More on the Gold Standard

The Goldsmith

- Wilson comes along and wants to borrow 20 oz of gold.
- You give him a gold receipt.

- **Assets**
  - 100 oz of gold
  - 20 oz IOU from Wilson

- **Liabilities**
  - 120 oz of gold accounts

You have invented fractional banking!

International Effects

- All major countries use Gold.
  - You don’t care whether you get paid in Dollars, Pounds, Rubles, Marks, Francs, etc. It is all gold.

- In fact very little gold moves.
  - Receipts are changed
  - Look at US after WWII.

World Price Movements

\[
M_w V_w = P_w Y_w \\
\left( \frac{\Delta P}{P} \right)_w = \left( \frac{\Delta M}{M} \right)_w - \left( \frac{\Delta Y}{Y} \right)_w
\]

Two Scenarios

- No new gold discoveries
  - Global deflation
- A nation finds gold
  - Global inflation

\[
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\]
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  – Your bank fails
  – Contagion occurs

Comes the day…

• A Bank Panic
  • The money supply shrinks
    – Deflation
    – Collapse of economic activity

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- The deflation becomes worldwide.

Some History

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  - We run out of gold
  - JP Morgan borrows gold for US from Europe

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- The Panic of 1893
  - We run out of gold
  - JP Morgan borrows gold for US from Europe
- The Deflation of the 1890’s
  - Who won, who lost
  - The Free Silver Movement
  - William Jennings Bryan

Good News, Bad News

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- A nation could not control its money supply
- A run on its banks could not be offset

Offsetting A Run

- Suppose the Monetary Base is $1,000 and the $M_2$Multiplier is 8. $M_2 = 8,000$.
- For some reason people want to hold more cash and the $M_2$Multiplier falls to 4.

With a Gold Standard

- Under a gold standard, nothing the government can do.
  - $M_2$ will fall to $4,000
  - A sharp decline in $M_2$ usually means a decline in GDP

With Fiat Money

- With fiat money, the government can offset decline.
  - $M_b$ is increased to $2,000
  - $M_2$ remains at $8,000
  - No money-induced decline in GDP

This Can Happen Here

- A run on another nation’s banks would lead to deflation here.
- Many examples of monetary panics crossing national boundaries while we were on the gold standard.

With Fiat Money

- Nothing stops the government from increasing the money supply any time it wants to. Clearly inflationary.
  - 1789-1913: Prices essentially stable
  - 1913-present: 14-fold increase in price level.
End