GRANT'S
INTEREST RATE OBSERVER®

Gold standard

A monetary system under which currencies were defined by gold and redeemable into gold. Exchange rates were fixed, and gold moved freely from one gold-standard country to another.

Gold has served as money since antiquity. "The gold standard," or the "classical gold standard," is a phrase that properly refers to the system in place between approximately 1880 and 1914. Then, money was defined as a weight of gold. Bank notes and other credit instruments were freely exchangeable into gold at the fixed and statutory rate. Gold coins passed from hand to hand. The term "sound money" derives from the pleasing ring of a gold coin striking a hard surface.

The final two decades of the 19th century were characterized by gradually falling prices, while the first decade and a half of the 20th century was characterized by gradually rising prices. However, when measured over the sweep of years, as Roy Jastram showed in his book "The Golden Constant," gold has tended to hold its value, and prices denominated in gold have tended to remain stable.

"It was," writes the economist Michael Bordo of the era of the gold standard in The Concise Encyclopedia of Economics, ". . . a period of unprecedented economic growth with relatively free trade in goods, labor and capital."

"Only a trifling number of countries were forced off the gold standard, once adopted," relates Arthur I. Bloomfield, in a monograph published by the Federal Reserve Bank of New York in 1959, "and devaluations of gold currencies were highly exceptional. Yet all this was achieved in spite of a volume of international reserves that, for many countries at least, was amazingly small and in spite of only a minimum of international cooperation, or of international agreements or commitments, on monetary matters." The classical gold standard was interrupted by the outbreak of World War I and was never restored.

Under the gold standard, money was a unit of measurement, like a yard or an inch. The dollar was defined as roughly one-twentieth of an ounce of gold, the pound sterling as roughly one-fifth of an ounce of gold. The dollar-sterling exchange rate was therefore fixed at roughly $5 (the fixed and seemingly permanent rate of exchange was $4.867, to be exact). This fixedness encouraged trade, but forestalled the kind of so-called aggressive money-policy interventions in vogue today. As there was only so much gold, there could be only so many dollars, pounds, French francs or German marks.

The British economist T.E. Gregory wrote of the system's "sweet simplicity." The exchequers or central banks of participating nations agreed to exchange currency for gold and gold for currency, at the official rate, on demand. Central bankers operated unobtrusively. They advanced funds against good collateral to solvent commercial banks, but they refrained from monetizing government securities. Neither did they engage in open-market operations with intent to steer the economy hither and yon. In fact, the very concept of the "macroeconomy" was yet uninvented.

"[T]he gold standard period witnessed a great expansion of trade," writes Kenneth W. Dam in his book, "The Rules of the Game," "and it is worth emphasizing in view of the attitudes taken during the Bretton Woods period, a flow of private investment on a scale the world had never seen, and, indeed, relative to other economic aggregates, was never to see again."

Gold had, and, indeed, still has, much to recommend it as a monetary metal. It is scarce, durable, malleable, dense, homogeneous, beautiful and portable. At a glance, anyone can tell it's valuable. And because it is never destroyed, above-ground stocks are immense in relation to current production. If the world's miners stopped digging tomorrow, the gold price would therefore not necessarily go up by much; any year's incremental production (e.g., 85.5 million ounces in 2011) is trifling in comparison to the world's inventory (five to six billion ounces).

"Unlike the paper dollar," writes Lewis E. Lehrman in his book "The True Gold Standard," "a dollar defined in law as a weight unit of gold is the monetary standard which simultaneously provides all the primary functions of true standard money: (1) a stable store of value; (2) a stable measure and unit of account; and, (3) a universally accepted means of payment. A gold monetary standard combines, in one monetary article of wealth, the three primary functions of money. Moreover, the true gold standard of history provides the global networking effects of universally acceptable, equitable, ubiquitous, standard money. Throughout long historical evolution gold became free trade money."

Associated Articles
Oct 21, 2011: What we've forgotten