Should the us be on a gold standard term paper sample

Finance, Investment

The gold standard is a monetary system which suggests pegging of economic unit of account with fixed mass of gold. For understanding the meaning of the gold standard a little digression in history is needed.

The United States switched to the gold standard in 1834 because of silver currency and bank notes crisis. The price for gold in the United States was set at $20. 67 per ounce that year. The majority of the countries adhered to gold in the period called Classical Gold Standard from 1880 to 1914. This was the period of unprecedented economic growth and free trade in the world.

Later on the period of Gold Exchange Standard (1925-1931) followed. The United States and the Great Britain held gold while other countries except for gold held dollars or pounds as reserves. Again the system broke because of Great Britain departure from gold resulted from massive outflows of capital and gold.

The gold standard revived in 1944 when 44 countries-participants of Bretton Woods Agreements made a commitment to fix the prices of their domestic currencies in relation to gold. Their international balances were tied to the U. S. dollars and the U. S. government intended to redeem central banks' holdings of dollars for gold. The deficit of balance of payments reduced U. S. gold reserves and finally caused abandoning the gold standard in 1971.

Departure from the gold standard caused unexampled inflation (more than five percent) in the late 1970's and early 1980's while it did not exceed the level of 0. 1 percent per year between 1880 and 1914. The situation brought dissatisfaction and willingness to return to the gold standard.

Implementation of the gold standard helped regulate domestic money supply and maintain the price level. Later it had become an international standard which determined the value of a certain country's currency in relation to other countries' currency. Simultaneously, " par exchange rate" (an exchange rate between currencies) was established.

Sometimes fixed exchange rate caused real and monetary shocks which were resulted from outflow of capital and gold between countries-participants. Thereby, a shock occurred in one country affected another country's expenditure, money supply, real income, and price level.

The central banks of the countries-participants were obliged to follow common rules which prescribed raising discount rates to speed a gold inflow and lowered discount rates in order to stimulate the gold outflow. Thus, in case of running a balance-of-payments deficit, a country was required to allow gold outflow until its price level was restored to the par exchange rate of its principal trading partner.

As economies under the gold standard were sensible to monetary and real shocks, domestic prices were unstable in a short period of time.

Monetary policy offers a little discretion in for the countries-participants of the Agreements. The real output was more variable and the rate of unemployment under the gold standard was higher in comparison with other periods.

In addition, the large negative aspect of adapting the gold standard is that the cost of producing this resource is extremely high. Milton Friedman estimated this cost on the level of 2. 5 percent of GNP.

Recently, the number of advocates of the gold standard monetary policy has significantly increased that could be explained by disappointment resulted from the current economic policy, inflation, and economic instability.

The main argument in favor of the gold standard is that the budget deficit and federal borrowings cannot be easily financed under this standard. On the other hand, the Treasury can legally borrow money in accordance with Congress authorization. If the conversion into gold would be unlimited, dollar issuance has to be limited. There is no federal deficit without financing it, thus, the taxes would be increased and federal expenditures lowered. The limitations of gold exchangeability could alter an existing fiscal policy.

Some of the professionals consider returning to the monetary management an inadmissible path. In their opinion, the era of gold convertibility caused large damage to the economies of several countries. A significant overhung of fiat currency represents insurmountable obstacle for implementing such monetary policy.

One of the immediate problems is that there is a need to fix a gold price compliant with market capacity. If the Treasury price offered appears to be understated, than an excessive demand could exhaust gold reserves. In this case the U. S. would remain off the gold standard for many years.

On the contrary, if the gold price offered is too high, the Treasury would be saturated with gold offerings. Increased payments drawn by excessive gold supply at the Federal Reserve would add to commercial bank reserves and expand money supply causing inflation.

Under the current circumstances the only adequate solution of the issue is to stabilize the general level of price and inference the dollar price of gold bullion. A small reserve of bullion would reduce insignificant fluctuations of gold price making possible changes in gold demand and supply to be taken up in the Treasury's inventory fluctuations.

Thus, a gold standard is assumed to create certain financial environment. But if the financial stability will be restored there is no need in implementing outdated monetary policy.

A gold-based monetary system will avert fiscal indiscretion and reinforce anti-inflation policies, thus making a difficulty to resume financial wastefulness.

The repayment of dollars for gold as a reaction for an excess federal credit creation has to be perceived as a strong political signal. Even after implementing instruments for control over inflation, political sensitiveness to inflation still remains. Despite of concrete actions regarding installation of gold standard are untimely, there are certain actions which could help define the feasibility of its recurrence. Certainly, returning to the gold standard could benefit by reducing inflation in a short-term period and cost little in case of failure.

As the quantity of dollars in the world is significant, overnight transition to gold convertibility could possibly create a discontinuity for the financial system of the U. S. Fortunately, current dollar obligations are not necessarily belong to immediate claims.

There is a possibility to create a dual currency and convert certain amount of dollars into gold. They could play the role of deferred claims to gold. Five-year Treasury Notes could be an example of such deferred claims. The interest and principal might be paid in ounces of gold.
Thus, there new payment instruments will be created in terms of gold and demand claims on it. The success of restoring the gold standard could be traced by the way the yield is spreading between gold and fiat dollar obligations having the same maturities. If yield spread for all maturities would virtually disappear, it means that the convertibility is successful. If not, then it would be difficult to implement. There is one more advantage of gold notes, namely: they could help reduce current budget deficit.

Still, there is a risk associated with the exchange rate of gold notes loss because gold notes have the same nature as foreign currency Treasury notes. An analysis of the U. S. history shows that there is certain probability of this event. The situation occurred with German mark and Swiss franc when Treasury sold significant amounts of their denominated issues having lost money in dollar terms due to the exchange rates fluctuations.

Before implementing the gold standard it is essential to make prognosis of gold prices growth for at least next five years. If there are not any force

majeure global changes, interest payments on the gold notes must be within the measures of conventional financing requirements based on the current interest rate. On the condition that gold prices remain stable of insignificantly grow, the savings could be significant.

Possible side benefits of gold notes should be also taken into account. Gold notes could set standards in terms of interest rates and prices. They could also exert pressure on the administration or Congress to force them moving to non-inflationary policy.

Advocates of the gold standard should be aware that returning to it is not merely technical or financial change. Returning back to the gold standard is a change of all economic processes.

Anyway, there is vast experience to be revised and analyzed. It is known that the history is developing spirally, so this is probably a time to make certain conclusions based on the experience obtained and undertake actions or invent a new path to the regulation.