Gold Standard

A simple way to run macroeconomic policy is to be on the gold standard, which means to peg your currency against gold – i.e., $1 is worth a certain amount of gold – and allow free convertibility. When there is a current account deficit (i.e., starting below the BB curve), gold tends to leave the country. This contracts the money supply – shifting the LM curve up and to the left. This will reduce investment and perhaps consumption, pushing the economy back towards the BB line. Full employment is not the top priority of macroeconomic policy under this system. But if there is persistent unemployment, wages and prices should fall – moving the economy up towards the NN line. The more general philosophy is: achieve price stability and the real economy (i.e., jobs, productivity growth) will take care of itself. Policy is “automatic” and “rules based”; there is no room for discretion.

Many countries, including the United States, used versions of the gold standard at the end of the nineteenth century. Prices sometimes rose and sometimes fell, but high inflation was not a problem. Current account deficits were small and capital moved easily between countries. It is hard to run sustained budget deficits under the gold standard; these tended to occur during wars, when countries “went off gold” (also known as suspending convertibility into gold.)

The End of Gold

The pure gold standard was prone to financial crises – there were periods of rapidly expanding credit, followed by sudden panics in which everyone “wants their money back”. In the United States, these became more severe over time, culminating in the 1907 Crisis. As economies move from agriculture to industry, the potential collapse of credit becomes more devastating.

As a result, there was a shift in opinion towards creating a central bank – and the Federal Reserve System came into existence in 1914. Nelson Aldrich (on the political right) was afraid this would make it too easy to finance government budget deficits. Louis Brandeis (on the left) worried that the Fed would give too much power to Wall Street barons. The compromise involved the Fed operating a form of the gold standard, i.e., being constrained by those rules.

But this system failed badly after 1929. There is still an intense debate about what exactly went wrong, but the collapse of credit and uncontrolled waves of bank failure must have played a role. In any case, central bankers and other policymakers began to operate with Keynesian ideas about “demand management”, i.e., the policies we can represent in the ISLM framework. Keeping unemployment down became a primary goal of policy – no one wants to repeat the Great Depression. Inflation was low in the immediate post-war period.

However, gold still played a role in the international payments system (as reflected in BBNN). Under the dollar-gold standard established after World War II (following the 1944 Bretton Woods meeting and as overseen by the IMF), countries held their reserves largely in dollars – but central banks could convert dollars into gold. The US was therefore anchored with a fixed exchange rate against gold; this created the basis for a stable, open, and fast-expanding global trading system.
The US was very concerned about any “gold drain” out of the country, but the logic of this system encouraged other countries to build up their dollar balances and thus their claims on gold – these are the reserves seen as essential. This tension is sometimes called the Triffin dilemma.

This system broke down in 1971 due to persistent US current account deficits – even though these were small relative to what we have seen subsequently. Countries with current account surpluses – such as Germany and Japan – did not want to revalue their currencies and accumulated dollar balances. The US faced losing all its gold and preferred to first devalue and then float the dollar (i.e., there was no more intervention to fix the value of the dollar).

Conquering Inflation

The 1970s were an era of inflation – driven mostly by (a) higher oil and other commodity prices, and (b) overly “accommodative” policies in industrialized countries, leading to overheating (i.e., policy mistakes that pushed the economy beyond the NN curve). High inflation became a serious problem in many places.

Inflation was brought under control by tight monetary policy in the United States – as implemented by Paul Volcker from 1979. This is a shift up and to the left of the LM curve, which produced a recession – moving the economy below the NN curve. Other industrialized countries followed along similar lines.

Subsequently, central banks worked harder to keep “inflation expectations” under control or, in their terminology, “well anchored”. This was perceived as a success.

However, the US was able to run larger current account deficits than ever before – because the world demand for dollars increased. Partly this was about government perceptions of risks under a floating exchange rate system – but largely it was about the rise of emerging markets, with several billion people joining the world trading system.

Rival Pathologies: Private v. Government

Financial markets also boomed – supported by what was known as the “Greenspan put”, i.e., the Fed would cut interest rates when markets fell (i.e., pushing the LM curve down), effectively putting a floor under asset prices. As a result, the size of the banking sector increased (e.g., relative to GDP), and the largest financial institutions became even bigger and more global. Financial integration in the eurozone further reinforced these developments. Bailouts for creditors to emerging markets also reinforced the notion that downside losses were always limited.

To some degree, moral hazard played a role in encouraging financial development – and overborrowing, which could be by the corporate sector (Japan 1980s, Korea 1990s), by the government (Mexico 1990s, Greece 2000s), or by households (US 2000s). Financial crises have again become prevalent, as was the case a century ago. The gold standard era teaches us that bad crises can happen even without moral hazard. But moral hazard today presumably just reinforces careless risk-taking at many levels.

In addition, government finances are in poor shape in many countries. When credit was easy and they could borrow at low interest rates, governments stopped being careful about their debt levels. There was not enough “fiscal space” to buffer the damage to economies caused by the financial crisis of 2008-09 – revenues naturally fall in recession and this tends to push up debt levels. Now some European countries are pressed into fiscal austerity. Will the US be next?