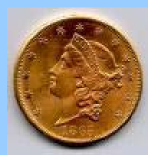
More on the Gold Standard



The Goldsmith

You have invented fractional banking!

- Wilso
  20 oz
- You give him a gold receipt.

- Assets
  - ✓100 oz of gold
  - ✓20 oz IOU from Wilson
- Liabilities
  - ✓120 oz of gold accounts

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  - 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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  - Contagion occurs

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- 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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- 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_2Multiplier is 8. M_2 = $8,000.
- For some reason people want to hold more cash and the M_2Multiplier 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