

Stability of the Gold Standard and Its Selected Consequences

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Austrian economists (and perhaps most economists of all ages) agree that sound money are of key importance for the good operation of the market system. Moreover, Austrians usually agree that sound money means the gold (or other commodity) standard. There is only marginal disagreement among them about the right reserve ratio. The reasons for this “preference for gold” are many; among them two are perhaps the most important: First, the gold standard is the system most independent of the government of all known monetary systems. The second major reason is the stability of the gold standard. Until it was manipulated and eventually spoiled by the government, the gold standard provided almost stable prices (at least in comparison with the outcomes of fiat money issued by central banks in the 20th century), and none or only mild trade cycles.

The ability of the gold standard to stabilize the price level is well known. Any change in the *stock* demand or in the *stock* supply of gold (monetary or non-monetary) may change prices only temporarily. Only a change of inflows of the new gold into an economy or of outflows out of it may change the equilibrium price level (the terms in- and outflow here denote functional relationships, not quantities). That is a well established fact. What deserves a special interest is the *dynamics* of the system, i. e. its *reaction to shocks*, especially the speed of reestablishing the equilibrium price level after the shock. In the lecture we will show that a swift vigorous transition from one equilibrium to the new one may be in this context harmful—much more harmful than slow smooth transition. The faster transition, the higher (*ceteris paribus*) price inflation or deflation and the higher percentage change in the stock of money. We know that changes in the quantity of money cause trade cycles; we may expect that the faster a transition the more severe a trade cycle they cause. (We assume that Mises was right that any change in the quantity of gold money may cause trade cycles.)

There can be two kinds of shocks: 1) monetary shocks, i. e. changes in the demand for the monetary stock of gold, and 2) non-monetary shocks, i. e. changes in the demand for the non-monetary stock of gold, and changes in the inflows and outflows of gold into and out of an economy. In the lecture we will show that the relative importance of these two kind of shocks depends on the size of the monetary stock of gold relative to a change in its non-monetary stock and to a change in the inflows or outflows of gold (i. e. shifts in those flow functions).

In the past the world monetary stock of gold was huge both in comparison with changes of the non-monetary stock, and with the flows of gold. That is why these non-monetary shock were able to cause only minor problems. If the equilibrium price level changed, the following transition to the new equilibrium was slow and smooth. Even the most severe non-monetary shocks, such as the huge influx of gold from America in the 16th century, produced only a mild price inflation (that would be called “price stability” according to the definition used nowadays by central banks). Great changes in the price level were then caused usually by great monetary shocks, such as a decrease of the demand for money after a poor harvest, or a Black Death epidemic.

The opposite holds good if the monetary stock of gold is tiny relative to the size of non-monetary shock. In such a case even a small change of the world gold flows can cause a fast transition to a new equilibrium price level, or in other words a swift price inflation or deflation. Since the price inflation or deflation is caused by the previous change of the stock of money, we may expect it would be associated with a trade cycle, possibly a severe one.

The above sketched hypothesis has some unwelcome consequences. We will stress two of them. First,

the mature fractional reserve free banking of the Scottish-type may undermine the stability of the gold standard, if spread in all gold-standard countries. This type of the free banking economizes on the resource cost of money through a great increase in the money multiplier. This can significantly decrease the monetary stock of gold (according to White even 50 times in comparison with the 100% reserve banking) with all of its possible consequences. Any other techniques economizing on money may do the same.

Second, a return to gold may nowadays be much more difficult task than it may look, even if we neglect all problems associated with the first transition of the price level to its new equilibrium after the resumption. If only a single country returns to the gold standard, it might suffer from the price instability and recurring trade cycles, since its monetary stock of gold would be most probably tiny in comparison with changes in the world non-monetary stock of gold and in the gold flow. Its problems may be even worsened by operations of central banks of other countries that sometimes buy or sell gold, and by actions of the public of these countries that buy or sell gold as well to protect themselves from the outcomes of the monetary policy of these countries. For the reasons presented above, the problem would be harder for a fractional reserve gold standard country. A collective resumption of many economically strong countries may be necessary to protect them against these problems, which makes the monetary reconstruction less politically viable, and hence not probable in the near future.