Return to the Gold Standard?

• Some recommend return to Gold Standard, as a means of imposing monetary discipline.

Most economists, remembering the lessons of the Great Depression, oppose the return.

A Virtual Return to the Gold Standard

• Many countries are essentially adopting the gold standard by use of the US dollar as their monetary base.
  – Fixed Exchange Rates
  – Currency Boards

Fixed Exchange Rates

• East Backwater wants to get the advantage of a stable exchange rate.
• It announces that its central bank will exchange 1 EB = $1.
• It holds reserves of US dollars and, from time to time, buys and sells EB’s on the exchange market to keep the exchange rate in line.
**Fixed Exchange Rates**

\[ D_{EB} = S_{EB} \]

- If the demand and supply of EB’s are in line, there is no problem. The central bank of East Backwater can sit back and let traders exchange EB’s for dollars.
- Otherwise:

**Fixed Exchange Rates**

\[ D_{EB} > S_{EB} \]

- EB will be running a positive balance on current account, selling more to the US and other nations than it is buying. The imbalance will reflect itself by dollars flowing into East Backwater.
- The usual solution is to buy the extra dollars, and keep the money in US treasury bills:
  - China
  - Japan
  - Southeast Asia
- This is called sterilization.

**Fixed Exchange Rates**

The alternative is do nothing. The exchange rate will fluctuate, and the EB will rise relative to the dollar (to say 1 EB = $1.25)

**Fixed Exchange Rates**

If EB had a currency board, it would increase the supply of EB, allow inflation and hence correct the trade balance.

- China
- Japan
- Southeast Asia
\( D_{EB} < S_{EB} \)

- If temporary, the central bank can borrow dollars from other nations or the IMF.

\( D_{EB} < S_{EB} \)

- If temporary, the central bank can borrow dollars from other nations or the IMF.
- If the imbalance is persistent, the central bank of EB has two choices.
  - Accept devaluation
  - Adopt domestic policies to bring demand and supply in balance.

End