Gold Standard

The gold standard is a monetary system where a country's currency or paper money has a value directly linked to gold. With the gold standard, countries agreed to convert paper money into a fixed amount of gold. A country that uses the gold standard sets a fixed price for gold and buys and sells gold at that price. That fixed price is used to determine the value of the currency. For example, if the U.S. sets the price of gold at $500 an ounce, the value of the dollar would be 1/500th of an ounce of gold.

The gold standard is not currently used by any government. Britain stopped using the gold standard in 1931 and the U.S. followed suit in 1933 and abandoned the remnants of the system in 1973. The gold standard was completely replaced by fiat money, a term to describe currency that is used because of a government's order, or fiat, that the currency must be accepted as a means of payment.

The appeal of a gold standard is that it arrests control of the issuance of money out of the hands of imperfect human beings. With the physical quantity of gold acting as a limit to that issuance, a society can follow a simple rule to avoid the evils of inflation.

Gold Standard System Versus Fiat System

As its name suggests, the term gold standard refers to a monetary system in which the value of currency is based on gold. A fiat system, by contrast, is a monetary system in which the value of currency is not based on any physical commodity but is instead allowed to fluctuate dynamically against other currencies on the foreign-exchange markets. The term "fiat" is derived from the Latin "fieri," meaning an arbitrary act or decree. In keeping with this etymology, the value of fiat currencies is ultimately based on the fact that they are defined as legal tender by way of government decree.

In the decades prior to the First World War, international trade was conducted on the basis of what has come to be known as the classical gold standard. In this system, trade between nations was settled using physical

gold. Nations with trade surpluses accumulated gold as payment for their exports. Conversely, nations with trade deficits saw their gold reserves decline, as gold flowed out of those nations as payment for their imports.

Using Gold as a Currency

Without the gold standard, the price of gold fluctuates freely in the market. Gold is seen as a safe haven, and a rising gold price is often an indicator of underlying economic problems. Gold allows traders and individuals to invest in a commodity that can often partially shelter them from financial turmoil. As mentioned above, disruptions will occur under any system, even a gold standard.

There are times when it is favorable to own gold and other times when the overall trend in gold will be unclear or negative. Even though the official gold standards are now gone, gold continues to be impacted by other currencies. Therefore, gold must be traded like other currencies.

Switching to a stronger currency can be the key to preserving wealth. For example, Germans who held gold-backed U.S. dollars during the Weimar Republic hyperinflation in Germany in the 1920s became rich rather than poor. Even when no countries are on a gold standard, investors can still buy gold. When they buy gold, investors exchange their local currency for the currency of many of the most successful nations in history. The Roman Empire of Marcus Aurelius, Victorian England, and George Washington's America were all on the gold standard.

By purchasing gold, people can shelter themselves from times of global economic uncertainty. Trends and reversals occur in any currency, and this is true for gold too. Gold is a proactive investment to hedge against potential risks to paper currency. Once the threat materializes, gold’s advantage may have already disappeared. Therefore, gold is forward-looking, and those who trade it must be forward-looking as well.

Problems with Gold Standards

When considering gold as a currency, many people support moving back to some form of the gold standard. There were various problems with earlier gold standards.

One of the main problems was that the systems were ultimately reliant on central banks to play by the rules. The rules required central banks to adjust the discount rate to maintain fixed exchange rates. Fixed exchange rates sometimes resulted in high interest rates, which were politically unpopular. Many countries chose to devalue their currency against gold or the U.S. dollar instead.

A second problem with the gold standard was that there were still short-term price shocks, despite long-run price stability. The California gold discovery of 1848 is an excellent example of a price shock. This gold find increased the money supply, which raised expenditures and price levels, creating short-run economic instability. It should be noted that such economic disruptions did occur under gold standards. Also, every attempt to maintain a gold standard ultimately failed.