International Monetary System

The Classic Gold Standard
1870-1914

The Classic Gold Standard (1870-1914)

- Under the classical gold standard, from 1870 to 1914, the international monetary system was largely *decentralised and market-based*

- This system *emerged gradually*, without the structural process in more recent systems

- The gold standard, in essence, created a *Fixed Exchange Rate System. An Exchange Rate* is the price of one currency in terms of a second currency

- In the gold standard system, each country *sets the price* of its currency to gold, specifically to *one ounce of gold*

- *Domestic currencies* were freely convertible into gold at the fixed price and there was *no restriction* on the import or export of gold

- As each currency was *fixed* in terms of gold, exchange rates between *participating currencies* were also *fixed*

- A fixed exchange rate *stabilises* the value of one currency vis-à-vis another and makes *trade and investment easier*

- *The classical Gold Standard* existed from the 1870s to the outbreak of the First World War in 1914

Rules of Gold Standard

- *Free movement of gold between countries*
- *Automatic expansion or contraction of currency and credit with inflow or outflow of gold*
- *Internal flexible Price System in Economy*
- *In theory, international settlement in gold meant that the international monetary system based on the Gold Standard was self-correcting*

Price-Specie Flow Mechanism

- 18th century *Philosopher and Economist David Hume*, set out the *'price-specie flow mechanism'*

- It explains how to *trade imbalances* can be *automatically adjusted* under Gold Standard

- According to this mechanism a country running a balance of payments *deficit* would experience *an outflow of gold*, a *reduction in money supply*, a *decline in the domestic price level*, a *rise in competitiveness* and, therefore, a *correction* in the balance of payments deficit

- The *reverse* would be true for countries with a balance of payments *surplus*

Working of Gold Standard

- *Central Banks* had two overriding monetary policy functions under the classical Gold Standard:

1. Maintaining *convertibility of fiat currency* into gold at the fixed price and defending the *exchange rate*

2. Speeding up the *adjustment process* to a balance of payments imbalance, although this was often violated

- Under the Gold Standard, a country's *money supply was linked to gold*

- International *balance of payments differences* were settled in gold. Countries with a balance of payments *surplus* would *receive gold inflows*, while countries in *deficit* would experience *an outflow of gold*

Fall of the Gold Standard

- The gold standard *did not survive* World War I intact
- With World War I, *political alliances changed*, international indebtedness increased and government finances *deteriorated*
- While the gold standard *was not suspended*, it was in limbo during the war, *demonstrating its inability* to hold through both good and bad times
- This created a *lack of confidence* in the gold standard that only increased *economic difficulties*
- It became increasingly apparent that the world needed something *more flexible* on which to base its *global economy*

Reasons for Fall/Failure

There are many reason for the failure of Gold Standard, some are:

- *Violation of rules of the system*
- *Restriction on free trade*
- *Inelastic Internal Price System*
- *Unbalanced Distribution of Gold*
- *Lack of Co-operation*
- *Political Instability*
- *Great Depression*
- *Rise of Economic Nationalism*

Thank You