A GOLDEN ANNIVERSARY

FOR THE POUND

It is 80 years ago this week that the pound came off the gold standard.

It was considered a prudent move back then to boost an economy ravaged by the Great Depression.

by

Kathleen Brooks

YAHOO FINANCE

http://uk.finance.yahoo.com/news/A-golden-anniversary-pound-yahoofinanceuk-1498259571.html

Thursday, 22 Sep 2011, 11:00

(2011)

CMG Archives
http://campbellmgold.com

--()--

But now, as we try to recover from the worst recession since the 1930's, there is a growing lament for the UK to return to the gold standard. But what is that makes the yellow metal so attractive to some FX investors?

To answer this question one needs to know what the gold standard was, how it worked and why it was generally abandoned by the late 1930's. Initially the concept of "exchange rates" didn't even exist.

So instead a currency's value was based on its value in gold. This makes sense in a less complex financial system: gold is the world's oldest known store of value, and more importantly its value is recognised throughout the world. So, a currency's worth would be based on how much it would cost to transfer it to an ounce of gold. This was known as the gold specie standard.

Back then currency exchange was a more cumbersome process, if you wanted to trade pounds for another currency first you would have to find one that was also trading on the gold standard, say the dollar, then you would have to take gold out of the UK, transfer it to the US and sell it there to buy the green back. The outbreak of World War One meant this process was no longer permissible.

The UK needed its gold to fund the war effort and traveling around the continent was all but impossible unless you were in the army and willing to snake along the trenches. So the Bank of England had to step in and introduce a form of paper money that the Bank promised to redeem at face value.

However, this was reversed with the Gold Standard Act in 1925. However, this was a modified form of the specie standard in that you no longer traded actual gold. Instead, if you wanted to cash in your pounds you could do so at the Bank of England for a fixed amount of gold.

The original text of the Act states: "the Bank of England shall be bound to sell to any person who makes a demand in that behalf at the head office of the Bank…and pays the purchase price in…gold bullion" which in 1925 was worth three pounds, seventeen shillings and ten pence halfpenny per troy ounce. This meant that the pound was worth $4.87 back in 1925, which compares with slightly more than $1.56 today.

For the past 80 years the Bank hasn't had to transfer our bank notes into, er, anything. Instead we have to accept the word of the government and the central bank that the pound has a value. Obviously this has its drawbacks, so why was the Gold Standard abandoned in the first place?

In essence it was too expensive for the UK to keep up. Its exports had ceased to become competitive in the latter part of the 1920's due to the strong value of the pound, which pushed up its trade deficit. The UK in essence couldn't afford to stick with the gold standard and abandoned it six years after passing the Gold Standard Act.

Some of this may sound familiar. By abandoning the gold standard the British government could de-value the pound, which boosted exports and the economy. A little over a year later confidence in the UK returned and the US/ UK exchange rate shot up to $5 as the US struggled through the Depression.

This is a similar argument to the one being played out in Europe right now. The single currency in Europe means that highly indebted, weak economies like Greece, Ireland and Portugal cannot de-value their own currencies and try and export their ways to economic health. But does this mean that the Gold Standard was a noose around the neck of the UK economy?

Well, yes and no. The benefit was that it kept inflation low since the pound was worth so much it lowered the value of imports like food and oil. However, it also hindered exports. In 1931 the UK government traded inflation for growth and came up trumps when it abandoned the Gold Standard, so why would we want to go back to it now?

It all comes down to central banks and governments. By abandoning the gold standard governments were given free reign to manipulate the value of their currencies. In the 1930's the pound needed to be lower to help the economy recover from the Depression, today you hear government officials talk about the need for Britain to export its way to economic recovery after relying on consumption for too long.

What do you need for exports: a weak pound. Governments find it easier to stay in office when growth is strong and jobs are being created thus they have a vested interest to keep currencies from getting too strong.

In the past month we have seen the Japanese and Swiss authorities directly intervene in their currencies to weaken them. Added to this the West has a massive debt problem and if you de-value your currency then you have a lower debt burden. But since we can't redeem currencies for gold any longer then we have to rely on governments and officials to protect the value of our currency. Of course this is an oxymoron, especially when the temptation is so high for official meddling in FX markets.

A return to the gold standard would eradicate this worry for investors. A stronger pound could also help bring down inflation, which rose to a 4.5 per cent annual rate in August [2011]. But there are also some risks; growth would likely take a hit as exports become more expensive. But there is a bigger concern, which is why a return to the gold standard is all pie in the sky. The global financial system is too big.

There is not enough gold in the world to finance all the daily FX transactions that take place. Also, the pound could only trade with other countries on the gold standard, which could hurt trade in the long term.

So while a gold standard could make officials more responsible when it comes to monetary and economic policy, the grass is always greener on the other side. The gold standard has its drawbacks, but when we are starring at high inflation and the possibility of the pound remaining in the wilderness for many years to come, it is easy to be wistful for a less complex financial world where the main store of value was still gold.

(Yahoo Finance - Kathleen Brooks)

http://uk.finance.yahoo.com/news/A-golden-anniversary-pound-yahoofinanceuk-1498259571.html

End

--()--

http://campbellmgold.com

23092011