Question No.2 a) Discuss the advantages and disadvantages of gold standard.

Solution: The international monetary system that operated prior to the 19 14- 18 war was termed as the gold standard. Then the countries accepted the major assets gold and sterling in settlement of international debt. A unit of a country's currency was defined as a certain weight of gold (e.g. a pound sterling could be converted into 113.0015 grains of fine gold and the U.S. dollar into 23.22 grains. Through these gold equivalents, the value of the pound was 113.0015 / 23.22 times, (or 4.885 times that of the dollar. Thus 4.885 dollars was the 'par value' of the pound). A country is said to be on the gold standard when its central bank is obliged to give gold in exchange for its currency when presented to it. The gold standard was the foundation of the international trading system. The currency of a country was freely convertible into gold at a fixed exchange rate. International debt settlement was to be in gold. When a country had a surplus in its balance of payments, gold flowed into its central bank. Thus the country with a balance of payments surplus could expand its domestic money supply without having the fear of insufficient gold to meet its liabilities. When the money supply increased, prices increased, hence the demand of exports fell, the balance of payments surplus was reduced.

On the other hand, when a country had a deficit in its balance of payments, gold flowed outside the country. Thus the deficit country had to contract the money supply with the reduction in its gold stocks. 'The prices of commodities decreased. Its exports become more competitive and the deficit automatically got corrected, as increase in exports resulted in gold Mows.

It is argued that the system based on the gold standard provided stability and an automatic adjustment mechanism. Since the value of gold relative to other goods and services does not change much over long periods of time, the monetary discipline imposed by the gold standard was expected to ensure long-run price stability. The data on wholesale prices reveals that prices at the beginning of the World War I in 1913 were roughly the same as they had been in the previous one hundred and fifty years. However, the long-run stability includes alternative periods of inflation and deflation. During Napoleonic wars, prices shot up and later in the nineteenth century they fell down remarkably.

It is argued that even during the gold standard system the central banks, rather than allowing gold flows to adjust their domestic money supplies, intervened by varying their interest rates or expanding domestic credit. Similarly, deflationary mechanism, inherent in the gold standard, depressed employment but widespread unemployment was prevented by massive migration of the people to other countries. Nevertheless, the period from 1880 to 1914 during which the classical gold standard prevailed in most countries was a remarkable period. There was rapid expansion of virtually free international trade, exchange rates and prices were stable, free flow of labour and capital across political borders encouraged economic growth and world peace.

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