The gold standard and the euro-area[†]

Paper submitted to

"The euro: (Greek) tragedy or Europe's destiny? Economic, historical and legal perspectives on the common currency"

Scott Andrew Urban*

ABSTRACT

The euro is only the most recent European effort at monetary union. The closest recent parallel is the interwar gold standard. In both cases, membership is hard-won and ostensibly irrevocable. In both cases, formation of the currency union occasioned a large influx in external capital for some members. Then comes a "sudden stop". The sovereign has borrowed in a currency over which it has limited or no control. Upholding the monetary order is deemed paramount. Among other things, this removes the exchange rate as an adjustment mechanism. It also imposes a constraint on lender-of-last-resort financing from the monetary authority. The initial policy response is to protect creditors and pursue adjustment in wages and prices. When this approach fails, heterodox policies get a hearing.

† JEL codes N24, F33, F34

* D.Phil. candidate, St Antony's College, Oxford. scott.urban@gmail.com

I.

> According to the earliest figures available by countries and by months, beginning in March 1931, approximately 40% of American short-term claims were on Germany, and there were substantial amounts in other central European countries, all of which had previously depended heavily on external borrowing. The rapid deterioration of the economic and financial structure of these countries as the world depression deepened led to a general run on them by their creditors, which produced the mid-1931 crisis of illiquidity, characterised by exchange control and blocked balances, and in Germany by the famous "standstill" agreements providing for a gradual repayment of part of its short-term obligations.
>
> Lary, H.B., *The United States in the World Economy* (Washington DC, 1943), 109.

US lending on short-term -- mostly trade acceptances and private deposits -- financed a balance-of-payments deficit in key parts of continental Europe in the middle 1920s. A decisive factor in this influx of capital was monetary stabilisation on the continent. By 1926, all major economies there had coalesced into an irrevocable, fixed-rate currency arrangement.[1] With the perceived safety of this arrangement, private capital was free to flow in. What followed was, unfortunately, a sudden stop and a hugely difficult process of adjustment.

Fast forward seven-and-one-half decades and one finds a European continent similarly newly joined into an irrevocably fixed currency regime and another influx of capital pursuing ostensibly (newly) safe domestic assets. These inflows naturally were married to large balance of payments deficits -- in the GIPSI economies of recent notoriety.[2] This paper reviews the "sudden stop" in capital inflows which befell the continent in both episodes. It examines the immediate policy response and the background circumstances conditioning that response. It then reviews the intermediate and final policy steps that followed on the failure of initial responses.

---

[1] The irrevocable, fixed-rate monetary arrangement is, of course, the gold standard. Spain did not run a gold-convertible currency, although its central bank statutes did specify minimum backing of central bank money with gold and silver. See US Federal Reserve, *Federal Reserve Bulletin* (July 1932 and July 1936).

[2] Greece, Ireland, Portugal, Spain and Italy.

II.

> A common characteristic of those regions first to experience the economic slowdown [culminating in the Great Depression] was that they imported capital on a large scale in the second half of the 1920s. The fragile economic equilibrium of the period rested squarely on this lending.[3] … In the summer of 1928, increasingly stringent Federal Reserve policy choked off U.S. foreign lending. … A heavy adjustment burden was consequently thrust on the debtor nations…. To keep debt service current, the borrowers were forced to quickly shift their current account balances from deficit to substantial surplus. … Channelling these resources into debt service entailed a draconian compression of spending. Debtor nations tightened their monetary and fiscal policies to limit domestic spending, strengthen the balance of payments and mobilize resources for service of public debts. Downward pressure on domestic demand was the inevitable result.
>
> Eichengreen 1992, 226

Similar dynamics took hold with Economic and Monetary Union. Periphery members of the euro-zone, which for decades had borrowed at large premia to the core members, especially to Germany, saw a dramatic decline in borrowing costs after monetary unification. Yet although notably compressed, the yields on these securities still paid a premium to *bunds*, while offering the confidence (and regulatory benefit) of a AAA rating. What followed was a rapid inflation of the non-traded sector. Consider this summary from an IMF Article IV review of the Spanish economy shortly before the downturn:

> Despite recent interest rate hikes, liquidity and credit conditions remain expansionary, with real interest rates negative or close to zero. Private sector credit grew at over 20 percent, spearheaded by real estate lending, and household indebtedness rose to over 110 percent of disposable income by end-2005. Headline and core inflation differentials with the euro area widened to 1.8 and 1.6 percent respectively in the first quarter of 2006 and unit labor cost growth, while slowing down, remained above the euro area average.
>
> The external position deteriorated further in 2005, with the current account deficit reaching 7½ percent of GDP. Financial institutions intermediated external savings to meet the increasing financing need of the nonfinancial private sector, mainly through the issuance of mortgage-backed securities in euro-area markets. Net external liabilities reached 46 percent of GDP (International Monetary Fund 2006, 1).

[3] Such lending was over-and-above the amount needed to finance war reparations: "Until 1929 there was no year in which reparations payments exceeded German capital imports." Eichengreen 1992, 226.

A sudden stop in this external financing boom in hindsight seems inevitable. The falloff in financing was not a function of tighter US Fed policy as had been the case in 1928. But it *was* the result of tighter global monetary conditions. With the credit seizure and generalised paralysis in the interbank money markets following the Lehman Brothers collapse in autumn 2008, risk-free assets such as US Treasuries surged. A year later, the debt standstill announced by Dubai World in November 2009 provided a further blow to peripheral euro-area sovereigns: Dubai had been considered a safe credit, and -- like Spain, Greece, and Ireland -- Dubai's growth had been strongly centred in the non-traded sector and financed externally.[4]

Table 1: sovereign bond yield and current account as % of GDP

III.

A variety of factors conditioned the policy response when boom turned to bust. Foremost was preservation of the monetary order. Policymakers in the interwar period went to great lengths to preserve the 1920s fixed-rate monetary system and in so doing drove down domestic demand, thereby transforming a series of unfortunate deflationary impulses (falling commodities prices; a US stock market collapse) into a full-blown crisis of the world economic and financial system.[5] Only when policymakers abandoned the gold standard did activity begin to recover.[6] Yet the admonitions to avoid this outcome came till the end:

> It would be difficult to devise a measure that would give a greater shock to the world's trade and credit than departure of Britain from the Gold Standard. <u>Countries have put a trust in us which can only be betrayed with grave moral and economic reactions.</u> Deposits were entrusted to London because they were withdrawable in gold; if London now repudiates this obligation, what centre will any lender trust? (emphasis in orig.) (UK Nat'l Archives 1931).

This excerpt from a memo circulated by British Prime Minister Ramsay MacDonald in early September 1931 came even as the gold standard in Europe had begun to

[4] The UAE, to which Dubai belongs, runs a current account surplus, but Dubai is not a source of it.
[5] See Appendix for a sketch of the Great Depression chronology, drawing on Eichengreen 1992.
[6] Viz Temin in the *New Palgrave Dictionary of Economics:* "Adherence to gold-standard policies led to a set of currency crises in 1931 that turned a bad recession into the Great Depression." Temin 2008.

unravel, compounding an already parlous domestic situation. UK unemployment was approaching 2.5 million, the social benefit payments for which were excavating a deficit in the government's accounts and by extension the balance of payments. The freezing of assets by Germany and Austria further encumbered the UK's external position, since it was a net creditor against them (Eichengreen 1992, 283-284).

When the decision to abandon gold came on September 21, 1931, the financial press were by no means sanguine.

> The facts must be faced that the disappearance of the pound from the ranks of the world's stable currencies threatens to undermine the exchange stability of nearly every nation on earth; that even though London's prestige as an international centre may gradually recover from the severe blow which the sterling bill has received, banking liquidity throughout the world has been seriously impaired, much more so in other countries than this; that international trade must be temporarily paralysed so long as the future value of many currencies is open to grave uncertainty; and that, though the memory of the disastrous effects of post-war inflations should be a useful deterrent, there is an obvious risk lest we may have started an international competition in devaluation of currencies motivated by the hope of stimulating exports and leading to a tragic reversion to the chaotic conditions which existed five or six years ago (*The Economist* 1931).

Why the overarching imperative to preserve the monetary order? Partly the answer is inflation. In hindsight it seems inconceivable that 1930s policymakers and commentators were obsessed with inflation, with such weak demand conditions and such huge reserves of unemployed labour. Yet from their vantage point, the most horrific episodes of inflation had only recently been visited upon continental economies such as Austria, Poland and Germany immediately after the First World War (inflation was high in France also in those years). Even so, the real threat now was the opposite of inflation. As Eichengreen notes: "There is no little irony in the fact that inflation was the dominant fear in the depths of the Great Depression, when deflation was the real and present danger" (Eichengreen 1992, 24).

To sum up: departure from interwar Europe's irrevocable monetary union was seen ex-ante as cataclysmic, and such fears undoubtedly motivated the best and noblest of the commentariat and the policy elite to prod the economy into harsher and harsher austerity.[7] Ex-post, departure was seen as good policy.[8]

---

[7] These are Paul Krugman's Very Serious People. See Krugman 2011b.

Overlay this history with today's situation. Foremost, departure from EMU is seen as an existential threat to the European project:

> "If the euro fails, not only the currency fails. Europe fails too, and the idea of European unification…. This test is existential -- it must be passed. If it does not manage to (be passed), the consequences for Europe and beyond are unforeseeable."
>
> Angela Merkel, May 16, 2010

IV

What is meant by 'gold standard', and how does this relate to today's circumstances?

The "gold standard" was a national currency regime and, when practiced widely, an international monetary system. As a national currency regime, the gold standard meant (a) allowing private agents to convert the domestic currency into gold at a fixed weight, (b) allowing gold to flow out of the country and (c) requiring the monetary authority to maintain some kind of quantitative or "backing" relationship between currency notes (or all central bank money) and gold. Such a regime of domestic money management was pursued in part because it encouraged fidelity to monetary and fiscal rectitude. These were necessary to keep the currency's link to gold and this link was seen as the best defence against currency debasement, chastening examples of which were well known to pre-WWI policymakers in the French *assignat* ("the first classic hyperinflation in modern Europe") and to interwar policymakers in the German, Polish and Austrian hyperinflations of the early post-WWI years (Sargent and Velde 1995, 476).

As an international monetary system, the gold standard dictated the exchange-rate relationships between countries. The parallel with EMU is clear. Whatever else its importance, a country's exchange rate determines how its economy will adjust to shocks, whether of foreign or domestic origin. The sudden stop in capital flows to the European periphery in the past several years, like the sudden stop to Germany and many other continental European economies in the interwar period, was such a shock. It is a shock in part because, as seen from the previous excerpt from the IMF's 2006

---

[8] But this consensus was not settled until 60 years after the event, taking the Temin-Eichengreen work as arrival of the new consensus (Temin 1989, Eichengreen 1992).

Article IV review of Spain, growth under the capital inflow boom is centred on non-traded parts of the economy -- e.g. real estate and construction. If credit conditions no longer allow growth in such sectors, then the economy is exposed to a severe contraction, since its traded sectors have become highly uncompetitive due to above-average rises in the costs of labour and (non-traded) inputs. One approach to switching resources from the non-traded to traded sectors is a currency devaluation, to make the traded sectors once again internationally competitive.[9]

The EU's decision to view euro-area integrity as a Maginot Line dictates that the exchange rate can play no role in such adjustment, just as the Very Serious Persons of the interwar period insisted that departure from the gold standard could play no role in response to the incipient Great Depression.[10] As in the Great Depression, the burden of adjustment for troubled EMU members falls on domestic prices and incomes.

V.

Preservation of the monetary order conditioned the immediate policy response to the Great Depression, as it has conditioned the policy response to travails in the European periphery today. What exactly is that response? Foremost is the response to over-indebtedness. Preservation of the monetary order precludes unconditional money expansion to relieve indebted sectors (true bail-outs, as opposed to the phony "bail outs" of the past three years which add more debt to existing debt). As these economies in both eras suffered a sudden stop in inflows, they witnessed a dramatic decline or outright contraction in money growth. One consequence is insolvency among those unable to meet obligations for lack of sufficient liquidity, no matter their long-term or fundamental business or personal viability. Unconditional money expansion, by contrast, is a deliberate effort to ease monetary conditions. It is enacted by the monetary authority in the form of base-money expansion through the purchase of domestic assets. These purchases not only inject new money into the economy, they support the price of these assets, keeping their owners balance-sheet-solvent. This is 'quantitative easing' in today's parlance. It was a discretionary tool available

[9] It is another matter whether this devaluation will trigger an offsetting inflation.
[10] As events will bear out, it is helpful to think of each EMU member as having an exchange rate even when there is no such independent currency nor quoted exchange rate. For the moment, it is merely a 'shadow' exchange rate. As these members are sovereign nations, their exchange-rate regimes merit recognition, and are so recognised as “no separate legal tender” by the IMF.

neither to countries under the gold standard nor to EMU members today. In both cases, the most that can be hoped for is that the nearest, biggest authorities or central bank can arrange interim financing.

It is a stylised fact of the gold standard that one of its chief demerits is the limitation on the role of such last-resort-lending by the central bank. In 1931, the Austrian central bank in fact *did* attempt to liquefy the troubled Credit Anstalt at the first emergence of bank runs in May 1931. But this effort soon came into conflict with the Austrian shilling's link to gold (Schubert 1991). As is known from the monetary approach to the exchange rate, the expansion in Austrian money supply put downward pressure on the shilling's value in the foreign exchange market. Only by spending its international reserves could the central bank maintain the shilling's value (in other currencies and thereby in gold). Obviously it had limited resources to carry this out. As they approached exhaustion, fundamental choices had to be confronted.

Table 2: Supplies of base money

Seeing the predicament of the authorities, and the potential for spillover to the rest of the continent -- Germany through a learn-by-example flight of capital (known today as "contagion") and Britain through a souring of British investments -- neighbours attempted to help. Support was arranged but proved insufficient in the face of panicked outflows -- featuring not only foreign depositors but domestic ones too. The choice was: preserve the outward manifestation of the monetary order or allow the currency to float. The Austrian authorities went for the former, as did Germany at about the same time, both of them now suffering a disastrous flight of capital. In order to maintain the outward appearance of a gold standard, the exchange rate was nominally guaranteed at the official rate ex-ante, but access to foreign exchange at that rate was rationed. These became the currency controls and debt standstills noted in the opening quote of this paper.

As in Austria and Germany, authorities throughout Europe faced a dilemma in how to respond to the crisis. The Great Depression was a laboratory in which dozens of countries were left to find their own way to respond to the failure of initial attempts to preserve the gold standard. For some countries, honouring foreign credits to the government was deemed paramount, and in service to that, exchange controls were erected in order to corral export earnings (Nurkse 1944, 162). In other countries, exchange controls were pursued in order to allow a more expansive stance by the monetary authority while limiting pressure on the exchange rate. Denmark and Germany are two examples. Such controls were avoidable on the current account, e.g. through mis-invoicing of trade. With further strains, the authorities either had to clamp down on all cross-border transactions (Germany's choice, which made it an "exchange-clearing country"), devalue (typically followed by pegging again to the main trading partner) or contract domestically in order that the strain in the foreign exchange market is eliminated. This latter was Denmark's choice, which came in 1935 (Nurkse 1944, 53). It pursued a contraction in domestic money supply which rivalled anything seen during the gold standard, and it succeeded in maintaining the kroner's link to sterling. (Like most of the rest of the world, Denmark initially allowed a large devaluation in the domestic currency when it followed Britain off the gold standard. When confronted with subsequent strains in the balance of payments, such countries either subverted domestic policy to the needs of the exchange rate or imposed capital controls, rather than letting the currency devalue. Urban and Stramann 2012)

All of which can be framed in the language of the monetary trilemma. The trilemma is the dictum that policymakers can sustainably choose only two in the triad of fixed exchange rate, open capital account and independent policy. This helps map out a decision set for when the initial response to preserve EMU proves unsustainable. As it happens, one can find all of the policy configurations in the Great Depression after defence of the gold standard proved only to make matters worse:

a) Devalue, default and re-globalise.

Letting the currency float in the foreign exchange market meant a decline in its value against other currencies. This improved the current account of the balance of payments in two ways: through the trade accounts (higher exports, lower imports) and through the impact on debt-service through default. Note that default can be unilateral (as in the case of Argentina 2002), coercive (as in Greece today) or implicit: Britain's 1931 devaluation left sterling bills worth less in gold than had been expected when the borrowing was transacted.

Countries which followed the devaluation route -- whether or not accompanied by default -- re-engaged with the global economy subsequently in the classical gold standard sense: with (increasingly) open capital accounts, fixed exchange rates and free trade.

b) Capital controls (first on current account, sometimes followed by all transactions).

As noted earlier, capital controls can be instituted precisely in order to repay external creditors; to marshal foreign exchange for that purpose. After all, if the objective is to keep creditors whole, there is no point in having to pay them back in a depreciated currency.

c) Trade barriers

As noted already, most countries in the depths of the Great Depression could not countenance leaving the gold standard, or at least the exchange-rate manifestation of a gold standard. Those which had entered the Great Depression in a relatively strong position gradually instituted a variety of barriers to trade, in order to provide a covert devaluation. France and the other countries of the 'gold bloc' are the main members of this group.

Reflecting back on the interwar period, Ragnar Nurkse -- arch critic of flexible exchange rates -- wrote that, when a currency is chronically overvalued, "the interests of outside countries in a revision of exchange rates is … plain; thus in 1935, for example, the outside world would have generally welcomed a certain measure of devaluation in France and Germany in preference to the alternative policies of deflation and import quotas in France and drastic exchange controls in Germany." (Nurkse 1944, 224).

One could put this another way. In preserving the manifestations of the monetary order, the outcome might be illiberal. The path to sustenance of globalisation and the liberal order might paradoxically lie in the abandonment of the trappings of the prevailing monetary order and the monetary orthodoxy.

Why is the initial policy prescription so unlikely to succeed? Again we turn to Nurkse:

> The reason [for the need for devaluation of a chronically overvalued currency] lies in the rigidity of wages and prices. Under existing conditions it may be impracticable to keep exchange rates permanently fixed since it is difficult or impossible to secure the adjustment of domestic money incomes needed to close a persistent gap in the balance of payments. A deficit country could close the gap by reducing total money income at home. Theoretically the reduction could be achieved by a concerted all-round cut of income-rates. In practice such a reduction, especially in a highly industrialized country, is liable to take the initial form of unemployment; and even if, as a result of this unemployment, it comes to be gradually "diluted" through wage-reductions, the adjustment is apt to be painful and slow. (Nurkse 1944, 225)

In the case of EMU, keep in mind the notion of "shadow" exchange rates, which for the periphery economies are overvaluations and for the core -- at least Germany -- are undervaluations. Is there any hope for relief being provided through an inflation in the undervalued core? Nurkse was sceptical:

> But the upward adjustment of incomes that would be necessary in the event of a persistent surplus may also encounter difficulties: for if a country's labour force is already fully employed, this would require a general inflation of incomes, costs and prices. Experience has shown … that in a highly organized industrial community there may be considerable resistance to such inflationary adjustment with all its attendant disturbances. (Nurkse 1944, 225)

VI.

To sum up, the Great Depression teaches us to expect something like the following course of events in the euro-area:

1. Sudden stop

A sudden stop in external financing introduces a solvency threat either through existing high sovereign debt service requirements or the assumption of high levels of private debt through bail-out of the banking system.

2. Preserve the status quo ante

Maintenance of the existing monetary order (the system of irrevocably fixed exchange rates) is conflated with the preservation of society itself. This mistake was committed in the gold standard and is being committed today by EU leadership.

3. Appeal to austerity; provide interim financing

In order to achieve (2), i.e. keep creditors whole and preserve the monetary order, adjustment must be achieved through domestic deflation. In the trilemma language, policy independence is sacrificed in order to preserve free capital flows and a fixed exchange rate. Prices must deflate sufficiently to generate external surplus.

4. Failure of austerity

Monetary non-neutrality makes austerity-cum-deflation an unlikely means of generating the surplus. Debt problems are exacerbated and labour is under-utilized because too expensive.[11]

5. Provide more interim financing. Repeat Step 3, until:

6. Heterodoxy

Political upheaval triggers a solvency crisis -- the official lending stops and the sovereign cannot raise funds on the capital markets. Heterodox policy steps are enacted. A different leadership is required; the Very Serious Persons and their externally appointed technocrats will have been discredited. As has been written of the Great Depression: "The world economy did not begin to recover when [governing elites] changed their minds; rather, recovery began when mass politics in its various guises removed them from office" (Eichengreen and Temin 2000).

[11] In order for deflation to work, money must be 'neutral' -- in other words, real effects must be indifferent to price increases and declines. The reality is that, with a few notable exceptions (Hong Kong), money is non-neutral in some important ways. For example, deflation might well contribute to insolvency through heightening the real debt burden and unemployment by raising the real wage. Workers typically *do* accept eye-watering wage cuts but rarely on the order required to achieve competitiveness for the economy. Remember, in a balance-of-payments crisis, the economy needs to shift into a surplus, not just a balance. The implied adjustment in the real exchange rate is sizeable, unless you believe in the "doctrine of the immaculate transfer". See Krugman 2011a.

Adjustment comes in one or a combination of the following:

a) Devaluation

This produces the external surplus. It is accompanied by debt default, which also contributes hugely to the external surplus through the cessation of income payments on the current account (which made a striking impact on Argentine balance of payments post-default; see Edwards 2004).[12] For those worried that such a country will be shut out of the international capital markets, it is important to keep in mind (i) that an external-surplus economy is not asking for external capital, and (ii) that the international capital markets have a short memory. This makes intuitive sense: whatever one's opinion on the *morality* of a default, it cannot be argued that a country starting with a 'clean slate' and competitive currency might present a very good investment opportunity.

It has been alleged that in the Greek case, for example, a devaluation -- setting aside the issue of default -- would be pointless because the Greek economy produces nothing and because wages and prices would shoot up so as to nullify the competitiveness gains. We are deep in the territory of conjecture here no matter which view one takes. From all available evidence, price signals are fundamental toward redirecting the flow of resources in the economy. It is difficult to conceive that a ratio of relative prices strongly in favour of the traded sector would not in fact produce an external surplus, and one which, although initially aided by import compression , would in fact soon be composed partly of export expansion (including services e.g. tourism and transport).

b) Capital controls

Controls are first levied on the capital account, but might later extend to all transactions. Note that capital controls can be instituted precisely in order to repay external creditors; it is a way of marshalling all available foreign exchange for that

[12] Re-introduction of national currencies in EMU would be accompanied by redenomination of debts -- perhaps largely legally. More than 90% of Greek debt seems to be legally re-denominable were such a route taken. See Buchheit and Galuti (2010).

purpose. This step can be taken by a country that devalues or it can be taken as a step in avoidance of devaluation. The Great Depression is replete with examples of both.

If EMU members are dissuaded from issuing new currencies, and foreign creditors are to be kept whole, then some control must be exercised over interactions with the rest of the world. This would be all the more necessary when steps toward reflation of the domestic economy must be taken, which reflation would put further pressure on the shadow exchange rate.

c) Trade barriers

This step is a covert version of devaluation. It is taken by those unwilling or unable to part with the irrevocably fixed currency regime.

It is vital to recognise that only step a) is consistent with a liberal world order. However, if euro-area integrity is sought at all costs, trade barriers and/or capital controls will be sought (and countenanced in Brussels) as a form of relief.

The euro-area is currently in Step 5 of the Great Depression sequence sketched a couple pages above. It is sustained by repeated rounds of official lending, the potential extension of which is large. This financing goes beyond current lenders the EU and IMF; officially arranged sources of finance can be brought to bear from much further afield, in the form of sovereign wealth funds and other long-term investors. Yet even though official lending can sustain the loop implied by (5), it is not clear the population can.

Step 6 will come in the form of a leadership that endorses the exercise of national sovereignty -- including decisions over the national monetary system. By "leadership" is meant leaders at the EU level and/or national leaderships of the affected EMU members. It is beyond the scope of this paper to conjecture the political-economy dimensions of the next steps in the euro crisis. However, it is worth noting that abandonment of the monetary-preservation orthodoxy in the EU core would enable a more constructive and realistic policy approach to distressed debtors. Mutually agreed devaluations (i.e. re-issuance of national monies) could be countenanced and multilaterally agreed restructurings with creditors imposed. All with the explicit aim of currency-zone reconstruction at an unspecified date and with better fundamentals -- both in terms of national competencies and a unified pan-European fiscal framework.

VII.

One of the dangers of using the interwar period as a guide for policy is misreading the history. A common mis-characterisation is the "lesson" that closure of the open world trading system caused the Great Depression. Ángel Gurría, Secretary General of the OECD, explained in mid-July 2010 that protectionism is the real and present danger facing the world economy, citing the 1930s as an object lesson (Gurría 2010). This view no doubt enjoys considerable support. It is practically a 'stylised fact' in our historiography of the Great Depression (Washington's Smoot-Hawley tariff is prominent in such treatments). It is presumably uncontroversial among policymakers, since Gurría heads the official talking-shop of the world's advanced economies. That makes it all the more alarming, because it misunderstands the dynamics of global depression.

An authoritative contemporary review of the interwar problem (Lary 1943, 182) begins the subsection, “Summary of Experience, 1930-33”:

> The principal conclusion that may be drawn from the foregoing survey of the international transactions of the United States during the great depression is simple and obvious: Whatever may have been the other factors contributing to the breakdown of the world economy, an orderly and integrated international society could not be expected to survive a contraction [in US GDP] on the scale that occurred after 1929.
>
> ... It was inevitable that many foreign countries should have ceased to depend on internal contraction as a means of adjustment to external pressure ... and embarked on programs of domestic expansion. And it was also inevitable that most of them should have resorted to additional and more direct measures of curtailing imports and that these measures should have fallen with particular severity on imports from the United States in order to redress the balance. <u>Under these conditions many approaches to the problem aimed at immediate restoration of the international gold standard and removal of trade restrictions and discrimination were more concerned with the outward manifestations than with the basic causes of disorder</u>. (emphasis added)

Were France and Germany's illiberal trade policies a cause of the Great Depression or a consequence? Nurkse (1944), writing the League of Nations' review of the interwar monetary system, is unequivocal:

> In practice, apart from its inherent disadvantages, income deflation and unemployment as a means of adjusting the balances of payments is liable to encounter insuperable social resistances. In these circumstances the only remaining alternative to exchange adjustment in cases of chronic overvaluation is a policy of import restrictions (Nurkse 1944, 224).

The modern literature is equally clear on this question. Illiberal trade policies were a refuge from the Depression, not a cause. It was the dogged pursuit of fundamentally flawed policy which fomented and transmitted that depression.

> The failure of economic activity to stabilize reflected not the rise of trade barriers but the tendency of supplies of money and credit to fall more rapidly in gold standard countries than they rose in countries with depreciated currencies (Eichengreen 1992, 290).

The alarming thing about Gurría's comment is that if policymakers adhere to it, and to the general notion of maintaining the external manifestations of the monetary order at all costs, they make refuge in illiberal policy all the more likely. The true "existential threat" to Europe might not be disintegration of the euro-area; it might be the advocacy of policies which not only can't succeed but will push domestic politics to breaking point.

VIII.

There are key differences between today's predicament and the situation at the depth of the Great Depression, in 1931. Also worth exploring are the roles of key external actors and what, if any, are the parallels today.

Today, the non-euro area can be more supportive of growth than it was in the interwar episode. Then, other countries were as committed to exchange-rate fixity as were the continental Europeans. This meant they easily were swept up in the downdraught as the world economy imploded, and that their own policies amplified the negative impulse to global demand. This time, non-eurozone economies can respond in more helpful ways. Even if their governments are also pursuing austerity, their monetary authorities are free to provide some heft. In the interwar period, central banks were beholden to an extremely cautious line, for fear of upsetting the exchange rate and breaching statutory limits on the size of the balance sheet.[13]

The biggest difference between now and then is that if policymakers want to save the euro, they can do so in a way that was much more difficult to imagine in the interwar period. Then, the ultimate limit on money creation was the supply of gold. No such limit confronts the creator of the euro-area's currency, the European Central Bank.

With a change in ECB law, the ECB could commit unlimited funds to euro-area sovereign debt. It could do this in an accord with the euro-area's paymasters to create a centralised authority whose remit is to assist with members' structural adjustment and fiscal consolidation on a medium-term basis. It is no exaggeration to say that only a robust approach from the ECB can preserve the integrity of the euro-area. Providing emergency liquidity out of the central bank's balance sheet has been a staple of central banking from at least the nineteenth century. Whether Berlin can countenance such a vision of 'money printing' is unclear, given its memories of hyperinflation. The odds suggest that it will do so, in exchange for far-reaching integration.[14]

If Germany in the Great Depression is akin to Greece today, what country in the Great Depression was akin to Germany today? That country was France. Like Germany today, France then was an international creditor and was running large external surpluses. Also like Germany, it had achieved this status after a long bout of hardship and some internal difficulties. Hence France was keen that the international order be maintained (the gold standard), and that other countries do the tough work necessary to maintain it, just as France had done. France was strongly inclined to see the Great Depression as a consequence of insufficient effort to uphold the gold standard.[15]

The biggest creditor of the interwar period was the United States; a role which in limited respects might be analogous to that played by China today. The comparison is not auspicious. One thing the interwar world needed but lacked was a US economy as

[13] Such limits survived even the end of the gold standard itself. See Urban 2011.
[14] Note that this does not explain where growth will come from in the overvalued economies -- it does not explain how their prices will be adjusted to produce a favourable external position.
[15] The differences in viewpoint on the origins of the Great Depression scuppered the 1933 world economic summit in London, which had been convened to put the liberal global economic system back together. See Eichengreen 1992, 317.

capable of running a trade deficit as a surplus. But a trade-surplus mindset was firmly implanted (Lary 1943). It was only after the Second World War that the US policy establishment commissioned a detailed examination of the US role in the international scale of the Great Depression. The result is a 1943 publication of the US Department of Commerce (Lary 1943). A main point of the book is that US trade surpluses drained dollar liquidity from the rest of the world, which liquidity was not replaced by US lending after 1928. Note that not only is China a serial net saver today, its currency is no more heavily managed or pegged than was the US dollar in the interwar period (in fact, it is substantially *less* pegged than was the US dollar).

IX.

In view of what we know about the Great Depression, it seems impossible simultaneously to view the immediate policy response to the interwar gold standard's fissures as mistaken whilst reserving judgement regarding the current policy stance amidst fissures in EMU. In other words: one cannot simultaneously agree with the *Golden Fetters* view of the Great Depression whilst supporting the policy approach unfolding in Europe since May 2010. The current policy path has no explicit strategy for growth. The interwar experience teaches us that refuge from a contraction in activity, prices and wages will be sought. The only question is what form that refuge will take. Paradoxically, the policy elite's approach makes a liberal outcome increasingly less likely.

Appendix

The Great Depression and the Gold Standard

The Great Depression (1929-33) was universal. Policy is crucial to the story, because the Great Depression might not have been so deep and long-lasting if the policy decisions had been different. To anticipate the conclusion of this Appendix: policymakers in the Great Depression pursued steps which raised unemployment and shrank the economy.

At the time of the Great Depression, the prevailing wisdom held that no currency was trustworthy unless it was "pegged" to other currencies. This arrangement means that the government is forced to keep its budget in order. If it spends more than it taxes, the extra money it spends finds its way to the foreign exchange market (simply, the market where supply and demand for foreign currency meet). Normally, just about as much foreign money is arriving at the fx market seeking local money, as local money is seeking foreign money; supply and demand are balanced and the exchange rate is steady. (The central bank can fine-tune the market to ensure that supply and demand exactly balance -- thus "pegging" the exchange rate. It does this by buying foreign currency when too much is offered and selling it when too little is offered.)

When the government overspends, there's too much money arriving at the fx market. Unless all the other governments are spending this freely, there's no reason to expect their monies to show up at the fx market in these greater amounts. Hence, the 'home' government has created an excess demand for foreign currency in the fx market.

Yet even when Country A's government is completely virtuous (no fiscal deficits), its currency can still weaken. The government of an important trade partner, Country B, might run a fiscal surplus (collecting more tax than it spends -- maybe it's worried about inflation). A smaller amount of its money will show up at the fx market, while the same amount of Country A money shows up, meaning there is an excess demand for Country B's currency. Although Country A's central bank can fill the gap, it cannot indefinitely supply the excess foreign currency demanded, because its reserves of foreign money are not unlimited. So, in order to keep supply and demand balanced (in the fx market), Country A's government is going to have to cut its spending and/or raise taxes to generate a surplus. It will have to do this even if the economy already has a high unemployment rate and spending cuts will throw even more people out of work. The prevailing wisdom demands it, since the prevailing wisdom holds that the currency must be pegged.

The government budget is a policy tool in the previous example. Another, more immediate tool (though ultimately beholden to the budget; see Sargent and Wallace 1981) is the central bank's interest rate. It has the power to affect demand and supply in the fx market immediately (except in acute circumstances -- on which more later). By raising the interest rate offered on deposits in the domestic money, the central bank increases the demand for domestic money (both among local residents and foreigners). So here are two policy tools. When the currency weakens, these tools must be deployed to keep it stable, or "pegged". These tools can be painful (and politically difficult). Imagine the government hiking taxes and the central bank sharply raising interest rates in the midst of today's recession.

Weakness in the foreign exchange market can result from one's own fiscal deficit (in the absence of fiscal deficits among the neighbours), and from a neighbour's fiscal surplus (in the absence of one's own fiscal surplus). Think of any source of demand or supply for foreign exchange, and you've identified a source of fx market weakness. (Another is implied in the previous paragraph: a hike in the neighbour's central bank interest rate.) In the Great Depression, several sources of fx drain hit the world economy in quick succession. Each necessitated a counter-response: a tightening in fiscal or monetary policy or both. The essence of the Great Depression is that each tightening required another tightening, and so forth.

This chronology will draw heavily on Eichengreen 1992:

Commodity collapse. The first round of the Great Depression was underway before the US stock market crashed in October 1929. This round touched the economies which were exporters of primary commodities. A late-1920s decline in the prices of their exports resulted in lower export earnings. Yet their imports, which contained a large proportion of manufactured goods, were not getting cheaper. This generated gaps in their fx markets which drove them to a variety of policy responses: not only fiscal and monetary austerity, but re-doubling their quantity of commodities exported in order to raise more earnings. This itself only exacerbated the decline in commodity prices. In mid-1929, the bottom fell out:

> ... the precipitous drop in commodity prices after the summer of 1929 rendered even the most heroic adjustments inadequate. Resistance to policies of austerity, which were blamed for worsening the economic crisis or shifting the burden onto the working class, was mounting throughout Central Europe and Latin America (Eichengreen 1992, 231).

Capital retreat. As the US stock market bubble inflated in 1928 and 1929, it lured US capital back from abroad, as well as attracting foreign capital to the United States. Moreover, the Fed was raising the interest rate to fight the bubble, making US deposits more attractive. This was particularly damaging to Europe, because US citizens had been important providers of short-term capital there in the form of bank deposits.

Trading partner weakness. If a major trade partner suffers recession, it will affect your fx market in two ways. First, the depressed state of the economy reduces the demand for your exports -- hence fewer export earnings. Second, if that economy starts deflating, then its prices are falling below yours, so that your economy is uncompetitive against it -- again reducing your exports. The US economy had a big enough trade presence globally in 1929 to inflict such stress widely. Its downturn in 1929, starting in August, compounded the strains already affecting commodity exporters and central European debtors. By the end of 1929, "recession was almost universally evident. Only France, Sweden and a few of their economic satellites were spared." (Eichengreen 1992, 246)

Debt amid deflation. Commodity exporters were also international debtors. Though their export earnings were falling (due to falling world commodity prices), their international debt obligations were fixed. They had to service and re-pay the same amount of debt out of a declining income stream. This dynamic also crushed indebted households and businesses, no matter where located. The US price level was already deflating before 1929; when prices began falling sharply from 1929, debt burdens ballooned. As firms and households subsequently became insolvent, their insolvency undermined the financial position of the lender (typically, a regional bank). Aware of the declining health of the lender, depositors withdrew money, triggering bank runs. Irving Fisher in 1933 called this the "Debt-Deflation Theory of Great Depressions."[16]

1931. Till this point there had been no major sovereign debt default. Souring loans among the commodity exporters killed the appetite for foreign lending, and this "transformed the Central European financial situation" (Eichengreen 1992, 261). The banking system there had grown heavily dependent upon foreign funds. As those vanished, there was little left to liquidate domestic depositors who wanted out. In May 1931, a lot of them did want out. The financial status of Austria's biggest bank was revealed: "deteriorating loan performance had completely wiped out" its capital, in a bank whose balance sheet was as large as the government's total budget (Eichengreen 1992, 265). The ensuing bank crisis was enough to bring down the Austrian currency and turn the spotlight on troubles in Hungary and Germany, bringing down their currencies too. Recall the household debt-deflation sequence above: the consequence of insolvencies is to question the financial health of the creditor. On an international scale, this brought Britain into the frame. It was a major creditor to central Europe, and the loss of those assets seriously undermined the already faltering confidence in sterling. By September 21, Britain's own currency had been brought down. There was little the Bank of England could do: in an acute phase of flight from the domestic currency, no level of central bank interest rate will prove attractive.

"Brought down" in this context means violating the prevailing wisdom: either losing the peg to the foreign currency, or departing the open world financial and trade system (in order to keep the currency ostensibly pegged; after all, if you can control trade and financial flows, you can control the supply and demand for foreign exchange). Both routes enabled recovery. The country could conduct expansionary policy (i.e. budget deficit and monetary expansion), possibly generating demand for the rest of the world as well. Indeed it is now an accepted conclusion that the first countries to leave the gold standard in the Great Depression were the first to recover. Those who could afford to, like France, stayed on the gold standard. France and its friends kept to it until 1935-36, calling themselves the 'gold bloc'. The USA kept to it

[16] Note his use of the plural here. In the Great Depression, the term "Great Depression" was already taken -- by the late 19th century decline in commodity prices and activity. Also, it is important to be clear about the title of Fisher's essay. Much subsequent confusion could have been avoided if he had called it the "Debt-and-deflation theory of great depressions", as the essay is about the tendency of falling prices to exacerbate debtors' burdens in real terms. Fisher 1933.

until 1933. In retrospect, the USA decision to devalue in 1933 was crucial: it turned the tide of the Great Depression in the United States. It also provided a liquidity boom for the world economy. By contrast, the gold bloc endured years of depression and deflation because they were hampered by uncompetitive exchange rates: all around them, trading partners had devalued.

Why did the gold bloc adhere to the pegged exchange rates? Because of the prevailing wisdom. The prevailing wisdom was so strong that it compelled everyone to go to great lengths to stay on gold. Those who stuck it out were mainly those who could afford to (with the exception being the USA). Defence of currency pegs was a cardinal principle of the gold standard, and the defence of the gold standard was likened to defending civilisation itself. "It would be difficult to devise a measure that would give a greater shock to the world's trade and credit than departure of Britain from the Gold Standard," pronounced a British Cabinet memo on September 3, 1931. "And the world is in no condition to stand shocks to-day." Such fears proved unfounded, which makes their unqualified assertion an example of dogma.

Which brings us to 2010. The crisis in the euro-area features sovereign debt of the weaker members of Economic and Monetary Union. Focus on Greece for simplicity. Greek sovereign debt is not repayable. Yet it is owed to the banking system at the core of the EU. Hence, the EU has arranged packages of loans to "help" Greece repay its debt (and to help Greece's neighbours repay their debts). This does not address the underlying problem. Greek prices and wages are uncompetitive within the euro-zone and within the global economy. Its economy needs both a debt restructuring and an independent currency. The reason for the latter is that this is the only realistic way of bringing Greek prices into line with the rest of the world.

The EU's leadership is hamstrung by a prevailing wisdom which is taking on the quality of dogma. The EU itself is said to face an "existential" crisis if Greece defaults and/or withdraws from the euro (Angela Merkel's words). What support does this statement have? The danger is that it traps policymakers into the absurd and the capricious, in the same way that gold standard dogma motivated such folly between the wars. Essentially, the EU is telling Greece (and its neighbours) to "take the pain" for an indefinite period, with severe austerity and certainly deflation and unemployment. All in the name of EMU.

Bibliography

Buchheit, Lee C. and Gulati, G. Mitu, How to Restructure Greek Debt (May 7, 2010). Available at SSRN: http://ssrn.com/abstract=1603304

Economist. "The End of an Epoch", *Economist*, September 26, 1931, page 547.

Edwards, S. "Thirty Years of Current Account Imbalances, Current Account Reversals and Sudden Stops", *NBER Working Paper* 10276 (February 2004).

Eichengreen, B. and Temin, P. "The gold standard and the Great Depression", *Contemporary European History* 9:2 (2000), 183-207

Eichengreen, B. *Golden Fetters: The Gold Standard and the Great Depression 1919-1939* (Oxford, 1992)

Fisher, I., "The debt-deflation theory of great depressions", *Econometrica* 1933.

Gurría, Ángel. 'OECD: Balance debt and growth.' BBC archive (15 July 2010), http://news.bbc.co.uk/today/hi/today/newsid_8823000/8823677.stm

International Monetary Fund. Article IV Review of Spain (2006). http://www.imf.org/external/np/sec/pn/2006/pn0665.htm

Krugman, P. (2011a). "The Doctrine of Immaculate Transfer", http://krugman.blogs.nytimes.com/2011/01/12/the-doctrine-of-immaculate-transfer/

Krugman, P. (2011b). "VSP Economics", http://krugman.blogs.nytimes.com/2011/05/07/vsp-economics/

Nurkse, R., *International Monetary Experience: Lessons from the Inter-war Period* (Princeton, 1944).

Sargent, T. and Velde, F., "Macroeconomic features of the French Revolution", *Journal of Political Economy* 103:3 (1995).

Schubert, A., *The Credit-Anstalt Crisis of 1931* (Cambridge, 1991).

Temin, P. *Lessons from the Great Depression* (Cambridge MA, 1989).

Temin, P., 'Great Depression,' in S. Durlauf and L. Blume, eds., The New Palgrave Dictionary of Economics, 2nd Ed. (London, 2008).

UK National Archives. Cabinet Papers 219(31): Memoranda distributed by the Prime Minister to the cabinet: Sterling and the Gold Standard. 1931.

Urban, S. "Persistent orthodoxy: explaining 1930s monetary conservatism". Unpublished DPhil chapter (2011).

Urban, S. and Straumann, T., "Still tied by golden fetters: The global response to the US recession of 1937-38", *Financial History Review* (forthcoming 2012).

US Federal Reserve, *Federal Reserve Bulletin* (July 1932 and July 1936)