WORLD MONEY September 27, 2010

Gold Standard and the Impossible Trinity

I recently read Liaquat Ahamed's "Lords of Finance: The Bankers who Broke the World", a book on monetary policy, inflation, exchange rates and economic activity in the four major economies (Britain, U.S., Germany and France) between the end of the First World War to the banking crisis (which led to a global depression) in the early 1930s. I would strongly recommend the book to anyone interested in the subject. The story of the Gold Standard in Britain and the U.S., of the disaster that awaits those who allow the financial economy to become the master of the real economy, is very interesting, and perhaps a time has come in our case to ponder on the issue. (Most of the facts in the column are borrowed from the book; the views are of course of your columnist's.)

The Gold Standard which existed in much of the global economy right until the First World War, meant that the supply of money was determined by the reserves of gold held by the central bank. Money supply bore a fixed ratio to the gold reserves: the ratio was rarely 1:1, and differed from country to country. But in all the leading economies, the ratio was large, and the central bank was under an obligation to convert domestic currency into gold at a fixed rate. Under major national emergencies, war for example, the stipulation was relaxed, but the expectation always was that the Standard would be restored as soon as normal conditions prevailed once again.

During the era, capital was free to move in and out of national economies and, in effect, capital flows, and fresh gold supplies, determined interest rates, money supply and, therefore, also economic activity. Under the Gold Standard, in effect, to use modern jargon, of the impossible trinity, central banks gave up an independent monetary policy but held on to a managed exchange rate and free capital mobility. Given that money supply was automatically adjusted to gold reserves, central banking did not require economists or, indeed, much analysis. (John Kenneth Galbraith has described the U.S. Federal Reserve of the immediate post-First World War years as "a body of startling incompetence"!)

There was an almost theological belief in the virtue of the Gold Standard and conservative bankers considered any devaluation as tantamount to cheating investors and creditors.

It was fortuitous that during much of the 19th century fresh supplies of gold were in reasonable alignment with economic growth, and the Standard worked relatively smoothly. If domestic costs/prices were high, a deficit on trade would result and needed to be financed by an outflow of gold and therefore a drop in money supply. This would lower economic activity and domestic prices, thus helping restore the trade balance. On the other hand, for surplus countries, gold inflows would lead to an increase in money supply and therefore higher domestic prices which would correct the surplus.

The Gold Standard was relaxed during the First World War, resulting in high inflation in the major economies. Amongst the major powers, broadly speaking, post-war, U.S. and Britain followed deflationary policies while France and Germany preferred to print money leading to inflation and a devaluation of their currencies. The problems were compounded by the imposition of huge reparations on the defeated Germany.

France went back to the Gold Standard in the 1920s, but at an undervalued exchange rate, which led to a highly competitive, fast growing economy. Britain, in contrast, took a far more “fundamentalist” stance on the exchange rate with the Bank of England insisting on restoring it back to its pre-war level despite the huge increase in domestic prices in the interim. Winston Churchill, the then chancellor, even while complaining that “*The Governor of the Bank of England shows himself perfectly happy with the spectacle of Britain possessing the finest credit in the world simultaneously with a million and a quarter unemployed*”, succumbed to the pressure from bankers, and restored the pound to the pre-war parity with gold, in 1925. The result was an uncompetitive domestic economy, huge unemployment, trade deficits and pressure on the gold reserves as the sustainability of the exchange rate came increasingly under pressure. Even after inflicting huge costs on the real economy, the exchange rate could not be maintained and the gold standard had to be abandoned in 1931.

In our today's version, we have opted for an independent monetary policy, ever-freer capital movements -- the latest move increases the ceiling on FII investment in the debt market by $ 10 bn – and, lately, allowing the exchange rate to go where it will: it has appreciated by almost 12% over 2008-09, in real effective terms, and is even higher than in 2007-08. Meantime, the trade and current account deficits continue to widen year after year, with huge loss of potential output and jobs. Should we fall victim to the impossible-to-sustain trinity of unfettered capital inflows, an appreciating currency, ever-growing deficit on the current account? The music stops one day and a crisis results – recall East Asia in 1997-98. But more on this next week.

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