The gold standard

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This is the proposed entry for the gold standard in the glossary I am writing.

There will be another entry on the myths that the gold standard still gives rise to. That is not ready to share as yet because getting it right is proving to be hard to do.

Comments are welcome, which is the reason for publishing this now.

This term refers to a method of attributing value to a currency issued by a country. It was in widespread use until the 1920s and 30s. It finally disappeared from any common use when the USA abandoned the gold standard in August 1971.

When jurisdictions developed their own currencies as an indication of their own sovereignty the need for a method of comparing value between different currencies was required to facilitate international trade. This was created by requiring that there be a fixed exchange rate between the value of a jurisdiction's currency and an ounce of gold, hence the term 'gold standard'.

To achieve this outcome, it was then decided that as a general rule a country could only issue new currency if it had gold reserves sufficient to back the currency that it put into circulation. Given that gold reserves were usually in short supply this restricted the issue of new currency. This approach also provided that currency which was in circulation with a value based upon its convertibility into gold, which was an asset assumed to have universal appeal.

As a result, by restricting new money supply the gold standard not only provided for the relatively easy exchange of currencies used in the course of trade but also provided a mechanism that was intended to restrict the ability of a government to create new money (see separate entries on money and money creation), so reducing the risk of inflation arising from the creation of new currency by a government.

A consequence of this was that governments were constrained with regards to their ability to run government surpluses and deficits (see separate entries). If a government ran a deficit it necessarily injected new money into the economy for which it was responsible but to do so it had to either secure that money from third-parties or alternatively secure new supplies of gold either by mining it or as a result of success in international trade.

The significance of the last two points should not be ignored. The role of the gold standard in promoting the growth of colonies to secure access to gold and to increase overseas financial markets for goods and services produced in the governing country had important consequences almost none of which stand to the credit of any country which undertook such activity.

Presuming that new gold was not available, the only mechanism available to a government to secure the currency that it needed to support a deficit when the value of money was linked to that of available gold resources was by borrowing existing money in circulation. As such, whilst the gold standard was in operation governments were necessarily obliged to borrow the currency for which they were responsible from those who might own it. This meant that the governments in question were necessarily indebted to the financial markets that might supply this currency to them, and to the various demands of those markets with regard to the payment of interest, leaving them vulnerable to the vagaries of such markets and sentiment within them.

Since 1971, when the gold standard was eventually abandoned, and since the introduction of floating exchange rates (see separate entry) (which means that almost no currency is now fixed in value against any other) the constraints that the gold standard created have disappeared. All major and most other economies in the world now use a fiat currency (see separate entry). This means that the currency in use in a country only has value because of the legal decree of the government of that jurisdiction declaring it to be its legal tender and, more practically, because its value is backed by the ability of that country to raise future taxation revenues. This capacity is partnered by the ability of the government to command its central bank to make payment to anyone to whom funds might be owing using newly created money, if necessary. In this situation, there is no reason for a government to borrow from financial markets.