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Does Monetary History Repeat Itself?

Address of Wm. McC. Martin, Jr.,
Chairman, Board of Governors of the Federal Reserve System,

before the

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When economic prospects are at their brightest, the dangers of complacency and recklessness are greatest. As our prosperity proceeds on its record-breaking path, it behooves every one of us to scan the horizon of our national and international economy for danger signals so as to be ready for any storm.

Some eminent observers have recently compared the present with the period preceding the breakdown of the interwar economy, and have warned us of the threats of another Great Depression. We should take these warnings seriously enough to inquire into their merits and to try to profit in the future from the lessons of the past.

And indeed, we find disquieting similarities between our present prosperity and the fabulous twenties.

Then, as now, there had been virtually uninterrupted progress for seven years. And if we disregard some relatively short though severe fluctuations, expansion had been underway for more than a generation--the two longest stretches of that kind since the advent of the industrial age; and each period had been distorted in its passage by an inflationary war and postwar boom.

Then, as now, prosperity had been concentrated in the fully developed countries, and within most of these countries, in the industrialized sectors of the economy.

Then, as now, there was a large increase in private domestic debt; in fact, the expansion in consumer debt arising out of both residential mortgages and instalment purchases has recently been much faster than in the twenties.

Then, as now, the supply of money and bank credit and the turnover of demand deposits had been continuously growing; and while in the late twenties this growth had occurred with little overall change in gold reserves, this time monetary expansion has been superimposed upon a dwindling gold reserve.

Then, as now, the Federal Reserve had been accused of lack of flexibility in its monetary policy: of insufficient ease in times of economic weakness and of insufficient firmness in times of economic strength.

Then, as now, the world had recovered from the wartime disruption of international trade and finance, and convertibility of the major world currencies at fixed par values had been restored for a number of years.

Then, as now, international indebtedness had risen as fast as domestic debt; recently, in fact, American bank credits to foreigners and foreign holdings of short-term dollar assets have increased faster than in the closing years of the earlier period.

Then, as now, the payments position of the main reserve center--Britain then and the United States now--was uneasy, to say the least; but again, our recent cumulative payments deficits have far exceeded Britain's deficits of the late twenties.

Then, as now, some countries had large and persistent payments surpluses and used their net receipts to increase their short-term reserves rather than to invest in foreign countries.

Then, as now, the most important surplus country, France, had just decided to convert its official holdings of foreign exchange into gold, regardless of the effects of its actions on international liquidity.

Then, as now, there were serious doubts about the appropriate levels of some existing exchange rate relationships, leading periodically to speculative movements of volatile short-term funds.

And most importantly, then as now, many government officials, scholars, and businessmen were convinced that a new economic era had opened, an era in which business fluctuations had become a thing of the past, in which poverty was about to be abolished, and in which perennial economic progress and expansion were assured.

If some of these likenesses seem menacing, we may take comfort in important differences between the present and the inter-war situation.

The distribution of our national income now shows less disparity than in the earlier period; in particular, personal incomes, and especially wages and salaries, have kept pace with corporate profits, and this has reduced the danger of investment expanding in excess of consumption needs.

Perhaps related to that better balance, the increase in stock market credit now has been much smaller.

Instead of a gradual decline in wholesale prices and stability in consumer prices, there has now been stability in wholesale prices though consumer prices have been creeping up.

The worst defects in the structure of commercial and investment banking and of business seem to have been corrected--although we are time and again reminded of our failure to eliminate all abuses.

The potentialities of monetary and fiscal policies are, we hope, better understood--although the rise in government expenditures even in times of advancing prosperity threatens to make it difficult to be still more expansionary should a serious decline in private business activity require it.

In spite of the rise in the international flow of public and private credit and investment, business abroad appears in general to be less dependent upon American funds. The recent restraint on the outflow of U. S. capital has had little effect on business activity abroad, in contrast to the paralyzing effect of the cessation of U. S. capital outflows in the late twenties.

While the cold war makes for sources of friction absent in the twenties, we are no longer suffering from the cancer of reparations and war debts.

We have learned the lessons taught by the failure of trade and exchange restrictions, and of beggar-my-neighbor policies in general, although the temptation to backslide is ever present.

We have become aware of our responsibility for helping those less developed countries that seem willing and able to develop their economies--although the poor countries still are not becoming rich as fast as the rich countries are becoming richer.

The International Monetary Fund has proved to be a valuable aid to a better working of the international payments system.

A network of international, regional, and bilateral institutions and arrangements has reduced the danger of lack of international financial communication.

And finally, the experience of the twenties has strengthened the resolution of all responsible leaders, businessmen and statesmen alike, never again to permit a repetition of the disasters of the Great Depression.

But while the spirit is willing, the flesh, in the form of concrete policies, has remained weak. With the best intentions, some experts seem resolved to ignore the lessons of the past.

Economic and political scientists still argue about the factors that converted a stock-exchange crash into the worst depression in our history. But on one point they are agreed: the disastrous impact of the destruction of the international payments system that followed the British decision to devalue sterling in September 1931. At that time, sterling was the kingpin of the world payments system, exactly as the dollar is today. While changes in the par values of other peripheral currencies affected mainly or solely the devaluing countries themselves, the fate of sterling shook the entire world.

This is not wisdom of hindsight. Only a few weeks before the fateful decision was taken, the most eminent economist of the day stated that "for a country in the special circumstances of Great Britain the disadvantages (of devaluation) would greatly outweigh the advantages" and he concurred with his colleagues in rejecting the idea. His name was John Maynard Keynes.

And soon afterwards, another great British economist, Lionel Robbins, declared that "no really impartial observer of world events can do other than regard the abandonment of the Gold Standard by Great Britain as a catastrophe of the first order of magnitude." This was long before the final consequences of that step had become apparent--the political weakening of the West which followed its economic breakdown and which contributed to the success of the Nazi revolution in Germany, and thus eventually to the outbreak of the Second World War and to the emergence of Communism as an imminent threat to world order.

As if neither Keynes, the founder of the anti-classical school of economics, nor Robbins, the leader of the neo-classical school, ever had spoken, some Keynesian and neo-classicist economists--fortunately with little support at home but with encouragement from a few foreign observers--are urging us to follow the British example of 1931 and to act once more in a way that would destroy a payments system based on the fixed gold value of the world's leading currency. In doing so, they not only show that they have not learned from monetary history; they also impute to our generation even less wisdom than was shown in the interwar period.

The British Government in 1931, and the U. S. Administration in 1933, can rightly be accused of underestimating the adverse international effects of the devaluation of the pound and the dollar. But at least they had some plausible domestic grounds for their actions. They were confronted with a degree of unemployment that has hardly ever been experienced either before or after. They were confronted with disastrously falling prices, which made all fixed-interest obligations an intolerable burden on domestic and international commerce. They were confronted with a decline in international liquidity, which seemed to make recovery impossible.

Neither Keynes nor Robbins have denied that, from a purely domestic point of view, there was some sense in devaluation. In the United States of 1933, one worker out of four was unemployed; industrial production was little more than half of normal; farm prices had fallen to less than half of their 1929 level; exports and imports stood at one-third of their 1929 value; capital issues had practically ceased. In such a situation, any remedy, however questionable, seemed better than inaction.

In the Britain of 1931, things were not quite as bleak as in the United States of 1933; but fundamentally, the economic problems were similar. Ever since 1925, the British economy had failed to grow, and by 1931, one out of five workers had become unemployed, exports--far more important for the British economy than for our own--had declined by nearly one-half, and most observers believed that over-valuation of the British pound was largely responsible for all these ills. Can anybody in good faith find any similarity between our position of today and our position of 1933, or even the British position of 1931?

In 1931 and 1933, an increase in the price of gold was recommended in order to raise commodity prices. Today, a gold price increase is recommended as a means to provide the monetary support for world price stability. In 1931 and 1933, an increase in the price of gold was recommended in order to combat deflation; today it is recommended in effect as a means to combat inflation. In 1931 and 1933, an increase in the price of gold was recommended as a desperate cure for national ills regardless of its disintegrating effect on world commerce; today it is recommended as a means to improve integration of international trade and finance. Can there be worse confusion?

True, most advocates of an increase in the price of gold today would prefer action by some international agency or conference to unilateral action of individual countries. But no international agency or conference could prevent gold hoarders from getting windfall profits; could prevent those who hold a devalued currency from suffering corresponding losses; could prevent central banks from feeling defrauded if they had trusted in the repeated declarations of the President of the United States and of the spokesmen of U. S. monetary authorities and kept their reserves in dollars rather than in gold. To this day, the French, Belgian, and Netherlands central banks have not forgotten that the 1931 devaluation of sterling wiped out their capital; and much of the antagonism of those countries against the use of the dollar as an international reserve asset should be traced to the experience of 1931 rather than to anti-American feelings or mere adherence to outdated monetary theories.

But most importantly, no international agency or conference could prevent a sudden large increase in the gold price from having inflationary consequences for those countries that hoarded gold, and deflationary consequences for those that did not. And the gold holding countries are precisely those whose economies are least in need of an inflationary stimulus since they are most prosperous--not prosperous because they are holding gold, but holding gold because they are prosperous; in contrast, those that do not hold gold are most in need of further expansion. Hence the inflationary and deflationary effects of an increase in the price of gold would be most inequitably and most uneconomically distributed among nations.

If we were to accept another sort of advice given by some experts, we might repeat not the mistakes of 1931-33 but those of earlier years. We are told that a repetition of the disaster of the

Great Depression could be averted only, or at least best, by returning to the principles of the so-called classical gold standard. Not only should all settlements in international transactions between central banks be made in gold; but also the domestic monetary policy of central banks should be oriented exclusively to the payments balance, which means to changes in gold reserves. Whenever gold flows out, monetary policy should be tightened; whenever it flows in, it should be eased.

This is not the place to discuss whether this pure form of gold standard theory has ever been translated into practice. I doubt that any central bank has ever completely neglected domestic considerations in its monetary policy. And conversely, we do not need to adhere to an idealized version of the gold standard in order to agree that considerations of international payments balance need to play a large role in monetary policy decisions. But even strict adherence to gold standard principles would not guarantee international payments equilibrium. As a great American economist, John H. Williams, put it in 1937:

> "For capital movements, the gold standard is not a reliable corrective mechansim. . . . With capital the most volatile item in the balance of payments, it is apt to dominate and to nullify any corrective effects which might otherwise result from the gold standard process

"of adjustment. . . . It is surely not a coincidence that most booms and depressions, in the nineteenth century as well as in the twentieth, had international capital movements as one of their most prominent features."

Even countries that advocate a return to gold standard practices do not practice what they preach. Gold reserves of some Continental European countries have been rising strongly and continuously for many years, and according to the rules, these countries should follow a clearly expansionary policy. But in order to offset inflationary pressures, they have done exactly the opposite--and who is there to blame a country that wishes to assure domestic financial stability even at the expense of endangering equilibrium in international payments?

But obviously, if we permit one country to violate the rules of the gold standard in order to avert domestic inflation, we must also permit another country to violate those rules in order to avert domestic deflation and unemployment. In other words, we must agree that a country may be justified in avoiding or at least modifying a tightening of monetary policy even though its gold reserves are declining, if otherwise it were to risk precipitating or magnifying a business recession.

True, this deviation from gold-standard rules could be carried too far. Domestic developments might be taken as a pretext to avoid an unpopular monetary move, although the payments situation would seem to demand it and although the action would be unlikely to be damaging to the domestic economy. But the possibility of abuse and error is inherent in all human decision, and just as no sane observer would ascribe infallibility to the decisions of central bankers, neither should he ascribe infallibility to a set of rules. Few experts today would want to argue that it was right for the German Reichsbank in 1931, in the middle of the greatest depression that ever hit Germany, to follow the gold standard rules by raising its discount rate to 7 per cent merely in order to stem an outflow of gold; or that it was right for our own Federal Reserve to take similar restrictive action, for the same reason, in the fall of 1931.

And just as the success of monetary policy cannot be guaranteed by an abdication of discretion in favor of preconceived gold-standard rules, it cannot be guaranteed by following the advice of those who would shift the focus of policy from national agencies to an international institution. Surely, international cooperation should be encouraged and improved whenever possible. And the functions of the International Monetary Fund might well be enlarged so as to reinforce its ability to act as an international lender of last resort and as an arbiter of international good behavior.

But no institutional change can exclude the possibility of conflicts between national and international interests in specific circumstances. Moreover, there is no reason to believe that such conflicts would necessarily be resolved more wisely, more speedily, and with less rancor and dissent if they were fought out in the governing body of some supra-national bank of issue rather than by discussion and negotiation among national authorities.

It is true that such discussion and negotiation may prove fruitless and that inconsistent decisions may be taken on the national level. But similarly, lack of consensus within a supra-national agency may result in a paralysis of its functions, and the effects of such paralysis could well be worse than those of inconsistent national actions.

If then we doubt the wisdom of the three most fashionable recent proposals--to increase the dollar price of gold, to return to pure gold-standard principles, or to delegate monetary policy to an international agency--what should be our position? And what is the outlook for solving present and future difficulties in international monetary relations, and thus for avoiding a repetition of the disasters of 1929-33?

In my judgment, it is less fruitful to look for institutional changes or for a semi-automatic mechanism that would guarantee perennial prosperity than to draw from interwar experience some simple lessons that could save us from repeating our worst mistakes.

First, most observers agree that to a large extent the disaster of 1929-33 was a consequence of maladjustments born of the boom of the twenties. Hence, we must continuously be on the alert to prevent a recurrence of maladjustments--even at the risk of being falsely accused of failing to realize the benefits of unbounded expansion. Actually, those of us who warn against speculative and inflationary dangers should return the charge: our common goals of maximum production, employment, and purchasing power can be realized only if we are willing and able to prevent orderly expansion from turning into disorderly boom.

Second, most observers agree that the severity of the Great Depression was largely due to the absence of prompt anti-recession measures. In part, the necessary tools for this were not then available nor were their potentialities fully understood. Today it is easy to understand where observers went wrong 35 years ago. But it is less easy to avoid a repetition of the same mistake; we always prefer to believe what we want to be true rather than what we should know to be true. Here again, we need most of all eternal vigilance. But we must also be ready to admit errors in past judgments and forecasts, and have the courage to express dissenting even though unpopular views, and to advocate necessary remedies.

Third, and most importantly, most observers agree that the severity of the Great Depression was due largely to the lack of understanding of the international implications of national events and policies. Even today, we are more apt to judge and condemn the worldwide implications of nationalistic actions taken by others than to apply the same criteria to our own decisions.

Recognition of the close ties among the individual economies of the free world leads to recognition of the need to maintain freedom of international commerce. This means not only that we must avoid the direct controls of trade and exchange that were characteristic of the time of the Great Depression. It means also that we must avoid any impairment of the value and status of the dollar, which today acts--just as sterling did until its devaluation in 1931--as a universal means of international payment between central banks as well as among individual merchants, bankers, and investors.

If the dollar is to continue to play its role in international commerce, world confidence in its stability must be fully maintained; the world must be convinced that we are resolved to eliminate the long-persistent deficit in our balance of international payments. The measures taken in accordance with the President's program of February 10, 1965, have so far been highly successful. But some of these measures are of a temporary character, and these include the efforts of the financial community to restrain voluntarily the expansion of credit to foreigners. We should not permit the initial success of these efforts to blind us against the need of permanent cure.

Some observers believe that our responsibility for maintaining the international function of the dollar puts an intolerably heavy burden on our monetary policy; that this responsibility prevents us from taking monetary measures which might be considered appropriate for solving domestic problems. I happen to disagree with that view. I believe that the interests of our national economy are in harmony with those of the international community. A stable dollar is indeed the keystone of international trade and finance; but it is also, in my judgment, the keystone of economic growth and prosperity at home.

Yet even if I were wrong in this judgment, and if indeed an occasion arose when we could preserve the international role of the dollar only at the expense of modifying our favored domestic policies--even then we would need to pay attention to the international repercussions of our actions. We must consider these international effects not because of devotion to the ideal of human brotherhood, not because we value the well-being of our neighbors more than our own. We must do so because any harm that would come to international commerce and hence to the rest of the world as a result of the displacement of the dollar would fall back on our own heads. In the present stage of economic development we could not preserve our own prosperity if the rest of the world were caught in the web of depression. Recognition of this inter-dependence gave rise to the Marshall Plan--in my judgment the greatest achievement of our postwar economic policy.

It should not have taken the Great Depression to bring these simple truths home to us. Today, as we approach the goal of the "Great Society"--to make each of our citizens a self-reliant and productive member of a healthy and progressive economic system--we can disregard these truths even less than we could a generation ago. By heeding them instead, we will have a good chance to avoid another such disaster. If monetary history were to repeat itself, it would be nobody's fault but our own.

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