Fractional Gold Standard/Fiat Currency

by Sophia Tutorial

WHAT'S COVERED

This tutorial will cover the fractional gold standard and fiat currency. We will discuss the definition and development of a fractional reserve system, as well as how the U.S. transitioned from a gold-backed currency to a fiat and fiduciary currency.

Our discussion breaks down as follows:

1. Banks and Gold Certificates
2. Fractional Reserve System
3. Bank Runs and Panics
4. End of the Gold Standard
5. Fiduciary Currency and Fiat Money

1. Banks and Gold Certificates

When people were using gold as a form of money, banks began to emerge as intermediaries. Banks allowed people to store their gold safely because it was not safe for them to carry all that gold around with them or store it in their homes. It also allowed people to write checks on their deposits without having to physically remove the gold from the bank.

Then, banks started to print paper money, which represented a designated amount of gold. This paper money was much easier to trade than the gold itself.

HINT

When a form of money is easy to access and spend immediately as a medium of exchange, we call that liquidity. Therefore, this paper money was liquid.

So, why did people actually value this paper money? We know that the paper itself had no intrinsic value; it is not a commodity. Well, it had value because people believed that they could actually convert it to gold.

When that belief exists, the paper money is known as a representative form of money, because the paper now represents something of value--the gold.

2. Fractional Reserve System

Let's briefly discuss how banks make money. As you are likely aware, if banks existed simply to store our money, they would not profit.

Banks figured out that they could pay interest to people who would deposit money into a deposit account or a checking account. They would then charge a *higher* interest rate to loan out this money to others, which is where they got their revenue.

This arrangement is what encouraged the fractional system to develop. Now that the banks were issuing paper money, banks realized that they could make more loans--and more money--by printing more paper currency than actual gold they had stored in their vaults.

When banks hold only a fraction of their deposits in actual gold, this is known as a fractional reserve system.

Now, this may sound a bit suspect. Well, the system works as long as certain things do not go wrong--meaning, what are the chances that everyone will show up at the bank/ATMs at the same time, demanding all of their money? The likelihood is not very high that this will happen, so banks were banking--no pun intended--on the fact that not everyone would show up demanding their money. Therefore, they could print more.

Now, as long as the demand for gold on any given day was less than the gold held in reserve, this system works. It allowed banks to make more loans and earn more interest.

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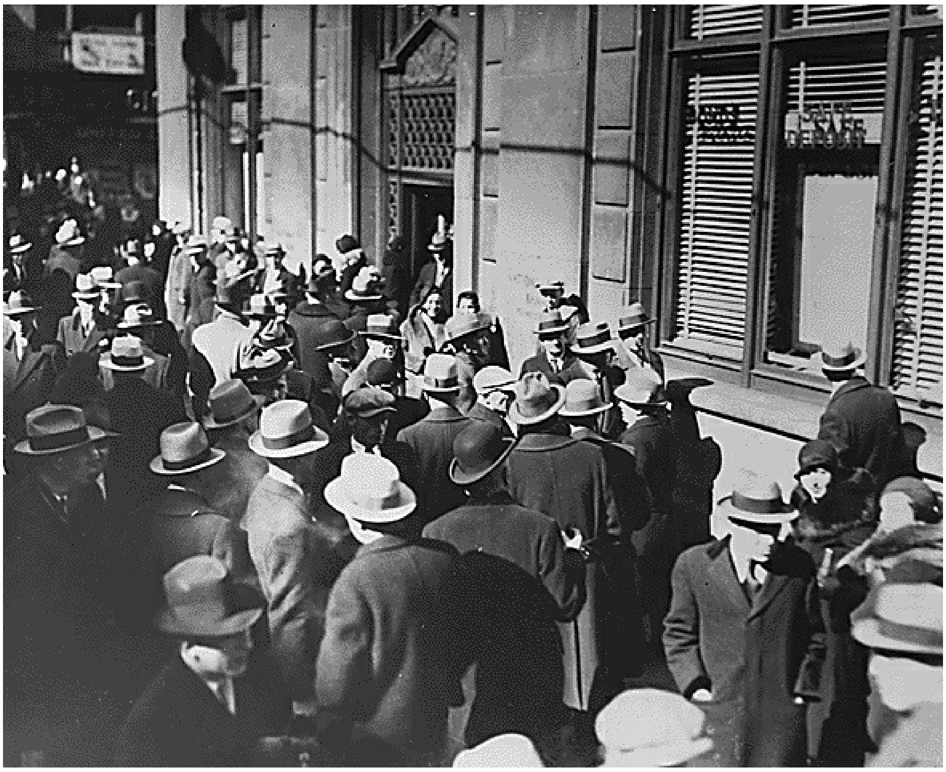
3. Bank Runs and Panics

However, if many people do show up demanding the gold held in their accounts, then the bank cannot meet these demands, because there are more notes out than gold reserves held.

If this worst case scenario happens, then the bank fails or goes bankrupt.

THINK ABOUT IT

Think about the scene in the film *It's a Wonderful Life* that shows a bank run. Everybody comes demanding their money all at once, and the bank manager has to explain to everyone that he does not have their money because it has been invested elsewhere.



When the stock market plummeted at the beginning of the Great Depression in 1929, there were many bank runs on the same day. This situation becomes a panic.

We call it this because people panic as a result of something major happening in the economy, and they all run to the banks to get all of their money.

The first people to arrive get their money, while others do not, because it is simply not there. It is all out in the form of loans for others.

These bank runs and panics take a bad situation and make it much worse. When banks start failing, it created even less confidence and more worry and panic from consumers.

So, how do we get the economy back on track in that case? Our economy is so dependent on people being confident to spend their money and take out loans, so this is not a good situation.

4. End of the Gold Standard

When the Great Depression hit and the stock market crashed, investors started trading in gold and other commodities.

This caused the price of gold to rise. People started trading in their dollars for gold; they did not trust the banks and they began hoarding gold because they knew that possession of that physical gold was worth something. Confidence in U.S. currency plummeted.

Franklin Delano Roosevelt responded by issuing an order that outlawed private ownership of gold, ordering people to turn their gold into the Federal Reserve in exchange for dollars at the current rate. This order was meant to prevent hoarding and to protect the U.S. currency.

At this time, then, the gold standard was suspended, because it was illegal to hold the gold.

FDR also increased the price of gold to $35 an ounce; this means that $1 now equaled 1/35 of an ounce of gold, instead of 1/20. Keep in mind, though, that those dollars were no longer redeemable for gold.

When the Great Depression ended, countries could go back to a modified type of gold standard. Most countries ended up valuing their currencies based on the U.S. dollar since, at that time, the U.S. owned most of the gold in the world.

However, as countries began to recover from World War II, especially countries like Germany and Japan, the U.S. share of economic output started to drop relative to the rest of the world. Because of this, our gold stock fell--as did the U.S. Treasury's fraction of gold relative to currency.

There were some issues, especially in the late '60s and early '70s, where the U.S. started having a negative balance of payments, increasing debt in the economy and causing inflation.

In an effort to stabilize the U.S. economy in the early 1970s, Nixon ended the convertibility between U.S. dollars and gold, which completely suspended the gold standard.

5. Fiduciary Currency and Fiat Money

Now, this is the point where the dollar has no tie to gold at all; it is no longer representative. What is going to give the dollar its value, now that it no longer represents 1/35th of an ounce of gold?

Well, its value now is completely based on people's trust in the Federal Reserve, which is what we call a **fiduciary currency**. Fiduciary currency is the currency whose value is based on trust or faith that it has that value.

Today our paper currency is not valuable in and of itself. It is not a commodity currency, because remember, a commodity is something valuable in and of itself.

It is also no longer backed by gold, so it is not a representative currency.

However, it is valuable. Everybody places value on dollars because people accept them widely as a form of payment. This is what is known as a fiat currency. **Fiat money** is money that is a recognized legal tender that is nonconvertible--so we cannot convert it to anything else of value--and has no intrinsic value in and of itself.

TERMS TO KNOW

Fiduciary Currency
A currency whose value is based on “trust” or “faith” in its value

Fiat Money
Money that is a recognized legal tender that is non-convertible and has no intrinsic value

SUMMARY

We began today's lesson by reviewing the emergence of **banks and gold certificates**. We learned what the **fractional reserve system** is and how it developed in the United States, including what happens during a worst case scenario involving **bank runs and panics**. Finally, we learned about how the United States transitioned from backing its currency with gold, moving from the **end of the gold standard** to a **fiduciary currency and fiat money**.

Source: Adapted from Sophia instructor Kate Eskra.

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