The History of the Twentieth Century
Episode 239
“A Barbarous Relic”
Transcript

[music: Fanfare]

In the years following the Great War, the consensus among economists and bankers in the Anglo-American world was that the key to restoring the pre-war prosperity was to return to the gold standard.

Against this traditional view came a new, more modern perspective that questioned the value of the gold standard. John Maynard Keynes articulated this viewpoint best when he dismissed it as a barbarous relic of a less advanced age.

Welcome to *The History of the Twentieth Century*.

[music: Opening Theme]

Episode 239. A Barbarous Relic.

Back in episode 233, we looked at the problem of Allied war debt to the United States. The heavy debts of the Allies, particularly Britain were impairing the ability of those countries to return to peacetime prosperity. The refusal of the US government to give the UK more than 20% in debt forgiveness had knock-on effects, as the UK was forced in turn to collect on debt owed to it by France and Italy and smaller Allied nations, which in turn gave the French an even stronger incentive toward ruthlessness in dealing with German reparations payments.

The German reparations obligation and the Allied war debt were two pieces of the problem, but they weren’t the whole problem. They were the elephant’s trunk and the elephant’s tail, but they weren’t the elephant. The elephant is the international system of finance and trade, and among its parts that we haven’t talked about yet is the gold standard.

I last mentioned the gold standard in episode 214. Before the war, all the major Western economies were on the gold standard. In the early twentieth century, it was accepted as a fact of financial life that the gold standard was the, well, the gold standard of international finance. In the Belle Époque, an era which saw unprecedented levels of international trade and freedom of movement between nations, every Western economy pegged the value of its currency to gold.

This had the effect of keeping exchange rates fixed between currencies, and this helped facilitate international trade. There was no electronic banking in those days. They did have wire transfers, facilitated through the telegraph companies, but this was expensive and not always available. If you were a merchant who traded internationally, you would get paid in foreign currencies, and it might take weeks to get those payments converted into your own national currency and shipped back home to you. It was easier for businesses to make international deals, knowing that the exchange rates were fixed and reliable, and that a German mark or a British pound would be worth the same amount in US dollars next month as it was today.

When the Great War erupted, the belligerents suspended trading in gold for the duration of the emergency. Even the United States went off the gold standard when it entered the war, though afterward, it promptly went back. Germany had no gold reserves, so in Berlin this was an academic question. For France and for Britain, though, the way forward was less clear.

The British had a previous experience with exactly this question that might serve as a precedent. Back in 1797, in the early days of the wars with Revolutionary France, a rumor got started in London that French soldiers had landed in Wales. This led to a run on the pound. That means people in London with a lot of pounds—and if you have a lot of pounds, of course you live in London, and vice versa—those people began taking their pounds to the Bank of England and exchanging them for gold, which they deemed safer and easier to move, you know, in case it became necessary to leave the country in a hurry.

At that time, the Bank of England had about £10 million in notes in circulation and held about £9 million in gold in its vaults. This sudden run on the Bank quickly shrank the Bank's gold reserves down to £1 million, a 90% reduction, forcing the Bank to suspend trade in pounds for gold, effectively taking the pound off the gold standard.

The pound remained off the gold standard for the next fifteen years, as the Napoleonic Wars played out. During this period, the total sum of pound notes in circulation increased from £10 million to £22 million, which inevitably meant considerable inflation. Beginning in 1815, with Napoleon safely tucked away in exile—for realsies, this time—the Bank faced the question of what to do about gold convertibility. Egged on by Parliament, the Bank spent the next six years, until 1821, shrinking the supply of paper money, by withdrawing it from circulation and sharply increasing interest rates as a means of restricting new money from entering circulation. This effort was successful, and gold convertibility resumed at the same prewar rate in 1821.

Successful, but at a cost. Shrinking the money supply means deflation, which harms a nation's economy. In Britain at this time, deflation meant falling wages and falling crop prices. Nobody in Parliament at that time cared very much about falling wages, but falling agricultural prices were bad for the landed gentry, who prevailed upon Parliament to pass the Corn Laws, which regulated food imports in order to keep domestic prices high. The combination of falling wages and stable food prices was disastrous for the working class, and it led to years of unrest. Rioting broke out, which led to repressive new acts suspending *habeas corpus* rights and prosecuting dissidents for sedition. In 1819, a non-violent protest in Manchester was dispersed by cavalry, who charged the crowd and killed six of the protestors in what was called the Peterloo Massacre.

But despite all the misery deflation wrought, the rest of the 19th century would see the British economy grow prodigiously and sterling became the world's most desired currency. There are many benefits to having your nation's currency be widely accepted internationally, including lower prices and interest rates for you and your own economy. It was a boon to Britain and most economists and financiers of the time took it as read that the Bank of England's grim determination to bring back gold convertibility at the prewar exchange rate despite the social cost that decision entailed had been dramatically vindicated by the good times that followed.

Then came the Great War and once again the Bank of England suspended gold convertibility for the duration of the emergency. Come 1920, the Bank made the decision to repeat its policy of a century before and restore gold conversion at the prewar rate. History seemed to teach that this was the right move. It was not.

The only other country that acted similarly was the United States, but the situation in the US was quite different. Before the war, the world's four largest economies, the US, the UK, Germany, and France, collectively held about US$5 billion in gold reserves. The US economy was about half the total, that is, it was about the size of the other three put together, and the US held 40% of the total gold reserve. Gold reserves were thus distributed in rough proportion to the sizes of the national economies.

By the end of the war in 1919, these same four countries collectively held a little more in gold reserves, about $6 billion now, but the distribution had changed radically. The gold reserves held in Paris and London were smaller, Germany's gold reserve was wiped out, while the United States now held 80% of the total.

In our time, the gold standard is largely discredited as an economic principle. You can still find people who believe in it, but then you can also find people who believe the Earth is flat, so what does that prove? Proponents of the gold standard argue that tying your currency to gold prevents inflation. The easiest way for me to refute that argument is to point you to episode 203. I told you then about inflation in the post-war United States, or the "high cost of living," as people liked to say in 1920. But if the US dollar was back on the gold standard, at the same exchange rate as it had been in 1914, how can there be inflation?

The answer is simple. The exchange rate between dollars and gold had not changed, but the supply of dollars in circulation had doubled. This was possible because the US gold reserves had also doubled. But when you get twice as many dollars chasing the same amount of goods and services, you get inflation. Whether or not those dollars are backed by gold is beside the point.

Modern economics understands that as an economy grows and produces more, the supply of money needs to grow at the same rate, if you want to strike a balance between inflation and deflation. It is the role of central bankers to manage the money supply and maintain that balance. Proponents of the gold standard argue that central bankers can't be trusted with this responsibility. Well, whether they can or not is also beside the point. If you replace central bankers with a gold standard, you've taken responsibility for managing the money supply away from the central bankers and handed it over to the gold mining industry. Why that would be a better policy is a question proponents of the gold standard have not answered.

You may well wonder then, how it was that the global economy did as well as it did during the Belle Époque era, when the gold standard was firmly in place. Well, economic historians think that the production of new gold during that era from places like California and Alaska and South Africa and Siberia increased the gold supply at about the same rate the economy was growing and thus maintained a happy medium. It's also important not to romanticize the Belle Époque economy too much. Things went very well overall, during the 40+ years between the Franco-Prussian War and the Great War, but if you zoom in more closely, you will see cycles of economic booms and economic slumps, the many "panics" of that period, which suggest that the economy of the time wasn't all that stable or well managed.

But I digress. The problem facing Britain and the other major powers wasn't that there was a shortage of gold. It was the imbalance of gold, with so much of it in the vaults of the Federal Reserve in the United States. In the other major economies, bankers scrambled to get hold of the stuff. First to go were gold coins. At the turn of the twentieth century, the clearest sign that you'd "made it" and you were financially secure was that you were walking around with a few gold sovereigns or double eagles or napoleons or gold marks in your pocket. By 1925, the only country where you could still find gold coins in circulation was the United States.

The Europeans wanted to see the Americans spend some of that gold they'd accumulated and help rebalance the world gold supply. One frustrated British banker asked his American counterpart what in Heaven's name did the US government intend to *do* with all that gold.

[music: Händel, *Water Music*]

We already met the English economist and British Treasury official John Maynard Keynes, first in episode 138, and again during our 1919 World Tour, when his book, *The Economic Consequences of the Peace*, became an improbable bestseller. I say improbable, because how often do highly technical, occasionally turgid, treatises on international economics become bestsellers? Of course, it wasn't Keynes's economic reasoning that sold his books; it was his willingness to draw back the curtain and give us an intimate look at the Paris Peace Conference, including insights as to what Mr. Lloyd George is *really* like, and so on. Keynes's book was an early example of a genre that's common in our time: the behind-the-scenes portrait of our political leaders, with close-up details on how and why they made their decisions. He was sort of the Bob Woodward of his time. The public ate it up. One of the long-term cultural consequences of the Great War was an erosion of authority; if the war had taught anything, it had taught that authority figures don't know nearly as much as they pretend they do.

Keynes was born in 1883 in Cambridge, England. His father was a lecturer in economics at Cambridge University. His eldest son went to Eton College and then to Cambridge University. At both institutions he showed uncommon gifts in mathematics as well as in romancing other young men. At Eton, he had a relationship with Dan Macmillan, the older brother of a future prime minister. He had more love affairs at Cambridge, notably with the artist Duncan Grant and future Liberal politician Arthur Hobhouse.

After the publication of his book, Keynes wrote on economics and international affairs for the magazine *The Nation*—that's the British magazine, not its American namesake—as well as the Manchester *Guardian*, and *The New Republic* in the United States. But he made his money in currency speculation, an enterprise that didn't exist before the war, in the days of the gold standard. Keynes made a substantial fortune by shorting the British pound, the French franc, and the Italian lira and investing in currencies of nations that had remained neutral in the war, like the Norwegian kroner, and naturally, the US dollar.

That was probably the most predictable thing about John Maynard Keynes, that he'd found a way to make money off his insights into the ailing postwar world economy. The least predictable thing about him is that in 1921, he became smitten with a ballet dancer nine years his junior named Lydia Lopokova. She was born in 1892 in St. Petersburg, trained at the Imperial Ballet School, and like many of Russia's best ballet dancers, jumped ship to dance for Sergei Diaghilev's *Ballets Russes.*

I am often amazed at how everything in twentieth-century history keeps coming back to Sergei Diaghilev and the *Ballets Russes*. It is rather remarkable, isn't it?

Lydia toured with the ballet in Europe, along with Vaclav Nijinsky. She was part of the Ballet's 1916 US tour. At that time, she was engaged to an American, the writer Heywood Broun, a sportswriter and columnist for *The Nation*, the American one. We've crossed paths with Heywood Broun once before, in episode 232 when he was bantering with Texas Guinan, and we'll run into him again, I'm sure. Broun broke off his engagement with Lopokova after he caught her in the act, so to speak, with one of the managers of the *Ballets Russes*, rumored at the time to have been Sergei Diaghilev himself, although you and I know that Diaghilev was gay and had never shown any interest in women. More likely it was Randolfo Barrochi, the ballet company's business manager. She ended up marrying him, but he stole her money and also turned out he was already married, so that relationship didn't last very long. She next had an affair with Igor Stravinsky.

In 1921, Lydia was playing the role of Princess Aurora in the *Ballets Russes* production of Tchaikovsky's *Sleeping Beauty* in London, when she caught the eye of John Maynard Keynes. It was love at first sight, although Keynes lamented to a friend that she was not a man and therefore he had no idea how to approach her and express his feelings. But he must have figured it out, because they began a relationship. She moved in with him in 1923, and in 1925, after her divorce from Randolfo became final, they were married. Duncan Grant was the best man. The marriage inspired a fragment of poetry of unknown authorship that went like this: "What a marriage of beauty and brains/the fair Lopokova and John Maynard Keynes."

Maynard and Lydia did indeed make an odd couple: he was sober and thoughtful, one of the greatest minds of his age. She was engaging and talkative, though English was not her first language and she was prone to making some remarkable mistakes, such as time she complained that she didn't like to go out walking in the English countryside because her legs were so often bitten by barristers. Together they hobnobbed with the likes of Virginia Woolf, T.S. Eliot, E.M. Forster, H.G. Wells, and Pablo Picasso. They were devoted to each other. They had no children, though they wanted them. Lydia became pregnant in 1927, but miscarried, much to their mutual grief.

In 1921, Keynes published a book on probability theory. In 1923, he took on the topic before us today, British monetary policy and specifically the drive to bring the pound back onto the gold standard. Keynes had initially supported this move, but by 1923, he had become a gold skeptic.

In the old days, the days of the Belle Époque, central banks like the Bank of England focused their monetary policy narrowly on the convertibility between pounds and gold. So long as the exchange rate remained fixed and stable, the bankers' work was done. What was going on in the larger economy, with inflation, deflation, unemployment, interest rates, booms and busts, these were someone else's problems.

It was this focus on preserving the convertibility of money for gold, even at the expense of economic hardship for the general public, that William Jennings Bryan was critiquing in this famous "Cross of Gold" speech, episode 3.

Keynes's book, titled *A Tract on Monetary Reform,* argued that the gold standard had outlived its usefulness. It had become "a barbarous relic," in Keynes's memorable phrase. Keynes argued that what a modern economy needed was stable prices, and that a fixed convertibility to gold does not guarantee that. Indeed, the exchange rate with gold has no connection to prices in the larger economy. But, Keynes argued, a modern central bank had all the tools it needed to keep prices stable simply by regulating interest rates and the money supply.

Like most of Keynes's work, *A Tract on Monetary Reform* is dense and technical, but leavened with Keynes's singular wit. He impishly dedicated the book to the directors of the Bank of England, knowing full well they would disagree strenuously with his arguments. He mocked conservative bankers and business interests for basing their economic arguments on moral principles rather than logic, as if they expected us not to notice that their supposed moral principles always led to the same conclusion: that the vested interests should be free to do as they please, while everyone else just had to deal with it. And the book included Keynes's most famous observation, that "in the long run, we are all dead."

For now, the world of finance would largely ignore Keynes's book. His suggestion that politicians and central bankers could be trusted with the responsibility to manage their nation's economy seemed ludicrous. To see that, you didn't have to look any farther than Germany. For this is 1923, and even as Keynes's book was published, inflation was reaching ridiculous extremes in Germany, episode 215. The conventional view at the time was that the value of the mark had collapsed because Germany was off the gold standard. But Keynes argued that inflation was more than rising prices. Inflation was a policy choice, a choice that favored certain groups over other groups. Debtors over creditors. Employers over wage earners. Governments over bond holders.

[music: Händel, *Water Music*]

In England, Keynes's arguments were largely dismissed as the idle ruminations of an intellectual gadfly, but in the United States, they were already being put into practice by a New York banker named Benjamin Strong.

In 1904, Strong had begun working at Bankers Trust Company in New York. Bankers Trust was just what its name implied: it was a banking and trust company created by a number of other banks to function as a sort of "bankers' bank." That is, a place where other banks could deposit excess funds and which would loan money to banks that needed it. It was a major US financial institution, and during the Panic of 1907, Benjamin Strong and Bankers Trust worked alongside JP Morgan to help rescue failing institutions, episode 43.

In 1914, Strong became president of Bankers Trust. He spent that summer in Europe, returning to the US just as the July Crisis was heating up. As you'll recall from episode 79, the outbreak of war in Europe stranded a large number of Americans, whose US dollars were suddenly worthless. Strong was the banker who organized the shipment of US government gold to Britain on the cruiser USS *Tennessee*, to prop up the value of the dollar in Europe and allow those Americans to get home again.

The outbreak of the war precipitated a financial crisis in the US, just months after the Federal Reserve Act had been passed and before the new Federal Reserve System had gotten up and running. I discussed this crisis in episode 115. In late 1914, when the system got going, Benjamin Strong, who'd emerged as a leader in the financial community during the crisis, was named the first head of the brand new Federal Reserve Bank of New York. Theoretically this was only one of twelve regional Federal Reserve Banks, but in practice it was the largest and most important of them. Strong would hold this position for 14 years, until his death in 1928.

During those years, Benjamin Strong helped define the role of the Federal Reserve, and indeed of central banks generally, and bankers today still walk the trails he blazed. Strong was one of the first people to appreciate the large amount of gold that was flowing into the United States and the imbalance this would create in the post-war international monetary system. When the US entered the war, Strong was vocal about the need for the American war effort to be financed by taxation and domestic borrowing. He became a high-profile public figure for the sale of Liberty Bonds, and this unassuming banker turned into a minor celebrity, appearing as he did at patriotic marches and bond rallies, where he shared the stage with the likes of Douglas Fairbanks and Mary Pickford.

In particular, Strong had opposed the Federal Reserve buying US government bonds directly, in effect creating new money to spend on the war effort, which is what they were doing in Germany. After the war ended, Strong recognized that the large amount of gold now in the US was inflationary. If there is more gold than dollars in the US, then the price of gold should go down, as measured in dollars. Classical gold standard thinking would say that you want to keep the exchange rate steady between dollars and gold, which means you would want to issue more dollars.

Strong recognized that classical thinking would produce inflation. He pioneered two new methods of managing the money supply. The first was by having the Federal Reserve Bank raise or lower the interest rates it charged its member banks. Those changes would ripple through into the larger economy. Higher interest rates would lock up more money into loans, thus decreasing the supply of money in circulation and increasing the value of the dollar. Lower interest rates would have the opposite effect, decreasing the value of the dollar.

Another management technique Strong pioneered was the buying and selling of those Liberty Bonds that were already in public hands. If the Fed buys Liberty Bonds, it's exchanging a future obligation for present money, thus increasing money in circulation. If it sells Liberty Bonds, it exchanges present money for future obligation, reducing the money in circulation. In this way, merely by buying and selling bonds on the open market, the Fed could and did regulate the national economy. And in this era, the Fed, led by Strong, moved aggressively to end the postwar inflation, raising interest rates to historic highs. It cured the inflation, though at the cost of slowing the economy and increasing unemployment, as we have seen.

This was exactly the sort of new order, postwar economic policy that Keynes campaigned for in his *Tract*. He was well aware of Strong's work in New York; indeed he called attention to it in his book.

Strong led the Federal Reserve System into the modern world, as Keynes recommended, a world in which its role was not to stabilize the American currency, but to stabilize the American economy.

There still remained the problem of gold. The US gold reserve was so large that the Federal Reserve threatened to become not just America's central bank, but central bank to the whole world. That was a challenge to the financial independence of the European powers. To tie one's currency to gold was to tie one's currency to the US Federal Reserve. And while the Fed was beginning to master the techniques needed to manage the US economy and keep it healthy, it wasn't even trying to manage the international financial order.

But that is a story for another episode. We'll have to stop here for today. I thank you for listening, and I'd especially like to thank Kenneth and David for their kind donations, and thank you to Vlad for becoming a patron of the podcast. Donors and patrons like Kenneth and David and Vlad help cover the costs of making this show, which in turn keeps the podcast available free for everyone, so my thanks to them and to all of you who have pitched in and helped out. If you'd like to become a patron or make a donation, just visit the website, historyofthetwentiethcentury.com and click on the PayPal or Patreon buttons.

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And I hope you'll join me next week, on *The History of the Twentieth Century,* as we continue our ruminations on the gold standard. The British did in fact put the pound back on the gold standard in 1925, and the fellow who engineered it was an old friend of this podcast. The Golden Chancellor, next week, here, on *The History of the Twentieth Century.*

Oh, and one more thing. If you'll indulge me, I'd like to say a few words in defense of John Maynard Keynes and his most famous aphorism, "In the long run, we're all dead."

I first encountered these words in high school, when the phrase "the long run" came up in conversation and a particularly clever and well-read young friend of mine said, "You know what John Maynard Keynes said about the long run?" Well, I didn't. I didn't even know who John Maynard Keynes was, but I had a good laugh when I heard the saying. Adolescents are very much impulsive and are all about living in the moment and are always being told by older people that they should think more about their future. So hearing about an authority figure who scoffed at the idea of "the long run" and handed us teenagers a pithy comeback we could use against our parents was like a breath of fresh air.

Only, that's a misunderstanding of what Keynes meant when he said, "In the long run, we're all dead." Keynes was not endorsing complacency; he was attacking it. More specifically, he was attacking *laissez-faire* economists who argue in difficult economic times that governments couldn't and shouldn't do anything to alleviate the suffering, because in the long run, it would sort itself out on its own.

Keynes compared a government trying to lead a nation through a period of economic difficulty to a mariner trying to pilot a ship through a storm. If the economist has no better advice to offer the mariner than to point out that tomorrow, after the storm is over, the sea will be calm again, then, Keynes concluded, such an economist is worse than useless. It is not enough to issue comforting platitudes that tell us everything will sort itself out in the long run. The mariner needs to know what to do right now, today, because in the long run, we're all dead.

In our time, it's become popular among those who want to discredit Keynes and his ideas and want to caricature him and his theories as feckless and short sighted to cite this quote as evidence that Keynes in fact had no regard for long-term consequences. Regrettably, the fact that Keynes lived as a gay man for part of his life also gets rolled into this caricature. He had no concern for the long run because he was gay and had no children and didn't care what would happen after he died.

In truth, Keynes also got married and tried to have children. His wife's miscarriage certainly shouldn't be held as evidence of the wrongness of his economic theories. And again, let me emphasize, Keynes wasn't advocating for complacency. He was accusing his opponents of it.

It's one thing if a couple of high school kids misinterpret Keynes; it's another when academics, historians, and economists do, and unfortunately there's quite a lot of that going on in our time, but now, dear listener, at least you know better.

[music: Closing Theme]