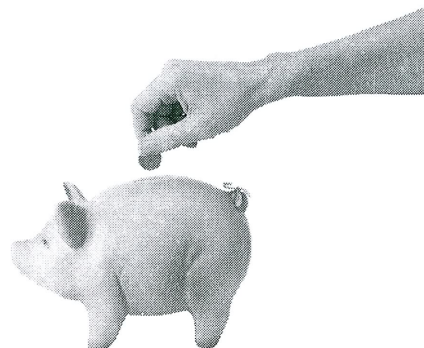


Should Canada Go back to a Gold-Based Monetary Regime?

Luca Filice



Introduction

In recent years, Canada has experienced major fluctuations in the value of its currency. The Canadian dollar has fallen from \$0.86USD in January 1990 to \$0.63USD in March 2002¹. This has caused the Canadian public to question the stability of their national currency. Before 1990 the Canadian economy was still facing the problem of increased inflation and high levels of unemployment. As we observe these issues, an age-old question comes to mind, should Canada return to a gold standard monetary regime instead of its current floating exchange rate system? This question involves a great deal of merit and this paper will show that Canada should not return to a gold-based system. Canada's current monetary system which involves the use of inflation targeting, open market operations, operating targets, and intermediate targets is highly effective in controlling inflation, maintaining trust in our monetary authority, and ensuring a positive environment for the stimulation of long-run economic growth. It is a much stronger tool

¹ The Bank of Canada – Historical Exchange Rate Statistics. Available: www.bankofcanada.ca/en/exchange-convert.htm

in managing the Canadian economy than a gold-based monetary regime.

We will first look at a brief history of the gold standard in Canada, followed by technical details on how the gold standard monetary regime operates. The next section will look at some of the more recent arguments in favor of a modern gold standard followed by arguments against. Finally, we will examine the success of Canada's current monetary regime and prove that reverting back to a gold-based system would prove to be inefficient and wasteful.

History of the Gold Standard in Canada

Officially, Canada followed a gold standard regime from the creation of the Currency Act of 1854 till the onset of World War I². The gold standard simply implied that the value of the Canadian dollar was fixed in terms of gold. After Confederation in 1867, the Dominion Notes Act of 1870 required that Canadian currency be fractionally backed by gold. This system proved to be somewhat effective till the beginning of World War I. Financial panic became frequent and individuals began to convert their money and hoard gold. This created several bank runs and subsequently led to numerous bank failures. It was at this time that the Canadian government abandoned the gold standard and implemented the Finance Act of 1914. This legislation allowed the government to act as "lender of last resort"³ to provide troubled banks with liquidity⁴. This was instrumental in

² Powell, James. "A History of the Canadian Dollar". Available:

http://www.bankofcanada.ca/en/dollar_book/dollar_book-e.pdf

³ Mishkin, Frederic and Apostolos Serletis. *The Economics of Money, Banking and Financial Markets*. First Canadian Edition. Toronto: Addison Wesley Longman, Inc., 2001

⁴ Ibid, p. 222

preventing further bank failures and instituted a great deal of confidence among the Canadian public. The gold standard was once again implemented in 1926 but abandoned in 1929 as the Great Depression led to further bank failures and financial panic.

How the Gold Standard Works – A Technical Viewpoint

Much of the world economy functioned under the gold standard prior to 1914. Each country had their currency equal to a defined amount of gold. For example, the United States dollar in 1879 was defined as 23.22 grains of pure gold.⁵ Once each country established its currency value, exchange rates would remain fixed. By keeping exchange rates fixed, international trade was conducted by transferring gold reserves to pay off any trade balances. If Canada purchased goods from Britain, it would have to ship gold to Britain equal to the dollar value of the goods purchased. Therefore Britain would be injected with more gold reserves whereas Canada would lose a portion of its gold. The money supply in each country was based on the size of its gold reserves. Therefore as Mishkin and Serletis state, “adherence to the gold standard meant that a country had no control over its monetary policy because its money supply was determined by gold flows between the two countries.”⁶ The supply and production of gold also affected the way monetary policy was conducted. When world gold production was low, the money supply was also low and deflation would occur. The inverse is true during times of high gold production as inflation levels rose. Therefore, this reliance on gold production made economic expansion very difficult.

⁵ Bordo, Michael. *The Gold Standard and Related Regimes*. New York: Cambridge University Press, 1999, p. 27

⁶ *Ibid.* p. 431

Irving Fisher described this as the commodity theory of money, which states that, “the gold standard contained a self-regulating mechanism that ensured long-run monetary and price level stability.”⁷ However, in the short run prices and the money supply tended to fluctuate severely and could not be adjusted with any central bank interference.

The Bretton Woods system worked in a similar fashion to the traditional gold standard. The United States pegged their dollar to the price of gold and all other countries that signed the Bretton Woods agreement pegged their currency to the U.S. dollar.⁸ Therefore, gold production and supply was still a very important aspect of the global monetary system and monetary policy was very difficult to control.

Clearly, both the traditional gold standard and the Bretton Woods system contained several flaws, however, there have been many people in favor of returning to a gold-based system. The next section looks at some arguments in favor of a return to a gold standard.

Arguments in Favor of a Gold-Based Monetary System

One of the strongest arguments in favor of the gold standard is that gold brings about trust and confidence in the government and monetary authority. Michael Bordo, a professor at Rutgers University and an authority on the analysis of monetary regimes, refers to this as a commitment mechanism and states that, “a credible precommitment mechanism, by preventing the government from cheating, can preserve

⁷ *Ibid.* p. 10

⁸ *Ibid.* p. 502

long-run price stability.”⁹ For decades, governments have pursued inflationary policies that have eroded the purchasing power of consumers. Individuals have lost faith in government and central bank policies and began to distrust any actions taken to improve economic conditions. However, over the course of centuries, people have trusted gold as a measure of value and as a store of wealth. Simply writing “legal tender” on a piece of paper does not mean that it has any validity or worth.¹⁰ This is the reason that people use the commitment mechanism as a strong argument in favor of a return to a gold-based system.

Another argument that is closely related to the commitment mechanism is that gold represents freedom. “To be concerned with the gold standard is to be concerned with a free economy, regulated by values and choices of men, rather than a controlled economy in which values and choices of men are regulated by government.”¹¹ Proponents of this argument see that the only solution to prevent governments from printing money and adjusting economic conditions is to return to a gold standard regime. Supporters of this argument also state that gold will bring trust back to financial markets and encourage appropriate levels of investment.¹²

The belief that government controlled monetary policy actually prevents long run economic growth is another common

⁹ Bordo, Michael. “*The Gold Standard, Bretton Woods and Other Monetary Regimes: An Historical Perspective.*” National Bureau of Economic Research, Working Paper No. 4310. April 1993.

¹⁰ Snyder, Leslie. *Why Gold? The One Sure Cure for Inflation and Economic Tyranny.* New York: Exposition Press, 1974, p. 123

¹¹ Stevens, Paul. “The Gold Standard: A Standard for Freedom.” *The Freeman – A Publication of The Foundation for Economic Education* 25 (1975): No. 1.

¹² *Ibid.*

argument in favor of a modern gold standard. Supporters of the gold standard do not believe that the money supply must grow in order for the economy to grow.¹³ They see monetary policy as destroying the true environment at which the economy can thrive. One reason for this is that artificially low interest and exchange rates give investors false signals on the efficient allocation of their capital. This leads to unnecessary business failures that could be avoided with the implementation of a gold-based system.

The final positive argument that we shall discuss is that a gold standard regime achieves price stability and reduces inflation. This is a major issue that has been raised by every gold standard proponent. The main belief is that “a gold standard, in which the goal is honesty and freedom and flexibility of prices, achieves significant price ‘stability’.”¹⁴ This statement shows that a trustworthy government would have no reason to manipulate the economy by changing the money supply, therefore the supply of gold would dictate that prices would remain relatively stable in the long-run.

As we have seen, there are many arguments that have been put forth in favor of the gold standard. However, is the gold standard the only way to achieve trust in the monetary authority, long-run economic growth, and stability of prices? This question can be answered by looking at the current Canadian monetary regime. Before we do this, let us take a look at some of the negative aspects of the gold standard.

¹³ Paul, Ron and Lehrman, Lewis. *The Case for Gold: A Minority Report of the U.S. Gold Commission.* Washington: CATO Institute, 1982, p. 156

¹⁴ *Ibid.* p. 157

Negative Aspects of the Gold Standard

The main flaw of the gold standard is that it ignores the existence of a business cycle. In the early days of the classical gold standard, economist did not conducted research on why fluctuations in the business cycle occurred.¹⁵ Fluctuations in the economy were viewed as “a phenomenon of organized financial and commodity markets”¹⁶ and did not attract significant interest from economists of the day. Monetary policy can now be used to control the business cycle and make the effects of expansions and contractions less severe. A gold standard can be seen as putting limits on the growth potential of the economy. This therefore restricts the central bank’s ability to fine tune the economy based on domestic market conditions.¹⁷

Another problem with the gold standard is that we now have accurate measurements of price levels such as the CPI and GDP deflator. During the period of the classical gold standard, prices were very difficult to determine. Gold was a much more stable measure and proved to be a relatively accurate system of determining the price level.¹⁸ However, in today’s economy we can accurately track inflation levels and the implementation of a gold standard would be a step back in the functioning of our economy. Under a gold standard, the pace at

which gold is mined would determine the long-run inflation rate.¹⁹ Therefore, any political or economic instability in the gold mining industry could adversely affect the inflation rate.

Currently, there is also evidence that the supply of gold available is inadequate in supporting a modern day gold standard. Many proponents of the gold standard do not view this as an issue, however, as we can see in Appendix 1, the current supply of gold has reached a peak and is predicted to decline significantly. This is a direct result of reduced gold exploration due to lower gold prices, as seen in Appendix 2. A severe constraint is placed on Canada’s economy if we reintroduce a gold standard. With gold production declining, we would be implementing contractionary monetary policy and leaving our economy susceptible to deflationary pressure. This could drastically impede future economic growth for Canada.

The Bank of Canada has also sold a significant portion of its gold reserves in the past 36 years. Gold bullion reserves fell from 1000 tonnes in 1965 to approximately 10 tonnes in 2001 (see Appendix 3). Due to the declining monetary role of gold, most major central banks have reduced their portion of physical gold assets.²⁰ This would make it exceedingly difficult for Canada to once again base their monetary system on gold as it would require the central bank to purchase enormous quantities of gold in order to provide enough liquidity for current market conditions. This action would prove

¹⁵ Laidler, David. “Remedies For Financial Crisis In The Classical and Neoclassical Literature.” University of Western Ontario Department of Economics Research Report. London: 2000. p. 4

¹⁶ Ibid. p. 4

¹⁷ DeLong, Brad. “Why Not the Gold Standard: Talking Points in the Likely Consequences of Re-Establishment of a Gold Standard.” Available: <http://www.j-bradford-delong.net/Politics/whynotthegoldstandard.html>

¹⁸ ¹⁸ Laidler, David. “Remedies For Financial Crisis In The Classical and Neoclassical Literature.” University of Western Ontario Department of Economics Research Report. London: 2000. p. 4

¹⁹ DeLong, Brad. “Why Not the Gold Standard: Talking Points in the Likely Consequences of Re-Establishment of a Gold Standard.” Available: <http://www.j-bradford-delong.net/Politics/whynotthegoldstandard.html>

²⁰ Alexander, Craig and Priscilla Kalevar. “Gold’s Lost Lustre.” TD Economics, July 24, 2001. Available: <http://www.td.com/economics/special/gold0701.pdf>

to be wasteful and inefficient as it would place a significant cost on our economy and induce deflationary pressure as the current supply of gold is inadequate to meet Canada's present monetary needs.

Let's now look at why Canada's monetary regime has been so successful and prove that we do not need to revert back to a classical gold standard regime.

Canada's Current Monetary Regime²¹

Proponents of a gold standard primarily seek specific conditions in their monetary system. Trust in their monetary authority, long-run economic growth, stable prices, low inflation, and low unemployment are major factors, yet the gold standard itself cannot provide these conditions. Canada's current monetary system can provide all these economic needs efficiently and effectively.

Canada's current monetary regime uses a system of goals to control the pace of the economy. Through the use of operating targets, intermediate targets and main policy goals, The Bank of Canada can effectively manage the Canadian economy.

Appendix 4 shows us exactly how Canada's monetary system operates. The Bank of Canada's main goal is price stability, moreover, it sets target inflation levels at 1-3%, 2% being the optimum level²². It achieves this goal by using operating targets, in particular the overnight interest rate and the reserve aggregates (monetary base, and

non-borrowed monetary base). Through these operating targets, they are able to control their intermediate targets, which are long-term interest rates (investment and consumption rates) and the monetary aggregates (M1, M2, M3). In order to adjust the operating targets, the Bank of Canada uses specific tools to influence the overnight rate and the reserve aggregates. The main tool used is open market operations however discount operations and government deposit shifting have also been used, but their role in the conduct of monetary policy has diminished in the past few years.

An important component of the Bank of Canada is the operating band, which sets the overnight interest rate. The bank of Canada fixes the upper band, which is known as the bank rate. The bank rate is essentially the interest rate charged to chartered banks for advances. The lower band is set at the bank rate minus fifty basis points. This is the interest rate that the Bank of Canada pays on settlement balances. The midpoint of the operating band is known as the overnight interest rate. This is the key interest rate that the Bank of Canada targets.

Dynamic open market operations are used to change the bank rate, depending on whether the Bank of Canada is pursuing expansionary or contractionary monetary policy. When the Bank of Canada pursues expansionary monetary policy, they initiate an open market purchase of bonds, which injects money into the economy. This has the effect of lowering interest rates and increasing the money supply. Conversely, when the Bank of Canada pursues contractionary monetary policy, they initiate an open market sale of bonds and take liquidity out of the economy. This raises the operating band and decreases the money supply. By setting the operating band, the bank of Canada can effectively control

²¹ Much of the theory derived from this section is from the Mishkin, Serletis textbook. A large portion also comes from the theory taught in Professor Alshawa's Economics 154 class at the University of Western Ontario.

²² The Bank of Canada. "Inflation Control Target." Available: <http://www.bankofcanada.ca/en/graphs/notes-1-target.htm>

inflation and stabilize the business cycle. The money supply is based on current economic conditions, which dictate the demand for money. Therefore, unlike the gold standard, the proper amount of money circulates in the economy, thereby avoiding unnecessary deflation and inflation.

With regards to price stability, this system has proven to be very effective. As Appendix 5 illustrates, since the Bank of Canada began targeting inflation in 1991, the inflation rate has consistently remained between the Bank's 1-3% target levels. Therefore, this disproves the argument brought forth by gold standard proponents. We do not need a gold standard regime to stabilize prices and keep inflation low. By targeting the inflation rate, Canada has been able to enjoy extremely stable inflation rates without placing a burden on the economy as in the case of a gold standard.

In terms of unemployment, levels have decreased dramatically. In 1997, the unemployment rate was 9.5%.²³ Currently, the unemployment rate is 7.9%²⁴ and has reached levels below 7% in 2000. This disproves the theory of the Philips Curve, which states that in order for inflation to decrease, unemployment must rise.²⁵

With regards to output, Canada has seen the money supply in terms of M1 increase from \$77.981 billion to \$118.990 billion from 1997 to 2001 respectively.²⁶ At the same

time, GDP has also increased \$885.022 billion in 1997 to \$1.084 trillion in 2001.²⁷ This shows that the government did not simply print money to finance deficits or create inflationary pressure for the economy to grow. Rather, the Bank of Canada injected the proper amount of liquidity into the market based on market conditions and the current demand for money. Therefore, the argument that monetary policy controlled by government prevents long-run economic growth is false as the above evidence shows that the Canadian economy has not experienced severe inflationary pressures, despite growth in the money supply and growth in GDP.

The other issue that gold standard proponents raised was trust in monetary system. In 1981, Alan Greenspan wrote an article that analyzed the case for the U.S. to return to a gold standard. In this article, Mr. Greenspan stated that, "the only seeming solution is for the U.S. to create a fiscal and monetary environment which in effect makes the dollar as good as gold, i.e., stabilizes the general price level and by inference the dollar price of bullion itself."²⁸ Indeed, this is what Canada has accomplished. The Canadian monetary system has worked effectively to instill trust from the Canadian public. It has been 13 years since the Bank of Canada changed their primary goal of inflation targeting and the public has shown great trust in the Bank during its conduct of monetary policy. The Bank of Canada also has predetermined announcement dates in which it reveals its

²³ Statistics Canada. "Labour Force Survey 2002".

Available:

<http://www.statcan.ca/english/Subjects/Labour/LFS/lfs-en.htm>

²⁴ Ibid.

²⁵ Mishkin, Frederic and Apostolos Serletis. *The Economics of Money, Banking and Financial Markets*. First Canadian Edition. Toronto: Addison Wesley Longman, Inc., 2001 p 420

²⁶ Statistics Canada. "Exchange rates, interest rates, money supply and stock prices". Available:

<http://www.statcan.ca/english/Pgdb/Economy/Economic/econ07.htm>

²⁷ Statistics Canada. "Gross domestic product, income-based". Available:

<http://www.statcan.ca/english/Pgdb/Economy/Economic/econ03.htm>

²⁸ Greenspan, Alan. "Can the U.S. Return to a Gold Standard?" *The Wall Street Journal*, September 1, 1981.

actions in prescribing changes to the overnight interest rate.

The one problem that remains in Canada is that the current status of the Canadian dollar is very weak. With all other factors such as inflation and interest rates being relatively stable in Canada, the only answer to this problem is that there is still a huge demand for the U.S. dollar as the world's primary currency. The U.S. dollar is held in reserve by several countries and there currently is not enough world demand for the Canadian dollar. However, the Canadian economy did not suffer from the effects of September 11, 2001 to the same extent as the U.S. economy did, therefore we should see our currency increase in value in the short-run.

Conclusion

It would be wrong for Canada to go back to a gold standard monetary regime. As Alan Greenspan stated, "if we restored financial stability, what purpose is then served by returning to a gold standard?"²⁹ Based on Canada's current system of inflation targeting and price stability, the Bank of Canada has proven that it can control inflation, stabilize the business cycle, reduce unemployment and ensure a positive environment for long-run economic growth. With all these factors, it would be absolutely unnecessary for Canada to ever take backwards steps in returning to a classical gold standard system.

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²⁹ Ibid.

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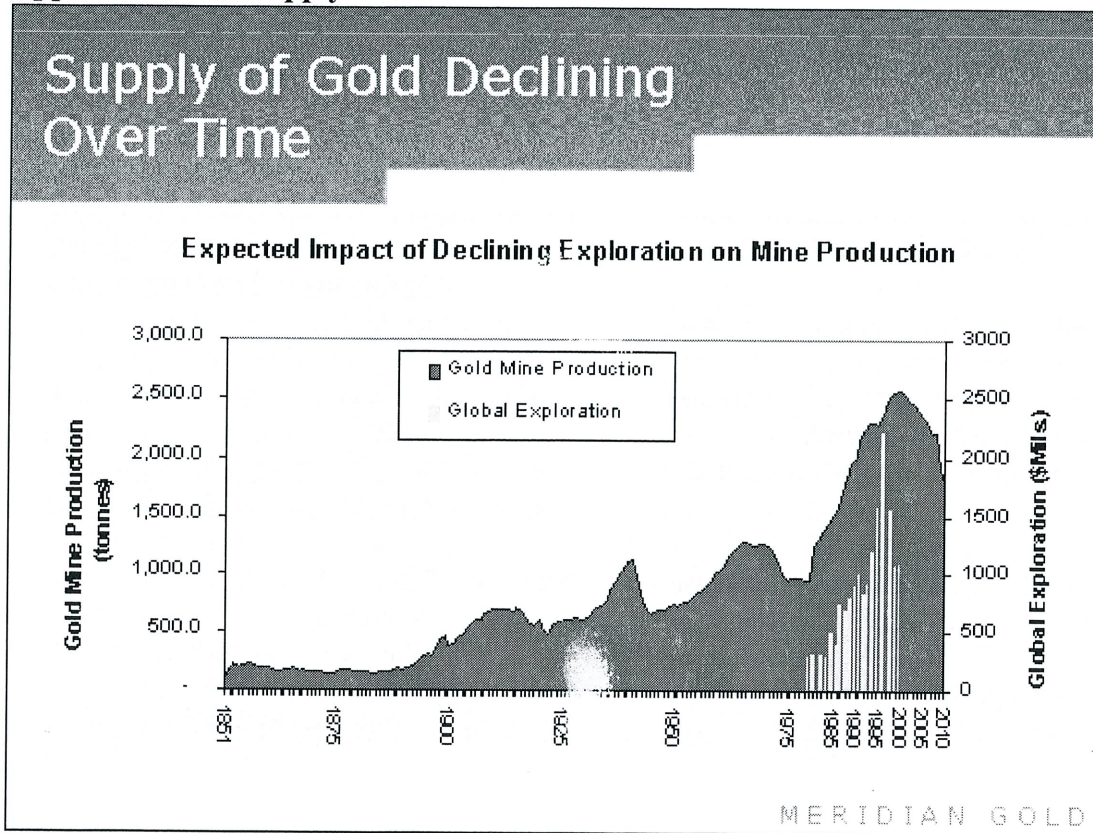
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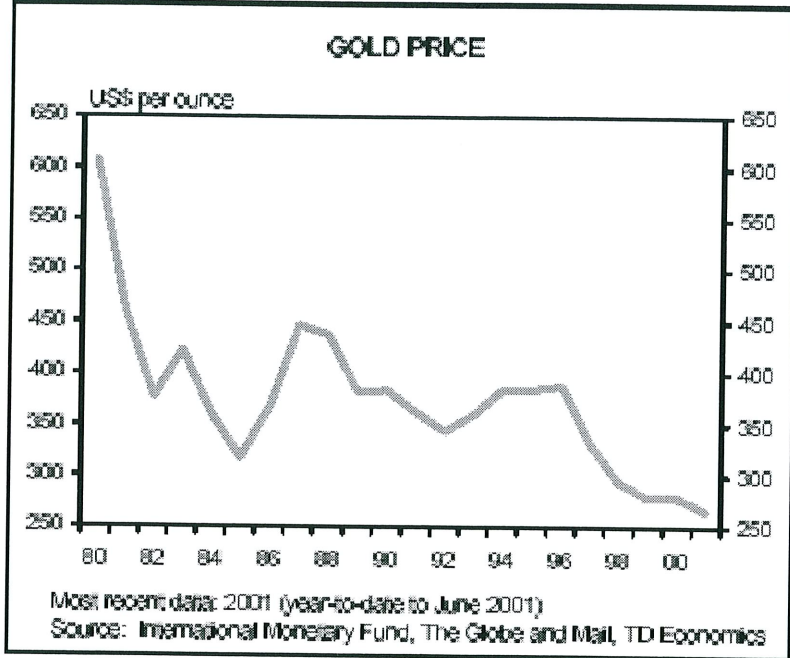
The Bank of Canada. "Inflation Control Target." Available: <http://www.bankofcanada.ca/en/graphs/notes-1-target.htm>

Appendix 1: The Supply of Gold³⁰

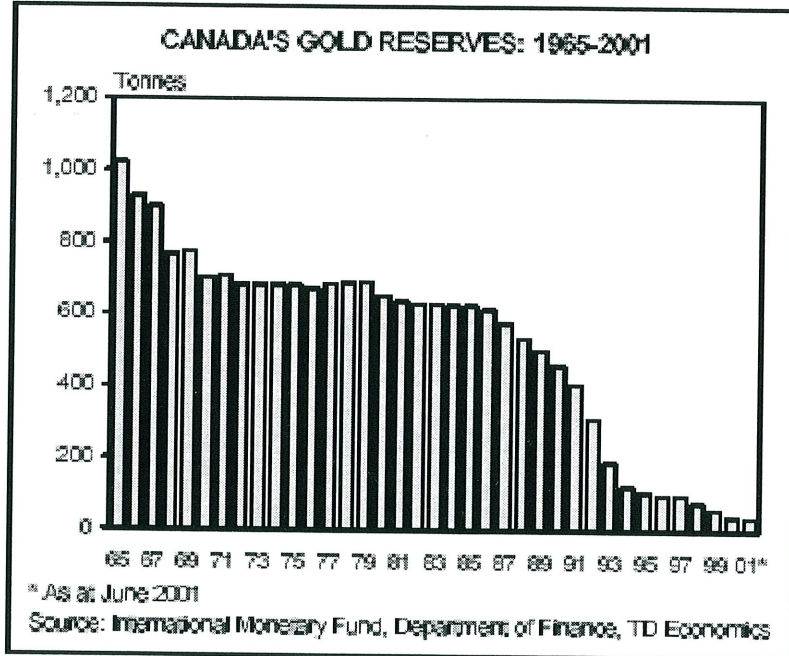


³⁰ Hathaway, John. "The Investment Case for Gold." Tocqueville Asset Management L.P. January 23, 2002.

Appendix 2: Declining Gold Prices³¹



Appendix 3: Canada's Gold Reserves 1965-2001³²



³¹ Alexander, Craig and Priscilla Kalevar. "Gold's Lost Lustre." TD Economics, July 24, 2001. Available: <http://www.td.com/economics/special/gold0701.pdf>

³² Ibid.

Appendix 4: Central Bank Strategy³³

ULTIMATE GOAL → Price Stability

Operating Targets	Intermediate Targets
Overnight Interest Rate →	Long-Term Interest Rates
Reserve Aggregates: Monetary Base (MB), Non-Borrowed Monetary Base (MB _n) →	Monetary Aggregates (M1, M2, M3)

BANK OF CANADA TOOLS → Open Market Operations, Discount Operation, Government Deposit Shifting

³³ Mishkin, Frederic and Apostolos Serletis. *The Economics of Money, Banking and Financial Markets*. First Canadian Edition. Toronto: Addison Wesley Longman, Inc., 2001 p. 407