A Model of the Gold Standard

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The gold standard emerged as the international monetary system by the end of the 19th century. We formally study its properties in a micro-founded model and find that the scarcity of the world gold stock not only results in a suboptimal output of goods that are purchased with money but also subjects the domestic economy of a country to external shocks. The creation of inside money in the form of private credit instruments adds to the money supply, usually resulting in a Pareto improvement, but opens the door to the international transmission of banking crises. These properties of the gold standard can explain the limited adherence by peripheral countries because of the potential risks to their economies. We argue that the gold standard can be sustainable at the core but not at the periphery.