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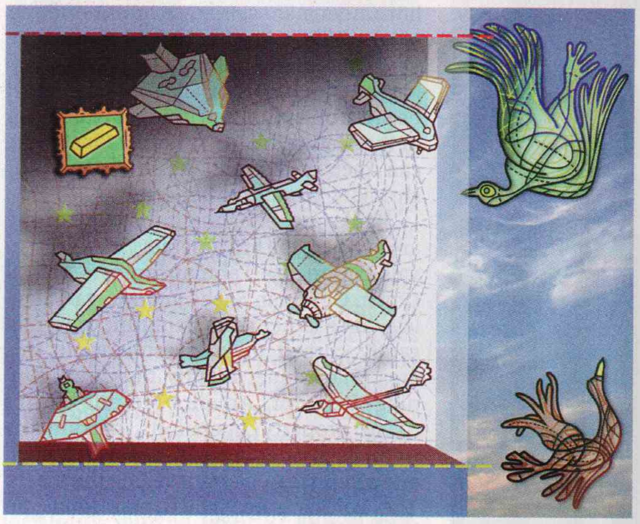
Tight policies in surplus countries helped undo the gold standard, which is a lesson for the euro



CHRIS ROCK, a comedian, is a big fan of Oprah Winfrey, a television host and philanthropist. He recalls one of Ms Winfrey's shows during which a woman confessed to her husband that she had frittered away $300,000 and as a consequence their home was about to be repossessed. "By the end of the show, it was all the guy's fault," a clearly impressed Mr Rock told David Letterman, another talk-show host. "He was apologising for not loving her enough—it was the greatest 'Oprah' of all time."

This may seem an odd sort of blame-shifting. Yet reasoning of this kind is increasingly used to explain how spendthrift countries get into trouble. On this view America's credit boom and bust owed as much to a savings glut in Asia as to laxity at home. A new paper* by Barry Eichengreen of the University of California, Berkeley, and Peter Temin of the Massachusetts Institute of Technology, adds a dash of subtlety and a generous slice of history to this sort of analysis. The authors examine the role of fixed exchange rates in booms and busts and draw parallels between the inter-war gold standard and contemporary schemes, such as the euro and China's peg with the dollar.

The strains in the rich-world economy in the inter-war years sketched out by Messrs Eichengreen and Temin seem eerily familiar to modern students of global imbalances. Today, America is a deficit country but back then it ran large trade surpluses. Unlike Britain, France and Germany, the world's other big economies, America had kept its currency linked to gold during the first world war. While the others were preoccupied with fighting, America strengthened its export markets at their expense. The European powers emerged from the war with heavy debts and a depleted capital stock. They struggled to contain inflation—or in Germany's case, hyperinflation.

Backing paper currencies with gold at a fixed rate, as its countries had done before the war, seemed to offer Europe a return to prosperity. By the mid-1920s Britain was back on the gold standard at its pre-war parity, despite inflation and rapid growth in the money supply in the interim. A new German currency was pegged to gold at its pre-war rate. France joined later but at a lower rate; high inflation had made the pre-war rate unrealistic.

This set the stage for a period of wide trade imbalances and for the Depression that followed. America's export prowess meant that by the end of the 1920s it held almost two-fifths of the world's gold reserves. A cheaper currency gave French exports a lift and France built up its gold holdings rapidly. The deficit countries in this constellation were Britain and Germany. Britain's exports struggled against an overvalued currency. The economy was further held back by the high interest rates needed to retain scarce gold reserves. Britain, like Germany, found cutting wages to make exports competitive was made harder by trade unions.

When recession came it was made worse by the strictures of the gold standard. An "unexceptional downturn then was converted into the Great Depression by the actions of central banks and governments," say the authors. Central banks kept interest rates high to counter fears that their currencies would be devalued and to attract gold deposits. A banking crisis that had spread from Austria and Germany finally forced Britain to abandon its gold peg in September 1931. The following month the Federal Reserve raised interest rates sharply to show America's commitment to gold. Indeed, America and France shrank their money supplies by more than was strictly necessary by liquidating gold-backed currencies from their reserves. That only increased the deflationary pressures at home and abroad.

The analogy between these events and today's problems is not perfect, as the authors concede. Modern-day fiat currencies mean that money supply is not restricted by the stock of gold. It can expand elastically to meet the increased demand for cash during a slump. Other differences are less comforting. Countries left the gold standard in wartime without much fuss and discovered they could do the same in peacetime. Those that stayed on gold for longer, such as America, suffered the most painful recessions. Modern members of the euro cannot easily quit it.

What would Keynes (and Oprah) do?

There are similarities, too. The "façade of stability" created by the gold standard encouraged a rapid build-up of loans to deficit countries until doubts were raised about their solvency. The huge foreign debts that Spain, Greece and Portugal ran up during the euro's first decade are the modern equivalent.

The thing that the authors put most emphasis on is the role of surplus countries in fixed exchange-rate schemes. When trade imbalances reach a limit the onus is on countries with trade deficits to keep the system intact by cutting wages and prices (think of Greece's struggles today). But countries with surpluses, such as Germany (or China), are not similarly obliged to offset this by boosting their own spending. This defect means fixed exchange-rate schemes have a bias towards deflation.

Messrs Eichengreen and Temin argue that both deficit and surplus countries are equally responsible for making exchange-rate systems work. This was recognised by John Maynard Keynes, who in the 1940s argued for a global clearing bank that would tax or even confiscate the excess earnings of surplus countries. America opposed the principle that creditors should play a role in balance-of-payments adjustments—although it is now in favour of it. This is an irony that Keynes would have appreciated, according to his biographer, Robert Skidelsky. The idea may yet be revived as policymakers in the euro area rewrite the rules governing the currency. Germany, like America in the 1940s, would resist this shift in focus. But perhaps Oprah would approve. ■

* "Fetters of Gold and Paper" by Barry Eichengreen and Peter Temin. NBER Working Paper number 16202 (July 2010).