

## **Would a Gold Standard Brighten Economic Outcomes?**

**January 2015**

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**Common Core State Standards (see page 12)**

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*Scott A. Wolla*

*Economic Education Group of the Federal Reserve Bank of St. Louis*

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## Would a Gold Standard Brighten Economic Outcomes?

Scott A. Wolla, *Senior Economic Education Specialist*

*“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.<sup>1</sup>

### 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.<sup>2</sup> The government’s ability to increase the money supply is then restrained by its gold reserves.<sup>3</sup> 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.<sup>4</sup>

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.<sup>5</sup> 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.<sup>6</sup>

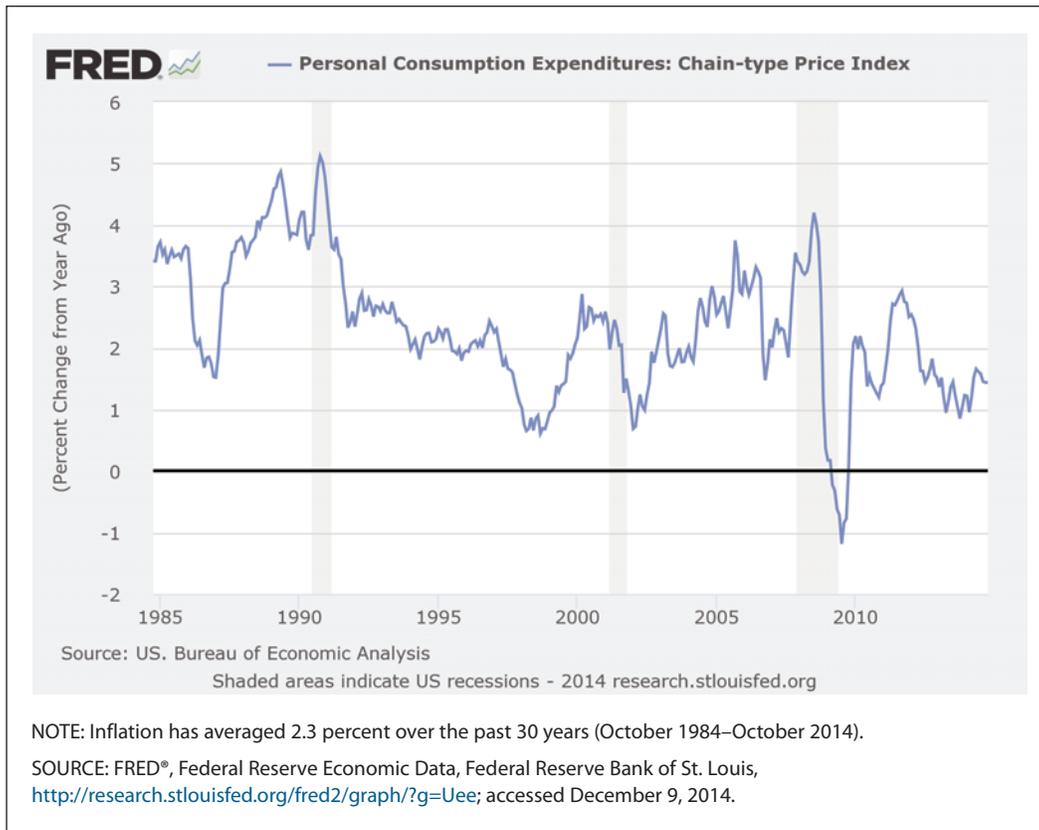
### **Fiat Money**

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.<sup>7</sup> 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 1920s<sup>8</sup> and the experience of Zimbabwe from 2007 to 2009).<sup>9</sup>

Central bank independence is an important protection against the tendency of governments to generate inflation to achieve short-term goals for electoral purposes.<sup>10</sup> 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.<sup>11</sup>

**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

- <sup>1</sup> 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](http://www.igmchicago.org/igm-economic-experts-panel/poll-results?SurveyID=SV_cw1nNUYOXSAKwrq)).
- <sup>2</sup> 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.
- <sup>3</sup> A central bank could increase the money stock without an increase in its gold reserves if its reserves already exceed the legally required minimum.
- <sup>4</sup> 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.
- <sup>5</sup> Bernanke, Ben S. *The Federal Reserve and the Financial Crisis*. Princeton, NJ: Princeton University Press, 2013.
- <sup>6</sup> Walton, Gary M. and Rockoff, Hugh. *History of the American Economy*. Twelfth Edition. Independence, KY: Cengage Learning, 2013.
- <sup>7</sup> 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.
- <sup>8</sup> 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>.
- <sup>9</sup> 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>.
- <sup>10</sup> 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>.
- <sup>11</sup> 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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Name \_\_\_\_\_ Period \_\_\_\_\_

Federal Reserve Bank of St. Louis *Page One Economics* Newsletter:  
“Would a Gold Standard Brighten Economic Outcomes?”

After reading the article, answer the following questions.

1. What is a gold standard?
2. Why do some say that a gold standard would prevent high rates of inflation?
3. How does an elastic currency give a central bank flexibility to respond to financial crises and natural disasters?
4. Is there a danger in giving government the power to create fiat money?
5. How can central bank independence help maintain price stability?

## Teacher's Guide

### Federal Reserve Bank of St. Louis *Page One Economics Newsletter*: "Would a Gold Standard Brighten Economic Outcomes?"

After reading the article, answer the following questions.

**1. What is a gold standard?**

A gold standard ties the value of a country's money 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. Why do some say that a gold standard would prevent high rates of inflation?**

Under a gold standard, a government's ability to increase the money supply is restrained by its gold reserves. And since gold is naturally limited and the global gold supply grows relatively slowly, a gold standard seemingly protects against high rates of inflation.

**3. How does an elastic currency give a central bank flexibility to respond to financial crises and natural disasters?**

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.

**4. Is there a danger in giving governments the power to create fiat money?**

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, or the government might purposely attempt to "inflate away" government debt. Germany (in the 1920s) and Zimbabwe (2007-09) both used policies that led to hyperinflation.

**5. How can central bank independence help maintain price stability?**

Central bank independence is an important protection against the tendency of governments to generate inflation to achieve short-term goals for electoral (political) purposes. Central bank independence helps insulate a central bank from the political pressures that might push it to create too much money.

## For Further Discussion

Distribute the graphic organizer and vocabulary handouts to students, then lead a classroom discussion using the discussion content and video links below.

1. Explain to students that they will use classroom discussion and four short video clips to increase their understanding of money, a **gold standard**, and the role of a central bank. Start by showing the “What Is a Gold Standard?” (2:01) video clip (<http://www.stlouisfed.org/timely-topics/the-gold-standard/what-is-a-gold-standard/>) and then ask the following question:
  - What is the difference between a gold standard and a fiat money system?  
*With a gold standard, the value of money is linked to a **stock** of gold reserves, and currency is redeemable with gold. With a fiat money system, money is not redeemable for an asset, but it can be used to pay debts and taxes.*
2. Review the following points:
  - Because the supply of gold is limited, the government’s ability to increase the money supply is also limited.
  - This limited supply will guard against inflation.
  - So, an **advantage** of a gold standard is that the government is less able to create massive amounts of money to pay government debts, thereby creating an inflation problem.
3. Show the “Gold Standard and Inflation” (2:56) video clip (<http://www.stlouisfed.org/timely-topics/the-gold-standard/gold-standard-and-inflation/>) and then ask the following questions:
  - According to supporters, what are the benefits of a gold standard?  
*Governments are not permitted to finance expenditures by printing new money; instead, they must raise taxes or issue debt.*
  - What do gold standard supporters fear about a government’s ability to create (“print”) money?  
*Supporters fear that governments will print money to finance debt, which will result in runaway inflation.*
  - Are there historical examples of such inflation?  
*Yes, Zimbabwe.*
  - Does a gold standard provide absolute protection against a government’s ability to create money?  
*No. A government can simply change the definition of a dollar, in terms of its gold-to-money ratio, to increase the money supply.*
  - Are there historical examples of changing this ratio?  
*Yes, the United States has changed the value of dollars. Before 1933 one dollar was equal to 1/20 of an ounce of gold. In 1933 the government redefined a dollar as equal to 1/35 of an ounce of gold. This means the supply of dollars could be increased by 60 percent without increasing the country’s gold reserves.*

4. Explain that there are **disadvantages** to a gold standard:
  - Because the supply of gold is limited and a government cannot directly control the stock of gold, it cannot directly control the money supply.
  - Because gold and money are linked, significant increases or decreases in the stock of gold will also affect the money supply.
  - These fluctuations can lead to volatile changes in the price level—**inflation, disinflation, or deflation**.
  - There may be times when it might be beneficial for a government to have more control over the money supply.
  
5. Explain that nearly all modern economies have developed a fiat money system. Define **fiat money** as 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). Discuss the following:
  - In a fiat money system, the government can control the money supply, but governments sometimes abuse that power.
  - Nearly all modern economies have delegated the responsibility of managing the fiat money supply to a **central bank**, which is an institution that oversees and regulates the banking system and quantity of money in a given country's economy.
  - In a fiat money system, a central bank has the ability to increase or decrease the money supply.
  - This gives the central bank the discretion to determine the money supply instead of the money supply being determined by something out of the central bank's control (such as the stock of gold).
  
7. Show the "Benefits of a Fiat Money System" (2:20) video clip (<http://www.stlouisfed.org/timely-topics/the-gold-standard/benefits-of-a-fiat-money-system/>) and then ask the following:
  - What are the benefits of a fiat money system during a financial panic?  
**In a fiat system, the government can create money and lend it to distressed banks to give to depositors who wish to withdraw—to accommodate the temporary elevated demand for money.**
  - How can a fiat money supply reduce the risk that people will cause a bank panic or bank run during a financial crisis?  
**When people see that money is available, the panic subsides and the risk of bank panics or runs is reduced.**
  
8. Explain that there are **advantages** to a fiat money system:
  - The central bank can increase the money supply to calm financial panics.
  - During a recession, the central bank can increase the money supply to increase the demand for goods and services and spur economic activity.
  - Alternatively, during periods of high inflation, the central bank can restrict the growth of the money supply to reduce inflationary pressures.

9. Explain that there are **disadvantages** to a fiat money system:
- If the money supply increases at a faster rate than the output of goods and services, inflation will result.
  - Define **inflation** as a general, sustained upward movement of prices for goods and services in an economy.
  - This is referred to as inflation caused by “too much money chasing too few goods.”

10. Show “The Gold Standard and the Central Bank” (1:42) video clip (<http://www.stlouisfed.org/timely-topics/the-gold-standard/the-gold-standard-and-the-central-bank/>) and then ask the following:

- How has the structure of the Federal Reserve been effective at providing price stability while under a fiat money system?

The Federal Reserve is accountable to the government, yet it has a degree of independence from the government to insulate it from the short-run political demands of the government. At the same time, it is charged with maintaining a level of price stability. The Federal Reserve has a 2 percent inflation target.

11. Ask students to complete the graphic organizer in Handout 1 (key below) and then write the assessment essay.

### Handout 1: Graphic Organizer

Money system	Advantage	Disadvantage
Gold standard	Prevents high inflation because the government is less able to create massive amounts of money to pay government debts.	Because gold and money are linked, significant increases or decreases in the stock of gold will also affect the money supply. These fluctuations can lead to volatile changes in the price level—inflation, disinflation, or <b>deflation</b> .  There may be times when it might be beneficial for a government to increase or decrease the money supply to influence economic conditions.
Fiat money	The central bank can increase the money supply to influence economic conditions. The central bank can also create bank reserves to calm a financial panic.	If a central bank increases the money supply too quickly, inflation will result.

**Assessment:** Some people propose the United States should return to a gold standard. Others support the current fiat money system. Write a persuasive essay that (i) explains both sides of the issue and (ii) expresses your point of view. Support your opinion with clear reasoning.

Name \_\_\_\_\_ Period \_\_\_\_\_

**Handout 1: Graphic Organizer**

<b>Money system</b>	<b>Advantage</b>	<b>Disadvantage</b>
<b>Gold standard</b>		
<b>Fiat money</b>		

**Assessment**

Some people propose the United States should return to a gold standard. Others support the current fiat money system. Write a persuasive essay that (i) explains both sides of the issue and (ii) expresses your point of view. Support your opinion with clear reasoning.

## Handout 2: Vocabulary Guide

**Central bank:** An institution that oversees and regulates the banking system and quantity of money in the economy.

**Deflation:** A general, sustained downward movement of prices for goods and services in an economy.

**Disinflation:** A decrease in the inflation rate or a slowdown in the upward movement of prices for goods and services in the economy.

**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 currency for gold at a fixed price.

**Inflation:** A general, sustained upward movement of prices for goods and services in an economy.

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

**Common Core State Standards**

**Grades 6-12 Literacy in History/Social Studies and Technical Subjects**

- **Key Ideas and Details**

RH.11-12.1: Cite specific textual evidence to support analysis of primary and secondary sources, connecting insights gained from specific details to an understanding of the text as a whole.

RH.11-12.2: Determine the central ideas or information of a primary or secondary source; provide an accurate summary that makes clear the relationships among the key details and ideas.

- **Craft and Structure**

RH.11-12.4: Determine the meaning of words and phrases as they are used in a text, including analyzing how an author uses and refines the meaning of a key term over the course of a text (e.g., how Madison defines *faction* in *Federalist* No. 10).