The Gold Standard

What was the Gold standard?

1) It was good for trade
   - Fixed exchange rate

2) Governments could not debase currency
   - Especially important during war

Seemed like a good idea to fix the price of the currency to gold
Not gold coins, but the banknotes and coins could be directly exchanged at the bank

↳ All of this is to prevent excess money supply

There was a fractional reserve system (40% Gold, 60% notes)
↳ New money had to be backed by gold

Gresham's Law:
Bad money will drive out good money

The first country on the Gold Standard was the UK
- They went on it by accident
- They were on a Bimetallic Standard (Silver & Gold)

In 1717:

Isaac Newton was in charge of the mint.
The exchange rate between silver and gold coins was not set according to market rate, and thusly, the silver supply "vanished" because of the arbitrage situation

Example:

Exchange rate: 1 gold coin = 10 silver coins

Market rate: 1 gold coin = 9 silver coins

↳ Everybody buys silver with gold, smelts the silver and gets a 10% profit by just exchanging currencys
↳ Bad (Gold) money drove out good (Silver) money

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Many currencys fixed in Gold => Fixed exchange rates

How did it function?

1) Hume: Price - Specie flow mechanism

Balance of Payments deficit → Gold outflow → ↓ Domestic Prices & ↑ Foreign Prices

↳ BOP e.q.

BUT: "Gold Point" Create a wedge for traders (because of insurance when transporting gold)

"Gold devices" Used to keep gold in London

2) Monetarist equation (Fisher & Friedman): $MV = PY$

→ Price level (P)

↳ National Output (Y)

M → Money Supply — What does this mean?

V → Velocity of Circulation

Narrow:

Coins and notes: M_0

Checks: M_1

Broad:

Credit cards and digital supply: M_4

Did the gold standard work?

Short answear: Not exactly

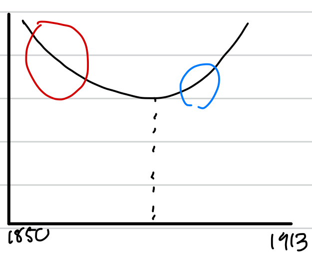
3) Did the Gold standard keep the price level constant? NO

We expect: $\uparrow M \Rightarrow \downarrow r \ \uparrow P$ "Gibson Paradox": r and P both fell in 19th century

Explanation: $\left.\begin{array}{l}\text{Nominal } r \downarrow 1\% \\ \text{Price level} \downarrow 1{,}5\%\end{array}\right\} \Rightarrow \text{Real } r \uparrow 0{,}5\%$

Expectations: (Adaptive)

Price level (1850 - 1913)



Why did it fall?

- The economy grew, but no new money was created

Why did it rise?

- Gold is exogenous, which means that if a large gold reserve is found then the money supply goes up

↳ Prices are determined by something "random" like finding gold

$\Delta Gold = \Delta M$ and $\Delta Gold$ is random

Was the Gold Standard an automatic mechanism?

1) NO. (Gold deuces, gold points) (Mory's paper)

2) Core versus periphery

- If there is a large difference between two core countries in interest rates i.e. UK and Germany, Gold would flow to the place with higher interest
- If a peripheral country raised interest, gold would still flow to London because it is a safe haven

Core countries: Interested in r in other core countries

Periphery: Coverage ratio

Bagott. He said: "Lend for an internal drain, tight for an external drain"

Periphery coverage ≈ 60%

GB coverage ≈ 25-30%

Germany ≈ 40%

Cheaper for the large nations, because people trust them

3) The gold standard could be suspended at times of force Majeure e.g. War

↳ They then returned at the old parity

Why would the government want to limit themselves to gold?

Because, it pays to be on Gold: r on Gov.t debt ↓ 0.4% on average for countries on the Gold standard

↳ Why was periphery countries on the GS: They was borrowing a ton of money