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ESSAY

# The Crisis of the Gold Standard

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WE HAVE this year passed through the most acute international money crisis that has ever occurred in time of peace. The panic which began with the failure of the Austrian Kreditanstalt in May, forced the Hoover debt holiday and the freezing agreement on German short-time debts in June and July, wrecked the British Labor government in August and drove England from the gold standard in September, and then drained $738,000,000 of gold from the United States by the end of October, has no parallel for speed and magnitude in the history of international finance. Coming two years after the beginning of the decline in business conditions, at a time when according to virtually all the professional forecasts recovery should have been well under way, these events produced profound bewilderment and dismay in all countries.

I do not pretend to be able to diagnose this depression. Though there are many plausible theories, there is very little agreement about the causes of the business cycle. There is reason to question whether economic changes unfold according to any pattern so definite as the term "cycle" implies. But we do recognize minor and major variations in economic conditions and have had experience of great world "conjunctures." Most frequently they have occurred after wars. The Napoleonic Wars were followed by such a period, the Civil War and the Franco-Prussian War by the long depression of the 'seventies. Indeed, the slump of the 'nineties seems the only one comparable in duration and severity which does not fit into this chronological sequence. As the current depression has unfolded we have ceased to regard it as a minor variation consequent upon our stock market collapse -- which seemed to be the majority opinion of American forecasters in the winter of 1929 -- and have come to view it as the culmination of certain deep-seated international maladjustments which had their origin in the war.

The greatest single change which has occurred since 1914 has been in the comparative international positions of the United States and England. From being the world's leading debtor we passed during the war to being the world's leading creditor. England's position has meanwhile become steadily weaker. It may take decades to work out all the implications of this revolutionary change and to make all the necessary international adjustments. Most of the larger world problems of today proceed out of it or have some intimate connection with it. England's creditor position in the nineteenth century had developed gradually, along with the development of a world economy involving the division of productive effort between the older industrial areas and the younger agricultural areas and the flow of accumulated savings from the former to the latter. The same circumstances which assigned to England the leading rôle in capital export made London the international money market and the Bank of England the administrator of the gold standard.

The international gold standard is based upon the assumption that the flow of gold makes an automatic correction of departures from equilibrium in international payments. This assumption is most valid when four conditions are fulfilled: (1) when there are no surplus gold reserves in the banking system and a loss of gold must mean a shrinkage of bank credit; (2) when there are no international capital movements, so that, on balance, exports of goods must equal imports and any excess of one over the other must induce a corrective flow of gold; (3) when unit costs of production are responsive to money price variations, so that when prices change in response to increases or decreases of gold, production and trade will respond to the movement of prices; (4) when international demand responds freely to changes in prices, so that a fall of prices will produce an increase in value of exports relative to imports, and contrariwise. Given these conditions, trade changes are corrected by the interaction of gold flow and prices.

It must be admitted that these conditions are never found fully and simultaneously developed and that there has never been that "automatic" working of the gold standard which the English Bank Act of 1844 was designed to insure. But there was a closer approximation to these conditions before the war than there is at present. At that time the chief qualification was in the flow of capital. A rise of prices in one country relative to others (such as in the absence of capital movements would cause increase of imports, outflow of gold, fall of prices, and thus an increase of exports to the point where exports again equal imports and gold flow ceases) may in fact attract capital from abroad. Rising prices usually mean rising profits, which attract capital, which in turn is likely to cause further rise of prices, and hence more profits, and hence more capital inflow. This cumulative movement is more apt to be accompanied by gold inflow than by gold outflow, and the gold inflow provides a monetary basis for still further expansion. Recent investigations of the pre-war movements of gold show, in the case both of England and the United States, a clearly defined tendency for gold to flow inward during prosperity and outward during depression. Outstanding instances of the cumulative effects of pre-war capital movements are the American boom which terminated in the crisis of 1873, and the Argentine boom which culminated in the Baring Panic of 1890; but in neither of these cases was the capital importing country upon the gold standard.

Under pre-war conditions, however, capital movements were less likely to produce serious maladjustments than has been the case under the conditions existing since 1914. The borrowers were the young, growing countries. The same conditions which attracted foreign capital attracted foreign products, particularly in the form of capital goods. Trade adjustment was thus to a large extent a simultaneous process rather than a sequence of steps. Foreign investment and foreign trade were not so much a cause and an effect as they were dual aspects of a single phenomenon. Gold flow would occur only when the balance of foreign investment was in excess of or less than the balance of foreign trade. But its effect when it did occur might still be cumulative rather than corrective. A flow of gold to the capital-importing country might produce credit expansion, rising prices, and a further inflow of capital, while producing in the capital-exporting country a more drastic, and at the same time less effective, curtailment of credit than the simpler theory had assumed. The Bank of England's discount rate policy, designed to protect the gold reserve, was an effective check upon the process in so far as a higher bank rate could discourage British foreign lending, attract outside short-term funds to London, and stop the outflow of gold by reversing the forces which caused it. Since the English banking system had in it very little slack, being operated upon a comparatively small reserve of gold and employing a very expensive form of currency in the Bank of England note, protection of gold reserves was the chief, and probably the only important, criterion of credit policy. The Bank of England's action was therefore prompt, and ordinarily effective. England was the leading exporter of capital, the free market for gold, the international discount market, and the international banker for the trade of other countries as well as her own. She thus held all the controlling elements of the situation in her hands, and her own monetary and trade position was such as to insure their prompt and effective use. The world was in this sense upon the sterling standard.

## II

Post-war conditions have in various ways been radically different. It is often suggested that maldistribution of gold is the major cause of the depression and the recent monetary crisis. But it is necessary to account for the maldistribution. When England left the gold standard the United States had $5,000,000,000 of gold and France about $2,300,000,000, out of a world total of about $11,500,000,000. This is obviously maldistribution in some sense or other; it strikes one immediately as undesirable and abnormal. But it is less easy to say in just what sense it is abnormal; and this is particularly important when one considers how to change it. The French supply is relatively much larger than our own, but France has always liked to have a large supply. France is the European sink for gold. Her price level is comparatively insensitive to gold flow, so that she finds it much easier to attract gold than to expel it. It is indeed unfortunate that this should be the case, but it is not altogether a new problem.

It is said by European and American economists that our own gold policy has been chiefly responsible for the world's ills. We are accused of sterilizing gold. As Mr. Keynes put it in 1924, the world's gold has been buried in the vaults of Washington. This view has gained wide support. It has become part of the viewpoint of the man in the street, a commonplace of newspaper financial gossip. The thesis has taken different and somewhat conflicting forms. Some writers complain of too much artificial "management" of the gold standard by the Federal Reserve System. When gold comes in it is "offset" by open-market sales of securities by the Reserve Banks, which decrease the reserves of member banks by as much as the new gold has increased them. When gold flows out it is offset by open-market purchases of securities which replenish reserves. Our gold holdings are so large that the Reserve Banks can afford to ignore the effect of gold movements upon themselves. By offsetting the gold flow we keep our domestic price level stable and throw the entire strain of trade adjustment upon foreign price levels. Other writers complain of too little management. Our banking system makes such an economical use of gold that the gold flow exerts little effect on prices; therefore the Reserve Banks, by appropriate open market operations, should compel the gold flow to influence prices. But far from inflating credit to the limits of our gold we are said to have pursued a policy of price stabilization, or at best a policy of indifference toward the plight of other nations. Meanwhile our international creditor position exerts a pull upon the world's gold whenever our new annual exports of capital diminish. Thus more and more gold becomes buried in our vaults. Now we have reached the breaking point and have cracked the world asunder.

This is indeed a serious indictment, but I am not at all sure that either version of it is valid. The analysis so interweaves truth and error that they are not easy to unravel. We can all agree that something is seriously wrong, but not necessarily on what it is. That we have acquired and retained the gold is clear enough. Since 1914 we have increased our gold stock by about $2,500,000,000. Much of it came during the war in part payment for our huge wartime exports; even more of it came in 1921--24. With Europe off the gold standard, and with European currencies depreciated and European capital seeking safety here, we were the only large market open to gold and the most effective bidder for it. In 1925--29 our gold holdings did not increase, though there were some rather violent inward and outward movements. From October 1929 to July 1931 we imported $573,000,000 of gold.

During the depression the gold has come mainly from the young countries of the world, whose commodity prices have been acutely depressed at the same time that their inflow of capital has been cut off. The burden of interest payments and of imports has turned the foreign exchanges against them and drained off their gold, partly to the United States but chiefly to France. It is very interesting to note that these countries have lost gold not because, as in the orthodox theory, their price levels were high relative to those of other countries but precisely because the prices of their exports have been abnormally low relative to those of other countries. This is a striking example of the way in which our four qualifications, previously stated, can alter the simpler theory of the gold standard. The demand for agricultural products is inelastic. When prices fall sharply the total value of exports is likely to decrease relative to imports, which consist of industrial products for which demand is more elastic. Since there is little or no diversification of production, these countries find it peculiarly difficult to curtail output. Meantime, interest on foreign debts must be paid. With prices falling, the debt payments entail a progressive increase in quantity of exports relative to value of exports, but increasing quantity depresses prices further. It becomes a case of indeterminate equilibrium, and gold flows out persistently until collapse ensues. Since 1928, the South American and Oriental countries, plus Australia and South Africa, have together exported over $1,250,000,000 of gold. Australia and Argentina are off the gold standard, Canada has been on and off a number of times, Brazil has defaulted on her foreign debts, and all South American bonds have been at panic prices.

I would especially hesitate to lay this draining off of gold from the agricultural countries to any sins of commission or omission by our banking system, except of course in so far as it can be shown that our earlier gold management was responsible for the depression's getting started in those countries. A more straightforward explanation may be found within agriculture itself: revolutionary improvements in technique, restoration of European production lost in the war, increased Russian exportation since 1928, price-fixing schemes in copper, rubber, coffee, tin and other products, not to mention the interesting experiments in this line by our own Farm Board, which have artificially protected high cost production and increased total output. All this has increased the difficulties arising out of the inelastic character of the demand for agricultural products. But even this explanation is not so straightforward as it seems, and agricultural economists are divided on whether overproduction preceded the fall of prices or the fall of prices preceded overproduction.

Banking statistics do not indicate that we have sterilized gold. The gold that flowed in before 1925 was used by our banks to pay off rediscounts which were swollen by the boom of 1919--20; but it also served as a basis for credit expansion, as loans and deposits increased substantially. After 1924 our gold holdings did not increase, demand deposits ceased to expand, but bank loans and time deposits continued to increase. For the period 1914--29 our bank deposits increased by over $35,000,000,000, or by fifteen dollars of deposits for every dollar of gold imported, and our gold reserves were less than 7 percent of our bank credit. This is a more intensive utilization of gold than is found in any other country except England.

It is true nevertheless that we do not need all our present gold, in view of the economy of the Federal Reserve System. The phenomenal expansion of time deposits since the war, and the continuance of this expansion after 1925 when demand deposits ceased to grow, would suggest not unwillingness of our banking system to use gold but a saturation of demand for credit. As bank assets increased, the public carried an increasing amount of the resultant deposits as idle deposits. The alternative, if we do not fully utilize the gold ourselves, would be to push it out; but this is less simple, under recent world conditions, than it might appear. We have, in general, kept discount rates low and assisted foreign central banks by various credits and exchange transactions. We have drawn no gold at all from England since 1929. In 1927 we tried to force out gold. By lowering our bank rate we did succeed in pushing out the accumulations of the preceding five years, but the low money rates contributed to our stock market boom, which induced a new inflow of gold.

There is a vast difference between trying to expel gold and controlling a flow which is induced by economic conditions themselves. England's pre-war task of administering the gold standard was simple in comparison with ours today. Some of our gold "management," for example, has clearly been directed toward inducing gold outflow by offsetting its effect on money rates and preserving the monetary ease essential for its continued flow. But if low money rates induce an increased domestic use of credit they may start a spiral of expansion, the last phase of which is inflow of the gold which flowed out at the beginning. We completed this full circle between 1927 and 1929. The problem of gold regulation by central banks has materially changed since the war. The world is more closely knit, and there is frequently a sharp contrast between the internal and external results of a change of bank rate. This fact has been felt in England and in Germany on many occasions in recent years. For example, the Reichsbank has found that when it put up its rate in order to decrease credit, short-time balances flowed in from abroad; and when it put down the rate in order to increase credit these balances went out again. Nothing could better prove that in the future central banking policy must be based upon closer international coöperation.

Since 1926 the world's gold has gone to France. At the end of that year the gold holdings of the Bank of France amounted to $725,000,000; on November 12, 1931 they amounted to $2,703,000,000, and there were besides some $535,000,000 of sight balances abroad, which represent a claim on gold. These figures do not of course include the foreign balances of French private banks. In view of these figures it is rather fanciful to put the responsibility for maldistribution of gold upon the United States. The Bank of France gold reserves are today within $200,000,000 of those of the Federal Reserve Banks, and a further conversion of French balances in New York would make them equal to ours. The French note circulation, the principal form of credit, is about $3,310,000,000, which means that there is almost 100 percent coverage by gold and gold exchange. This indeed is sterilization of gold. Meanwhile, England since 1925 has been struggling unsuccessfully to maintain the £150,000,000 gold minimum recommended by the Cunliffe Committee, and Germany's gold reserve has ranged between $303,000,000 and $666,000,000.[i]

Why this enormous drain of gold to France? The explanation is somewhat complex, but goes back to the fact that France stabilized the franc at too low a figure. The *de facto* stabilization was accomplished in December, 1926. Prior to that time the franc had been depreciating rapidly, and got down at one time under two cents. Capital had been leaving the country. When Poincaré succeeded in stabilizing the franc at about four cents confidence revived. French capital began to come back and foreign speculative capital was attracted by prospects of a rise in francs and French securities. At the same time the French price level remained low relative to outside prices, the balance of payments was favorable, and the export trade piled up increasing balances in foreign centers. The result was that France had difficulty in holding the franc down to the stabilization level, and was compelled to buy foreign currencies. Thus she accumulated very large balances abroad, chiefly in New York and London. By the middle of 1927 the foreign exchange holdings of the Bank of France exceeded a billion dollars.

But France had no intention of employing the gold exchange standard except as a step toward the gold standard itself. She therefore proceeded to convert her balances into gold with the object of bringing her reserves up to the pre-war level, which had been almost two billion dollars. From 1927 to the middle of 1929 the Bank of France became the leading buyer of gold. French economists argue that up to this point the movement merely established a better balance of gold in the world, since in large part it represented the reclaiming of gold which had previously gone to the United States. But one significant difference from the pre-war situation was that the drain exerted great pressure upon London, which was much less capable of protecting its reserves than it was before the war. Much credit is due the Reserve Banks during this period for their assistance in relieving the strain upon London. By the middle of 1929 the Bank of France had about one and a half billion dollars of gold, the *de jure* stabilization of the franc had been accomplished (June 25, 1928), the foreign exchange holdings of the Bank of France had ceased to grow, and the Bank of France had ceased to purchase gold abroad.

But the French private banks continued their purchases. The French price level had shown no effect of the gold inflow, remaining stationary from 1926 to March 1929, and then beginning a gradual decline; the trade balance was still favorable to a gold inflow. Since 1929 it has been this private inflow which has been the source of disequilibrium in the world's distribution of gold. France has no adequate bill market, and the French banks have never leaned heavily on the Bank of France, which they regard as being somewhat their competitor. They increase their reserves by drawing on their foreign balances, and the Bank of France cannot refuse to accept gold from them so long as the gold standard remains in force. The corrections for this situation would be a rise of the French price level or an exportation of capital; but the French price level is remarkably insensitive, and until 1929 the export of capital was virtually prohibited by tax and other restrictions. In any case, the French people have not been interested in foreign investments. The result has been the continued accumulation not only of gold in France but of balances abroad. These balances, of course, are highly unstable. Together with the short-term foreign balances of other nations they have been a chief cause of the acute monetary disturbances of the present depression period.

III

The task of administering the gold standard belongs logically to the capital exporting nations. One significant difference between the pre-war and post-war periods is that formerly this rôle was assigned to England, not only by the monetary necessities of the case but also by the economic circumstances. Today this logical alliance is by no means so clear. The monetary situation assigns to the United States and France the rôle of preserving a proper balance in the world by the flow of capital. But France has long pursued the ideal of the self-sufficing nation, and has neither the financial machinery, the business flexibility, nor the economic motivation which fit a nation for such a rôle. It is not possible to conceive a nation less fitted than France to hold the world's gold or administer the gold standard.

The foreign investment position of the United States contains some highly abnormal elements. We achieved our creditor position as a result of the war. In four and a half years we exported eleven and a half billion dollars of goods in excess of our importations, an amount which equals the sum of our export surpluses from 1873 to 1914. We received part of the payment in a billion dollars of gold, another part by the return of our foreign-held securities and by various exchange-pegging loans, and the principal part in the form of credit advances by our government to the Allied governments. The Allies bought our goods with promises of future payment which they could not honor except as Germany supplied the means by reparation payments. Germany, lacking present capacity to pay, turned to the Allies' creditor. In so far as this system works at all we substitute one debtor for another. The German debts to us are private debts, the Allied debts and the reparation payments are public debts, so that the further result is an inextricable tangle of public and private debts. This is no doubt the kind of thing that Mr. Macdonald calls "crazy economy." One aspect of it is the present conflict of interest among Germany's creditors, the French being reluctant to concede priority to private debts while this country and England are most concerned over private debts.

One of the larger aspects of this condition is that since 1914 the flow of capital has been, to a large extent, perverse. By pre-war standards it would be called a flow of capital in the wrong direction; it is a flow of capital not from old countries to new countries but from new countries to old countries. Its purpose was not to develop productive capacities but to meet extraordinary war expenditure. Partly by reason of the processes involved in Europe's restoration of the gold standard, the capital movement has taken peculiar forms. We have exported capital to Europe on long term at high rates and imported short-term balances from Europe at low rates. Meanwhile England because of economic conditions has exported capital on long term, and because of her monetary requirements has imported capital on short term. As time has gone on, our own capital export has become increasingly short-term in character, until the world's money markets have been saturated with short-term balances and a pronounced gap has developed between short-term and long-term interest rates. Nothing could better show the abnormality of much of the post-war capital flow, or the increasing distrust of it among bankers and investors. Given, then, a further and more severe shock to confidence in the present year, the consequences have been tremendous.

There is theoretical validity, I believe, in the view that a nation's capacity for payment can be developed by capital borrowing, even though the nation is not a young country, provided the process is spread over a long period, provided the burden of payment is moderate and definite in amount, and provided the borrowed capital is directed into productive employment. There is considerable evidence that Germany was responding in this fashion between 1924 and 1928 -- in the rise of real wages, the growth of savings, the expansion of output, and the lowering of costs by rationalization; though there is also evidence that the capital inflow was too rapid and too large and that some of it was extravagantly spent. On the whole, I am not convinced that Germany cannot in a more normal world pay reparations of moderate amount, though it is obvious that with a world price level one-third lower than in 1928 she cannot by any means carry the burden imposed under the Young Plan. And I am unable to see how, prior to the restoration of normal business conditions, she can make any payments at all. Germany's difficulties today are similar in kind to those of any debtor country under conditions of acute depression. She is worst hit because her debt is greatest, but she is by no means unique in her position. On broader grounds I have from the start disapproved of reparations. Large, arbitrary payments of this sort are bound to distort the international economic structure. It is not primarily a question of whether Germany can pay, but whether the world can afford to have this sort of thing.

The abruptness and the abnormal character of the change in our international position, forced on us by war, raises questions regarding our ability to perform the functions of administering the gold standard as well as England did before the war. It is an interesting question whether, had there been no war, we should today be exporting capital on balance. Such a change would have come in time, without doubt, but it would have been accompanied by a change in the general conditions affecting external versus internal investment. Monetary equilibrium now requires an outflow of capital from this country, but investment is a matter for individuals, and it is by no means clear that individuals may not prefer domestic investment and be quite right in their decision. The boom of 1928--29 was of course an extreme case, but not without very great significance. Though the causes of such a boom are always complex, it grew, without doubt, out of the kind of economic progress and the general conditions of economic change that we associate with young countries rather than with old. It was a case of America reverting to type. We witnessed the paradox of large imports of capital coming into the country which, on monetary grounds, should have been supplying capital to other countries. The draining of foreign funds into our stock market seems, without question, to have been one cause of the depression.

We have seen in England the opposite aspect of the matter. British economists complain that capital which should go into home investment goes abroad. That any Englishman should make such an outcry is a striking commentary on how times have changed. Before the war British foreign investment was quickly reflected in the export trade. Foreign investment meant more and cheaper food and raw materials and an increased market for British goods. As I have said, investment and trade were dual aspects of a virtually simultaneous process. The cumulative effects upon England were extremely beneficial. She was enabled to specialize at home in industries operating at decreasing costs as output increased, while developing abroad cheaper products of increasing cost industries. Armed with these advantages, and intellectually fortified by her doctrine of free trade as a universal and eternal truth, England played at will upon the economic world, with enormous advantage to it as well as to herself. The more capital she exported the more she had for home investment. In this way she piled up capital and labor upon her small island, and earned excellent rewards for both.

England was the first user of mass production methods, but by exporting her capital, labor, and business-men she put the world in a position to use her methods. Now younger nations, with superior resources, have outstripped her. England's trouble is in part a bad balance of productive forces, too much capital and labor for her resources. But in part it is the increased rigidity and immobility of her economic structure. In part, also, it comes from her war-time loss of markets, for example the Oriental market for cottons, which in some cases no amount of improvement in production costs could probably now win back for her.

England stabilized the pound in 1925 at its pre-war value. By so doing she assumed the full burden of her internal war debts, in contrast with the continental countries which by currency devaluation were largely relieved of their internal burdens. It must be noted further that British industry likewise became saddled with the full weight of the fixed charges upon its heavy capitalization, in contrast, for example, with German industry which by currency depreciation had largely freed itself from interest charges. It is sometimes contended, nevertheless, that England might have succeeded with her stabilization program had she pursued proper policies in subsequent years, though there seems to have been little agreement about what constitute proper policies under such conditions as England has had to face. A more correct statement, perhaps, is that the pre-war sterling standard might have served tolerably well as a fair-weather post-war standard, but England has had very little fair weather since 1925 and very bad weather indeed since 1928.

Stabilization at the pre-war figure involved some fall of prices, though it was not a great fall initially, and would not perhaps have proved serious had production costs been more flexible and had the general conditions affecting British foreign trade been less seriously deranged. Wages would not come down; in some cases technical equipment and methods proved inefficient and difficult to change. Labor has been immobile, both externally and internally. It does not leave the country and it does not move readily between industries within the country. The dole has intensified both evils, being based on the principle that the worker should have employment in his own type of occupation. Generations of employment in specialized industries unfit both capital and labor for other employment. Specialization in foreign trade industries creates the problem of unequal magnitudes as between industries. Once these trades are lost, the productive factors must shift into other foreign trade industries of equal magnitude or must migrate to other countries. There cannot, in the nature of the case, be domestic alternatives, and foreign trade alternatives do not present themselves full-blown. Meantime high wages, high taxes, and the dole constitute a tremendous burden upon capital. There thus develops a vicious circle. Foreign investment is preferred to home investment, but export trade does not respond because costs are high relative to foreign costs. Imports increase relative to exports. The increase of foreign investment and of imports throws domestic industry out of employment, which further decreases export trade, and further increases foreign investment as against home investment. The cumulative effects are just the opposite of those which existed in the pre-war period. They have exercised, of course, an insistent pull on British gold.

There has been evidence since June of a better understanding of the world's problem and of a greater willingness to work it out. There is as much danger of over-pessimism today as there was of over-optimism in 1928. The process of adjustment will no doubt be gradual, but it will proceed much faster if there is continuing evidence of a disposition to make mutual adjustments. England's suspension of the gold standard was economic nature's temporary cure for an impossible situation. It affords temporary relief by lifting prices, since costs will not decline; it should to some extent improve the trade balance and revive trade, and there is some evidence that this is happening. But it is not a permanent remedy. The most pressing problem at the moment is to relieve the uncertainties of Germany's position. The solution of gold maladjustments does not readily suggest itself. The problem will of course be less acute under more normal conditions. It is unlikely, if we make proper adjustments now, that the world will soon again have to face international movements of such speed and magnitude, or of such uneconomic origin and character, as we have witnessed since the war. The immediate problem is to restore normal conditions. The greatest single help of international character would be the further postponement and substantial reduction of war debts and reparations, along with the slow and orderly liquidation of German private debts. Looking farther ahead, I favor improving the gold standard rather than abandoning it in favor of some other standard. There is still much room for economizing gold and for improving the mechanism and control of international clearance. With war debts reduced and some of the abnormalities of international payment thereby removed, it should be possible by international coöperation to work out a better administration of the monetary standard.

[i] On November 14, 1931, the Reichsbank's reserve, exclusive of credits owed to foreign central banks, was about $131,000,000.

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