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THE WORKING OF THE GOLD STANDARD UNDER PRESENT CONDITIONS

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THE gold standard has emerged triumphantly from the welter of disordered currencies of the World War period and gold has now become more universally than ever before the foundation of the structure of credit throughout the world. This return to the haven of familiar monetary practice is significant of the widespread conviction that the gold standard is an essential factor in the maintenance of a reasonable measure of international financial stability for which there is no promising and practicable substitute. Aside from the defect, perhaps not incurable, of long-time secular price trends, the gold standard worked well during the half-century preceding the war and the public is hopeful of not less satisfactory results in the future. That these hopes can be realized, I am firmly convinced, but under present and prospective conditions they can be realized only through a greater measure of coöperation and conscious effort than was required under the conditions that obtained in the pre-war period.

Deferring to the close of this paper the problem of secular price trends, I shall first discuss the gold standard in operation as through gold movements, actual or anticipated, it affects the supply and cost of credit and brings about changes in economic and financial conditions. Between countries that are on the gold standard forces are constantly at work tending to check any wide departure from an international equilibrium of payments. When the causes of disequilibrium are not of a deep-seated nature involving difficult and far-reaching readjustments, industrial and financial, the corrective process through the operation of the gold standard is in large measure impersonal and even automatic. Gold exports, not so much because they are a means of payment, but through the restraining influence which they exert on the countries losing the gold together with the easing of the money markets of the countries receiving it, are an effective means of correcting those slight departures from equilibrium that are of constant occurrence in the ordinary course of international trade and other foreign transactions.

During a long period of years preceding the World War, a continuous series of slight, or at all events by no means extreme, adjustments was characteristic of the international economic situation and the influence of gold movements of quite manageable proportions was sufficient to maintain the nations in financial equilibrium. But now the gold standard has been restored to a world that is by comparison at a far greater remove from economic and financial equilibrium; to a world also in which international payments of great magnitude and largely of non-economic origin are to be made over a long series of years. The situation would clearly seem to be one in which anything approaching the automatic operation of the gold standard might be expected to involve stresses and strains so severe as to threaten the breakdown of the machinery of credit. There are limits upon the amount of gold that can be withdrawn for export without endangering confidence in the credit structure and there are also limits upon the possibilities of credit contraction and consequent shrinkage of values if disastrous industrial dislocation is to be escaped. On the other hand, gold inflows may be of such magnitude as to threaten serious inflation if the gold is fully utilized as a basis for credit expansion. And yet, if the gold is not thus employed, the extent of the necessary readjustment is widened in the gold exporting countries.

Payment of reparations and the interallied debts together with changes in trade channels, more and higher tariff walls and much foreign borrowing of a more or less distress character all combine to create a situation in which less reliance than formerly can be placed upon the unfettered working of economic forces and particularly upon those of a monetary nature. It is a situation that demands the adoption of concerted policies based upon intelligent foresight and adopted well in advance of the appearance of emergencies. Indeed, the international position at the present time seems not unlike that of business enterprises which have promising possibilities but which require time to work themselves out of an unsatisfactory situation. The application of such basic and time-consuming remedies as the development of new industries and improved methods of production can only to a limited degree be hastened under the spur of monetary pressure and may be indefinitely deferred if that pressure is extremely severe.

In addition to these familiar conditions that must render the establishment and maintenance of an international balance of payments an exceptionally difficult matter in the immediate future, there is still another factor militating against the smooth working of the gold standard that is perhaps less generally recognized. I refer to the effect of the presence of the United States as a creditor country and to the functioning of the New York money market as a world money market. On the basis of recent experiences, it is hardly too much to say that the United States is a most unsatisfactory creditor country from the point of view of the rest of the world. This is due to the fact that we are only intermittently a creditor country. In the good old days prior to the war, capital was largely distributed throughout the world through the London investment market, and a supply of funds for long-time use in foreign countries was always available. The domestic demand for capital in Great Britain and in the neighboring countries of the Continent was fairly stable and never approached the aggregate of current savings signifying investment. In other words, the domestic demand never absorbed all of the available supply and consequently foreign borrowers could rely with a fair degree of assurance upon the possibility of securing additional accommodation in London. Contrast now the experience of the foreigner with the American market. We began a few years ago with not a little blare of trumpets to make very considerable foreign investments. Satisfactory investments, no doubt, but at the same time, we congratulated ourselves upon the assistance that we were rendering the rest of the world. Then the domestic demand for funds increased and we, so to speak, closed up shop.

Consider the case of a bank which had taken the accounts of numbers of business concerns, granted them credit for a season or two, and then one fine day informed them that the bank had found a better use for its money. No well managed bank does that sort of thing. It assumes that it has a certain responsibility to its customers and so long as they remain in satisfactory financial condition, they can rely upon the bank. The foreigner, at least so far as recent experience may be taken as a basis for judgment, cannot rely upon the United States as a source of a fairly stable supply of additional funds or even consider himself secure against endeavors to withdraw rather suddenly some of the funds already invested.

Our money market for short-time accommodation has also appeared as a more disturbing factor in the international situation than at any former period. We have had many stock market booms in this country but the recent boom is the first since the United States has become a creditor country. In the old days when we were a debtor country, an 8% to 10% or 12% rate for call loans would have frightened the foreign investor and far from attracting additional funds, it would rather have tended to bring about the withdrawal of some of the accommodation already extended. But since our market has become exceedingly strong as a creditor market, the advance in money rates no longer has that effect but rather tends to force up rates in other countries through its attractive force.

If from time to time in the future the New York money market is to show an increasing demand for funds measured in billions of dollars which continues to expand in spite of 12% money, then the question will doubtless present itself whether it might not be to the advantage of the rest of the world to establish its systems of currency upon some other basis than that occupied by the United States. In the light of recent experience, however, it is perhaps reasonable to presume that operations in the security markets are altogether unlikely to be similarly disturbing again for many years to come, if ever. I think we may anticipate that the Federal Reserve System in the future will take more drastic action and at an earlier date in order to check a speculative movement of the type which we have recently experienced, and I think we may also be fairly confident that the precedent conditions favorable to an extreme advance in security quotations and the attitude of the public at large will hardly be so favorable, at all events during the lifetime of most of us here present. I am therefore disposed to think that the disturbing influence on the working of the gold standard arising out of the character of our stock market activities will not reappear and may be regarded as being out of the way for the future. But, I repeat, other factors requiring careful management in the near future remain, and for that reason I believe it will be a long time before we approach anything like the simplicity of functioning of the gold standard of the pre-war period. Too much must not be expected from the gold standard in a period marked by very wide departures, actual or prospective, from an equilibrium of payments between the nations.

I now turn to another aspect of the gold standard problem, that which has to do with secular price trends. I accept the view that it is highly probable that the supply of gold currently produced from the mines will not be adequate under existing methods of monetary use to support a sufficient amount of credit to maintain the present level of prices throughout the world. The question therefore presents itself whether it is possible under the gold standard to meet a situation of declining production in gold without a serious decline in prices over a somewhat indefinite period of, let us say, from fifteen to thirty years. It may be noted first that some changes have occurred in the mechanical relationship between gold and the volume of the circulating medium. It happens that in some directions, recent changes economize the use of gold and in other directions, changes have apparently the opposite effect. The net result, therefore, seems rather indeterminate. A very great economy has been secured through the practical elimination throughout the world of gold coin as currency and there will probably be no reversion to this quite needless use of gold unless there should be a very large increase in the output of gold from the mines threatening undesirable upward movements of prices. On the other hand, there is now a more general establishment of definite legal reserve ratios. In this country, we have for generations had reserve ratios and by the establishment of the Federal Reserve System and subsequent changes in the Reserve Act, the gold legally required as a basis for a given volume of credit has been materially reduced. In the case of many other countries, however, which did not have any gold reserve requirements in the pre-war period, these requirements have been established as, for example, in the case of

France where a 35% gold reserve has been set up against both the notes and deposit liability of the Bank of France.

The establishment of legal reserve ratios has an effect that is not fully measured by the ratios themselves since they inevitably lead the banks of issue to desire to acquire more than the legal minimum. Working on the basis of a 35% legal requirement, a bank of issue naturally will desire to have 40% to 50% in gold in order to take care of increasing credit demands as well as to meet contingencies. This universalization of gold reserve ratios appears to me to be the most serious obstacle in the way of meeting a situation that will arise in the event of declining gold production. What is needed to meet that situation is an attitude of mind on the part of the public together with legal authority which will give elasticity to or remove rigidity from the relationship between gold stocks on the one hand, and the supply of credit and currency on the other. It cannot be too strongly emphasized that there is no particular ratio between gold on the one hand and credit and currency on the other that is required to support and to give strength to the credit structure. Attention has been called to, some alarm expressed at, the declining ratio between gold and total bank deposits in the United States, a ratio that has declined in recent years from 7% or 8% to between 5% and 6%. This decline is a matter of absolutely no real consequence. What is important in the case of our banks is the character and nature of the other 95% of assets backing the deposits. Whether out of the 100% of assets, 7% is gold and 93% other assets, or 95% other assets and only 5% gold, is a matter that has no practical significance. What is important in the case of gold is that there should be a sufficient amount available in each country to meet any requirements for use that may conceivably arise in particular requirements of gold for export. Looked at from this point of view, the amount of gold that the different countries need greatly varies, but the amount does not depend upon the magnitude of the outstanding volume of credit. The United States, for example, needs comparatively little gold because from its creditor position it would be able to check a gold outflow by very moderate advances in rates which would be followed by the usual repercussion upon security movements and trade. On the other hand, a country like Brazil needs a relatively large gold reserve or gold exchange because it is a country which is mainly agricultural. Its exports are largely made up of coffee, a product subject to considerable variation from year to year on account of differences in the crop and the course of prices. Moreover, the country is heavily a debtor country. Therefore, no possible increase in discount rates and other lending rates in Brazil could be relied upon to check an outflow of gold due either to withdrawals of foreign capital or to a shrinkage in the value of exports. But the amount of gold that might be required cannot be directly related to the volume of credit and currency that might be outstanding in the country.

In the event of a shrinkage of gold production and clear evidence of a deficiency of the supply of credit owing to inadequate reserves under existing legal requirements, the appropriate remedy would be a very gradual reduction in the reserves of the central banks of issue throughout the world. This reduction to be effective should be limited to the banks of issue and not extended to any reserve balances required of other banks. A reduction in the reserve required of the member banks in the United States, for example, would not accomplish the desired result because it is certain that the member banks would immediately utilize to the full any reduction without any reference whatever to the course of prices. But a gradual decline in the reserve ratio of the Federal Reserve Banks from the present level of 70% to, let us say, 20% would be quite within the limits of safety if it were made gradually and with a view to the prevention of credit contraction or such a limitation on the normal increase in the supply of credit as would force a downward movement of prices over the years. We need not be slaves to the supply of gold, and the reason is the very simple one that the character and strength of the credit and currency of a country is in no fundamental way determined, much less measured, by the amount of gold which is held.