Week 1. The Gold Standard.

How did the Gold Standard operate in its 'heyday' (1870-1914) and what was the role of London? What internal and external functions did the Gold Standard fulfil and was there an inherent conflict between them?

Why did Britain leave the Gold Standard in 1919? Examine the causes and consequences of Britain's decision to rejoin the Gold Standard in 1925 at $4.86.

What forces drove Britain off the Gold Standard once again in 1931? How did this benefit Britain?

Readings.

Eichengreen, B., *The Gold Standard in Theory and History* [Chapter 1 (Eichengreen)]. Explains how the standard worked.

Eichengreen, B., *Golden Fetters* [Chapter 2]. Contrasts the pre-war and inter-war Gold Standard.

Levacic, R., and A. Rebmann, *Macroeconomics: an Introduction to Keynesian-Neoclassical Controversies*. [p161-74]. Useful (traditional) analytical framework.

Pollard, S., The Gold Standard and Employment Policies between the Wars [Chapters 1 (Keynes) and 4 (Sayers)]. Explains the economics – and politics – of 1925.

Walcott, S., 'Keynes versus Churchill: Revaluation and British Unemployment in the 1920s,' *Journal of Economic History* (1993). Examines the consequences of over-valuation.

Eltis, W., and P. J. N. Sinclair, 'The Money Supply and the Exchange Rate,' *Oxford Economic Papers Supplement* (1981). [Chapter by Dimsdale]. Heavy going but very worthwhile, discussing the impact of 1925 and 1931.

Cairncross, A., and B. Eichengreen, *Sterling in Decline*. [p52-102]. Examines whether devaluation was inevitable.

Redmond, J., 'An Indicator of the Effective Rate of Exchange of the Pound in the 1930s,' *Economic History Review* (1990). Describes briefly the exchange rate movements after devaluation and discusses their importance.

Richardson, H. W., *Economic Recovery in Britain, 1932-39*. [Chapter 8]. Examines the mechanisms by which cheap money stimulated recovery – they are not the ones which we would normally expect.

THE GOLD STANDARD.

The Classical Gold Standard.

1. How did the Gold Standard work?

a) Price of currencies fixed in terms of gold (and therefore each other). Legal right to convertability in UK, where all new note issue (and most existing note issue) was fully backed by gold.

b) Surplus or deficits in BOP were offset by movements in gold (Hume's model) or movements in interest rates (Whale model). The movements in gold (interest rates) changed the price level (price of securities). This automatically adjusted the level of domestic activity in order to restore equilibrium.

c) The gold standard was theoretically self-regulating. (E.g. demands for gold induce the Bank to sell/buy securities from banks and alter the money supply). These were the *'Rules Of The Game'*. But Nurkse (1944) and Bloomfield (1959) showed that these rules were violated via sterilisation.

d) Co-operation was essential (Scammel). E.g. banking crises such as Baring (1890).

2. What was London's role?

a) London was the centre of all the most important markets (gold, securities, commodities etc) and facilitated trade.

b) The Bank acted as a Lender of Last Resort, not only to the commercial banks but also to overseas institutions etc (e.g. it co-operated with the Bank of France to ensure the smooth functioning of the gold standard).

c) London provided liquidity through the circulation of sterling. There simply was not enough gold in the world to facilitate trade, so many institutions (especially central banks) operated a combined gold and sterling standard (Scammel, 1965).

d) The Bank 'led the international orchestra' by signalling the need to raise interest rates.

<u>BUT:</u>

e) The Bank's actions may not always have been benign - the Triffin Effect (1968). Evidence from Moggridge and Kenen.

f) Supporting the gold standard placed great strain on the Bank's liquidity (e.g. 1890, 1893, 1896, 1907) because it had only limited reserves. Yet this was an essential attribute of the gold standard. Hence it can be said that the strength of the gold standard depended on London, as much as the strength of London depended on the gold standard.

3. What functions did it perform?

a) Regulated the domestic price level and inflation rate by determining the money supply ('Knave-proof'). Predictability ought to encourage more planning and investment.

b) Fixed exchange rates, international co-operation and the ease with which accounts could be settled all stimulated trade.

BUT:

c) Broad money varied more than the gold supply.

d) The gold supply and aggregate output both varied over time, so that the price level could still fluctuate.

e) Changes in the *levels* of price and output in the UK and US were more moderate under gold (Bordo, 1981). But *fluctuations in output and prices were more severe (only UK price fluctuations were less severe).* Predictability of changes was equally bad under both regimes (Cooper, 1982, tested this by seeing whether real interest rates rose during deflations).

The Return To Gold (1925).

1. Why return to gold at all?

a) Pride and tradition.
b) Keep down inflation (bad European experience and bad UK experience in 1920) - said to be "knave-proof".
c) Beneficial output effects of stabilising the external rate of exchange (promote the hard-pressed staples such as steel; keep pre-eminence of London and encourage invisible trade). Worked in tandem with rationalisation etc. in order to lower unemployment.

2. Why choose $4.86?

a) Focal due to pride and tradition.
b) UK price level had risen much higher than the competition and it was thought desirable to deflate prices (a higher parity ensured greater deflation).

c) Everyone (except Keynes) overestimated the degree of downward wage flexibility after the relatively painless experience of 1920. (This error was avoidable, as Lipsey showed).
d) Some people anticipated that the US price level would rise due to their BOP surplus (although in fact the Fed sterilised the gold inflow).
e) Labour costs fell more rapidly in the US than in the UK (productivity rose faster) allowing stiffer price competition.
f) The UK government could not foresee that France and Belgium would choose to rejoin the gold standard at a much lower parity than either the UK or historical experience.

3. Was sterling overvalued and with what consequences?

a) Note that sterling only rose to $4.86 on the back on a rise in interest rates. The capital account was fundamentally weak compared to the pre-war situation, which necessitated continuously high interest rates to defend sterling.
b) Keynes thought that sterling was overvalued by 10% - and is supported by Moggridge. Lower parity would have boosted exports, employment and economic dynamism (easier adjustment). Any competitive benefits (such as a lower RPI due to cheaper imports) was absorbed as a higher real wage.
c) Eichengreen's model of competitive deflation shows why it was rational (but Pareto inferior) for France and the US to take advantage of the UK's new weakness.

BUT:

d) The Bank thought that the parity was correct and is backed by evidence on monetary aggregates. Wright argues that decline of staples was inevitable and shake-out was necessary (some overvaluation may have been *beneficial*, and Lorenz might agree).

Devaluation (1931).

1. Was devaluation inevitable?

a) Yes - Moggridge feels that the underlying economy was not strong enough to support $4.86.
b) No - model by Eichengreen and Cairncross. Capie.
c) Devaluation prompted by a series of unfortunate accidents (Central European liquidity crisis caused a banking collapse; the Navy mutinied at Invergordon; the Labour Government could not agree on budget cuts in order to balance the budget; the Macmillan Report was released at an inopportune time).

2. What was the result?

a) The Bank allowed (and encouraged) a low sterling value. They operated a managed float through the Exchange Equalisation Account).
b) Permitted the cheap money policy which sparked recovery (housebuilding, investment). But this was only *permissive*.
c) The UK export performance improved (as a share of world trade UK exports declined more slowly after 1931). But the gains were small and there was not much relief for the staples (due to the Depression). They gained more from protection and rearmament.

REDMOND, "An Indicator Of The Effective Exchange Rate Of The Pound In The 1930s," *Economic History Review* (1980).

1. Redmond emphasises the persistence of the devaluation effect after 1931. This is in contrast to previous authors who have focussed on the sterling/dollar rate and consequently found that Britain's devaluation advantage was quickly removed.

2. Redmond measures the overall value of sterling by an Effective Exchange Rate Model which weights all the various sterling exchange rates by their importance in international (merchandise) trade. He constructs a range of Effective Exchange Rates based on different weights. Redmond uses a *bilateral* weighting system which weights the change in each sterling rate by the proportion which that trading partner represents in Britain's total value of trade; he also uses a *global* weighting system which weights the change in each sterling rate by the proportion which each country represents in total world trade.

3. The rationale for the global index is that it takes into account *third country effects* (e.g. the effect on British trade with Germany of a change in the sterling/franc rate). Redmond also offers a *composite* index which is a geometric mean of the other two rates.

4. Redmond finds that the effects of the sterling devaluation did not wear off within a few years (as is usually argued). In fact sterling only recovered its gold standard parity around the end of 1936. Redmond also finds that the rise in sterling after its initial fall was steady. From this he concludes that the devaluation effects were both larger and more *benign* than is usually thought.

<u>BUT:</u>

5. The elasticity of demand for exports was low in the 1930s, so that even *a substantial fall in price was of little benefit.* (Indeed, if elasticities were low enough then devaluation may lower the total value of exports and worsen the balance of payments problem rather than improving it). Hence the benefits of devaluation were felt through the *domestic* cheap money policy which it permitted, rather than through export-led recovery as we might have expected.

6. An effective exchange rate model may lead us to seriously overestimate the benefits of devaluation. E.g., the average may hide the fact the sterling/dollar rate rose dramatically whilst the sterling/franc rate fell dramatically. The benefit to Britain of such a change might be much less than if they had both conformed to the average change. This is because it may take some time for the large fall in the sterling/franc rate to be reflected in increased demand for British products. (With imperfect information the French importers may not know that British prices have fallen below the prices of their established sources, such as Germany - therefore there will be a switching delay). However, the rise in the sterling/dollar rate may have immediate effects because the US importers know immediately that their suppliers have increased their dollar prices. Therefore US demand may fall before French demand rises. The overall impact on demand for British goods may not be as benign as the effective exchange suggests.

WRIGHT, "Britain's Inter-War Experience"
Oxford Economic Papers Supplement (1981), edited by Eltis and Sinclair.

1. It is argued that the overvaluation of sterling after 1925 was a major cause of high unemployment in Britain. This is plausible because theory predicts that overvaluation would lower profitability and raise unemployment particularly in those industries producing tradable goods (such as iron and cotton) which were empirically the hardest hit. Also, those industries faced higher demand elasticities and therefore the adverse impact would be most marked.

2. We would expect the contraction of the traded sector to be offset by expansion in the non-traded sector - unless a BOP weakness prompted monetary tightness (to defend sterling) which also depressed the non-traded sector. (p282).

BUT:

3. Monetary policy was not outrageously tight after 1925. UK *real* interest rates were high by historical standards after 1925 - but they were not particularly high by international standards (i.e. the UK had merely ceased to enjoy an advantage to which it had become accustomed). (p283).

4. There were no exceptional quantitative restrictions on credit on prudential grounds (even though asset prices were falling); by 1927 bank loans and advances were about 55% of deposits (which was about the usual level). Indeed, Midland Bank were trying to encourage deposits from overseas in order that they could increase their domestic lending.

5. If money were tight then we would expect the velocity of circulation to increase (a fall in the ratio of money stock to income). Sheppard (1971) shows that velocity rose slightly 1924-5 but was roughly constant thereafter until 1929 (whereupon it fell due to the cheap money policy). (p285).

6. UK growth was low by international standards in the late 1920s but not by UK standards (there was no relative decline). The exceptional problem for Britain was the diversity of industrial experience (massive decline in staples versus strong growth in new industries). But we can ask to what extent this was inevitable and independent of the gold standard. (p291).

7. Firstly, international technology transfer and consequent new capacity overseas occurred the war: this led directly to over-capacity and invasion of traditional UK markets (e.g. cotton). Secondly, there were more substitutes for UK staple products (e.g. oil for coal). Thirdly, UK industry had become grossly over-manned and inefficient (e.g. between 1913 and 1923 coal production fell by 5% but the workforce increased by 6%). (p296).

8. If the shake-out had not occurred in the 1920s then it would probably have done so in the 1930s (in steel in continued in both decades). If Lorenz is to be believed, only a massive adverse demand shock was sufficient to lift most UK industries out of the low productivity equilibrium into which they had fallen. (p297).

9. If this argument is valid then we can only ask whether a lower parity could have assisted

matters by making labour transfer between industries easier. It probably would not have done so. A devaluation would not have greatly slowed the precipitate decline of the staples nor greatly encouraged the expansion of other industries. Many of the alternative industries (such as chemicals and electrical engineering) in any case enjoyed protected status which had a similar effect to a devaluation. (p298).

10. We should also note that the UK employment record was not very bad in absolute terms (the workforce increased substantially during the 1920s so that total employment rose even whilst the rate of unemployment rose). (p292)

Capital Markets.

1. Before and after the First World War London was the major international financial market - but the position of London nonetheless changed drastically either side of the War. Before 1914 the UK short term capital account was roughly balanced and the large invisibles surplus enabled Britain to lend abroad long term on a large scale with impunity. Consequently, the Bank of England could usually keep sterling steady by small adjustments in interest rates (sometimes combined with gold devices) which did not put substantial pressure on the domestic economy. Severe fluctuations hit the domestic economy but they were only *transmitted* by the gold standard, not caused by it. (p287).

2. In the 1920s the short term inflows amounted to only half of the short term outflows. The deficit had to be made up by attracting short term funds ('hot money') via high interest rates. Hence London was borrowing short to lend long. This was compounded by the fact that everyone recognised Britain's new weakness and this made them more jittery than heretofore.

3. The Bank's reaction was to limit new issues of overseas debt on the London exchange, a strategy which became more marked after devaluation. (p288). This mechanism (combined with a reduction in the demand for loans after the crash of 1929) improved Britain's balance of payments position and was probably more powerful than the devaluation effect itself. It was the surplus on capital account that countered the decline in the current account after 1930, although the net result was still a BOP deficit in the 1930s compared to a surplus in the 1920s. (p291).

[NB There is some useful detailed discussion of wage flexibility in the 1920s compared to the years before and after, quoting Pigou, Bowley et cetera]