

The **Gold Standard** Loses Luster

KEY POINTS

The gold standard eliminated the need for a discretionary central bank to control the money supply.

Even so, central banks were known to work around the “rules” of the gold standard according to their needs, and in the process undermined the standard’s credibility.

The gold standard proved too inflexible during the crisis conditions that prevailed during World War I and the Great Depression. It was abandoned in stages around the globe thereafter, setting the stage for a new era in central banking.

When Congress established the Federal Reserve System in 1913, the concept of monetary policy as we understand it today did not exist.

Instead of central bankers actively influencing the level of bank reserves in pursuit of low inflation and full employment, the job of keeping the money supply in balance was left to the gold standard, a time-tested system. Money backed by commodities, including gold, had been the norm for millennia. Between 1870 and 1914, in fact, most of the world, including the United States, was on a gold standard.

It is easy to understand why. Under certain conditions, the gold standard has much to recommend it. Most alluring is its potential for preventing central banks and governments from generating inflation for purely political ends. The gold standard by itself keeps the money supply in check, so no modern-day monetary policy is necessary. Unless—as events eventually showed—the global financial system outgrows the constraints of the relatively inflexible gold standard.

Gold’s Heyday

Here is how the gold standard is supposed to work: Governments define their currencies in terms of gold, agree to freely exchange their currencies for gold at that official price, and allow the unfettered import and export of gold. Countries’ official gold prices then establish fixed exchange-rate parities among national currencies. When, for example, Britain set an ounce of gold equal to £4.24, and the United States fixed it equal to \$20.67, they automatically established an exchange-rate parity of \$4.88 per pound between their currencies. (The exchange rate, \$4.88 per pound, results from dividing \$20.67 per ounce by £4.24 per ounce.)

Actual exchange rates might fluctuate around these parities, but they should more or less even out over time. For example, if a nation’s currency should depreciate sufficiently because of high prices, low interest rates, or trade imbalances, people would have a strong financial incentive to exchange that nation’s currency for gold and ship it abroad, where they could earn more for their money. Their actions—not the discretionary decisions of central bankers or Treasury officials—would automatically bring prices in line with the world levels, re-establish parity among national currencies, and



restore the balance of payments (the record of a country's international transactions).

Under normal circumstances, using gold to fix exchange rates would be no problem for central banks. However, any economic development that generated public uncertainty about the adequacy of gold reserves could trigger a rapid shift from notes and deposits into gold and an outflow of gold. In this way, the gold standard sometimes proved relatively unstable.

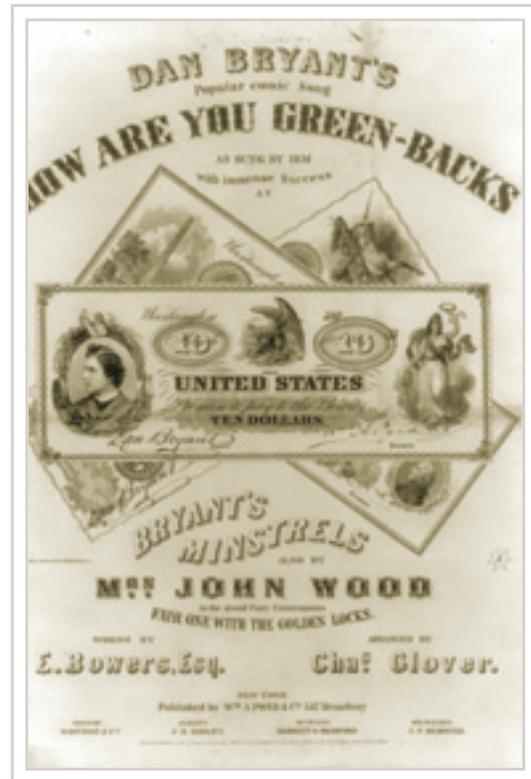
Because nations' money stocks were multiples of their gold reserves, a given loss of gold could contract countries' money supply by substantially more. Consequently, central banks and governments often managed gold flows actively. Ideally, central banks were to adjust the rates at which they lent to commercial banks and, if necessary, undertake open-market-style operations to reinforce the impact of gold flows on their money stocks. For example, a gold outflow would lower the money supply. By taking actions to reinforce the gold loss, a central bank could achieve the same money supply with a smaller gold loss.

Sometimes, compliance with the rules had a depressing effect on the domestic economy. For that reason, when gold outflows did not immediately threaten convertibility, many central banks flouted the rules. A leading researcher on the topic concluded that between 1880 and 1914, central banks followed the rules only about one-third of the time.

An Unsustainable System

Still, policymakers of the era generally considered the economic costs and political consequences of maintaining convertibility small relative to potential gains from a gold-standard commitment to price and exchange-rate stability. As it happened, the period witnessed a substantial expansion of international commerce, which fueled strong economic growth. Whereas 15 percent of the world operated under the gold standard in 1870, 70 percent did so by 1913.

The United States adopted the gold standard in two steps: In 1873, Congress defined the dollar in terms of gold, excluding silver; in 1879, Congress agreed to redeem "greenbacks"—fiat money issued during the Civil War, but still in circulation—for gold.



Publishers of nineteenth-century sheet music like this song, circa 1863, used illustrated covers to promote sales.

But the commitment proved shaky, especially in times of crisis. World War I abruptly reversed the benefits and costs of compliance with the gold standard. World trade fell substantially and remained depressed long afterward, as countries imposed restrictions on trade flows. With the postwar extension of suffrage to more citizens and the rise of the labor movement, prices and wages became less flexible. This raised the costs of maintaining convertibility, while the people who bore these costs most directly gained a stronger political voice.

To be sure, after the war, policymakers maintained their commitment to a gold standard, but not one for which they would long sacrifice domestic policy objectives. To maintain economic growth and employment, they were more willing to offset gold flows, devalue their currencies, impose trade restraints and capital controls, or abandon the gold standard—in other words, they increasingly violated the rules of the game. The gold standard of the late 1920s lacked the credibility of its predecessor, and events sparked fears that exchange-rate parities might not hold. Speculators moved funds out of gold-standard countries—often with self-fulfilling results.



The \$100,000 gold certificate shown here, the highest denomination ever issued by the United States, was not intended for general circulation and could not legally be held by private individuals. It was used instead as an accounting device between branches of the Federal Reserve.

“The way I see it is the politicians took us off the gold standard prematurely before we economists understood how to work what we call an inconvertible paper standard. And even though the gold standard was abandoned formally in the early 1970s, for all intents and purposes, the Federal Reserve’s activities decades before that operated without much attention to the gold-standard restraint. The politicians said, we’ve got to be able to do better than the gold standard, but the economists in the early part of the century were not ready to manage the standard. Essentially, without the gold standard, what we have is an economist standard—a standard that depends entirely on the understanding of a monetary system that economists alone have been producing and that economists alone have some hope of understanding. It was premature in the twentieth century to let it loose on the world.” ►

Marvin Goodfriend, Carnegie Mellon University



Franklin D. Roosevelt, seated, was the first president to visit the Federal Reserve Board of Governors in 1937. In his remarks, he described as the Fed's purpose "to gain for all of our people the greatest attainable measure of economic well-being, the largest degree of economic security and stability."

The Great Depression dealt a major blow to the gold standard. Countries that tightly adhered to gold and failed to ease their monetary policies saw unemployment levels mount as they slipped into depression. Overall, these countries fared worse than those that abandoned gold and eased their monetary policies.

The dominoes began to fall. Britain abandoned the gold standard in September 1933, and the pound quickly depreciated. Many other countries followed. In the face of domestic bank runs and outflows of gold, President Franklin Delano Roosevelt suspended convertibility, nationalized private holdings of gold, repealed gold clauses, and prohibited private transactions in gold.

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The Bretton Woods system—the international gold standard that emerged after World War II—sought to fix exchange rates. Policymakers viewed the exchange-rate movements of the 1930s as detrimental to trade, international cooperation, and global prosperity. The system that they established contained an inherent flaw. Countries needed gold reserves to manage their exchange-rate parities, but the official gold price was too low to encourage a sufficient supply of the metal. Countries began holding US dollars—now linked to

gold—and used them instead of gold in official transactions to manage their exchange rates. To supply these needed dollar reserves, the United States ran persistent balance-of-payments deficits.

By 1960, however, outstanding dollar liabilities exceeded the US gold stock, creating a strong incentive for central banks to convert their dollar liabilities into gold with the Treasury. Resolving the situation would have required the United States to tighten monetary policy and other countries to ease monetary policy; but by the 1960s, no nation was willing to subordinate their domestic objectives for price stability or growth and employment to the rigors of fixed exchange rates. In August 1971, the United States refused to convert official dollar reserves into gold, and the major developed countries abandoned fixed exchange rates by early 1973.

Into Uncharted Terrain

The world had completed the long transition from money backed by gold to money backed by public confidence. But the Federal Reserve's transition to this new operating environment was still in progress.



► Watch the video at www.clevelandfed.org/annualreport.