a more pronounced role in managing their economies. Ideally, governments would hold dollars in "reserve." If an economy needed an influx of money because of a balance of payments deficit, the government could exchange its reserve dollars for its own currency, and then inject this money into its economy. The dollar would ideally remain stable since the U.S. government agreed to exchange dollars for gold at a price of $35 an ounce. Thus, world currencies were officially off the gold standard. However, they were exchangeable for dollars. Because dollars were still exchangeable for gold, the "gold-exchange" standard became the prevailing monetary exchange system for many years.

The effect of the gold-exchange system was to make the United States the center for international currency exchange. However, due to the inflationary effects of the Vietnam War and the resurgence of other economies, the United States could no longer comply with its obligation to exchange dollars for gold. Its own gold supply was rapidly declining. In 1971, President Richard Nixon removed the dollar from gold, ending the predominance of gold in the international monetary system.
In retrospect, the gold standard had many weaknesses. Its foremost problem was that its theoretical balancing effect rarely worked in reality. A much more efficient means to resolve balance of payments problems is through government intervention in their economies and the exchange of reserve currencies. Today, very few commentators propose a return to the gold standard.

References

- Multinational Financial Management by Jeff Madura, Thomson Publications
- Barry Eichengreen and Raul Razo-Garcia; “The international monetary system in the last and next 20 years”; Economic Policy, Vol. 21, Issue: 47, InterScience Publication

Model Questions

1. Write, in brief, the historical developments of international monetary system.

2. Discuss, with examples, the operational aspect of Gold Standard.