Today's floating currency system is just one of many that global trade has operated under. Each previous system broke down after multi-nation wars. This series reviews previous monetary systems and examines history to shed some light on the viability of the current fiat system.

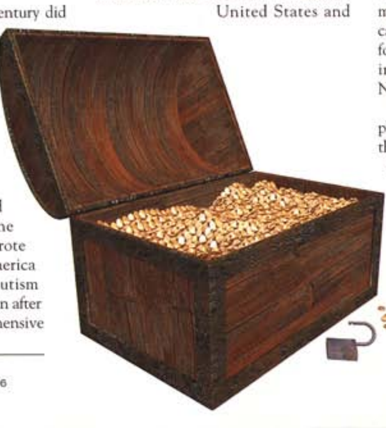
Money's sordid tale of dirty floats, debasement and doom

BY ANN BERG

Marx extolled it as the numeraire. Keynes damned it as a barbarous relic. In the end, Nixon snuffed it. Yet for more than two millennia, gold was matchless among precious metals, valued in multiples against silver, copper or bronze. Rare, ductile and noncorrosive, it gave reins to commerce, providing a universal medium of exchange.

But not until the 19th century did gold play such an integral role in international trade, the balance of power and societal advancement.

The scientific and philosophical discourses of the late 18th century Enlightenment stirred an eruption of new political and economic institutions. The same year Adam Smith wrote *The Wealth of Nations*, America revolted against the absolutism of monarchial power and soon after developed the first comprehensive contract in history between state and citizenry. Working under a Constitutional framework during the first Congressional Congress in 1789, Alexander Hamilton, the nation's first treasury secretary, brought a fractured country to the international forefront. In three years he restructured the nation's war debt into revenue backed (import tariffs) marketable securities, facilitated the IPO of the Bank of United States and ensured dollar convertibility by linking it to gold. Such confidence arose in the international investment community for this new sovereign that by 1803, half of American issued bonds were held by foreigners. The American financial miracle had begun.



As America ascended, the muscular era of mercantilism characterized by state-chartered trading monopolies was sinking in decline. The embodiment of economic nationalism, mercantilism aimed to enrich the state by forcibly promoting exports and limiting imports through tariffs and the Navigation Acts.

Echoing Smith, the German philosopher Immanuel Kant in 1795 rejected the mercantilist dogma in the prophetic Perpetual Peace, asserting only representative republican governments that respected autonomy and universal hospitality could be trusted to keep citizenries out of war. Five years later, the 200-year-old Dutch East Indies Corporation, once towering in the seas with a fleet of 150 battle and merchant ships and a labor force of 50,000 was bust.

The Napoleonic Wars, which lasted 25 years and bankrupted Austria, Holland and nearly Russia, proved the last outbreak of commercial wars between the Great Powers until the 20th century. In 1815, a quadruple alliance of Britain, Russia, Austria and Prussia, and later France, emerged from Vienna to create the Concert of Europe and brought stability to the continent. A new creed of economic liberalism emerged, and despite brief and mostly localized conflicts, such as the Crimean War (1853) and Franco-Prussian War (1870), the peace continued for a 100 years. The adoption of the gold standard would prove critical to this era and China would play a curious role.

THE CHINA PROBLEM

Just as the trade deficit with China vexes America today, it doubly vexed Britain two centuries ago. China snubbed British manufactures and Britain, a voracious importer of silks and tea, exchanged Chinese goods for silver. The pound sterling (literally a pound of pure silver), Britain's currency since the millennial crusades, was fixed to gold under the tenure of Isaac Newton — Britain's master of the mint from 1700 until his death in 1727 — in a ratio of approximately 15 to one. While European trade followed the Newtonian 15:1 ratio, China and Japan valued silver much higher at 9 or 10 pounds per one pound of gold. Drained of silver bullion through the trade deficit with China, in 1816 Britain made the pound sterling note directly convertible to gold.

As the largest economy, Britain led the way in building institutional credit and ridding the market of 18th century restraints. David Ricardo rose on the shoulders of Smith, and after amassing a fortune on the London Stock Exchange, theorized in his 1811 treatise "The High Price of Bullion" that not unlike today, Britain's inflation was due to its lax monetary policy. The growing wave of bullionist thinking eventually led to the 1844 enactment of Peel's Law, requiring the Bank of England to control banknote issuance and maintain a statutory level of gold reserves, casting it into a central bank role. In 1834, England abolished the 500 year-old "Poor Laws" that had guaranteed wage subsidies based on the price of bread, creating a free market in labor. It repealed its "Corn Laws" in 1848, the parliamentary debate about which arguably marked the beginning of the modern theory of international trade.

The year 1848 saw a wave of revolutionary activity. Anti-monarchial uprisings erupted in Poland, France, Austria, Germany and Italy but did not ignite a larger war. Karl Marx in *The Communist Manifesto* blasted the commoditization of land and labor and exhorted workers of the world to unite. Ironically, his communist philosophy never wavered with the laissez-faire economists such as Ricardo and Mill on the solidity of the gold standard.

So powerful became England that at the time the influential *Economist* editor Walter Bagehot wrote his famous essay *"Lombard Street"* describing the money market in 1873, he could

GOLD STANDARD

Every monetary system including the gold standard broke down after global conflicts. Trade standards had to be rebuilt after war.

Defeated Countries stabilized to gold		Victorious Countries stabilized to gold		Victorious Countries went off gold	Universal Lender went off gold
Russia	1923	Great Britain	1925	1931	United States 1933
Austria	1923	France	1926	1936	
Hungary	1924	Belgium	1926	1936	
Germany	1924	Italy	1926	1933	
Bulgaria	1925				
Finland	1925				
Estonia	1926				
Greece	1926				
Poland	1926				

Source: "The Great Transformation," by Karl Polanyi (1944).

The Opium Wars

Unable to compel a modern-day "currency alignment" between gold and silver on China, in 1839 the British navy launched an assault against China to coerce the resumption of the India to China opium trade into the port of Canton. The British East India Company maintained a monopoly in opium, which was the only significant product exported to China. China maintained a large trade surplus with the British; and when the Chinese Emperor took steps to restrict trade — opium had long been illegal in China and England, but enforcement was non-existent — the war was on.

An observer commented in the *Bombay Telegraph*, "As an article of commerce, opium stands out without a parallel. From the skilful management and cultivation of about 100,000 acres of land, the East India Company produces an article which sold at a profit of several hundred per cent, yields to them a net revenue, annually of nearly three millions sterling." Under the Treaty of Nanking, Britain succeeded in forcing opium upon China's population. The Concert of Europe's nonaggressive policy practiced within the Continent didn't extend to colonial wars that were carving up whole continents elsewhere.

declare London was the banking center of the world, noting it held twice the deposits of New York, Paris and the German Empire combined.

HAUTE FINANCE

Based on the balance of power among nation states, a self-regulating market and the gold standard, laissez-faire bloomed during the century. But one other factor that proved critical in maintaining it was the growing sophistication of financial institutions — haute finance.

In today's dollarized economy, watching the Fed has become an obsessive pastime; each utterance from Fed Chairman Ben Bernanke, or his predecessor Alan Greenspan, carefully parsed, testifying to the U.S. central bank's hold on the global flow of money via its interest rate and money supply controls. Haute finance, on the other hand, was a supranational phenomenon.

Rising out of the Napoleonic Wars, the Houses of Barings and Rothschild revolutionalized banking and credit. When Napoleon needed money in his war with England, he turned to Barings of London to arrange the sale of the French held Louisiana territory to the United States in 1803. The deal was structured in U.S. bonds, which resulted in a discounted payment to Napoleon for the property of 87.5¢ on the dollar. With no wire transfer, one of the Barings brothers shuttled to the United States to collect the bonds, brought them to Britain as an investment offering, and remitted France the money so that the two countries could continue their war uninterrupted.

The fraternal banking enterprise of the Rothchilds, wary of the risk of sovereign default after the French defeat, took up domicile in Frankfurt, Paris, Vienna, Naples and London as a brilliant risk diversification strategy. In 1817, when Prussia needed a loan, the Rothschilds structured a bond offering in the London market denominated and repayable in pound sterling, creating the first Eurobond. Both the Rothschilds and Barings grasped the need for peace on the Continent as the transnational market in equities and bonds grew. The various nation states and principalities of Europe came to understand that credit depended on good behavior, ceding the haute financiers remarkable clout against their foreign and monetary policies. As capital markets integration grew, haute finance became instrumental in several cross Continental projects to build railway and seaway systems including the Suez Canal. Wars, a continuous feature of the 17th and 18th centuries and once the source of great profits, became perilous to the new European economy.

WAR DISRUPTS TRADE

By the 1890's haute finance was at its peak. All major countries had made their currency convertible to gold, creating a global fixed rate currency system. However, the amount of exploitable foreign lands was diminishing. Germany formed an alliance with Austria-Hungary and Italy. In 1904, Britain made a sweeping deal with France over Egypt and Morocco and later compromised with Russia over Persia, ending the multi-lateral balance of power preserved by the Concert of Europe. In 1914, after decades of wrangling, Germany and England signed an agreement on the Baghdad railway, but left the expansion beyond Basra an open question. It was too late and too little to avert war.

Once war broke out, gold convertibility halted practically overnight. Capital outflows were prohibited. The fixed rate of exchange among nations remained throughout the four-year conflict, but without gold-redeemable bank notes and countries inflating and debasing their currencies to fund the war effort, the system fell apart like a spoked wheel without a hub. No other war had changed the map of Europe so dramatically. Four empires disappeared: the German, the Austro-Hungarian, the Ottoman and the Russian. Ruling dynasties, such as the Hohenzollerns and the Habsburgs, all collapsed during the war.

Because the United States came so late to the conflict and managed to remain on the gold standard, it emerged the strongest in the aftermath. Just prior to the war, in 1913, President Woodrow Wilson, growing wary of haute finance, created the Federal Reserve to give government greater monetary policy control.

The dollar/pound rate that had held steady at $4.87 throughout the late 19th and early 20th centuries fell to $3.66 by 1920. When the gold standard was re-introduced and the dollar/pound rate fixed at $4.82, it proved unsustainable due to Britain's balance of payment problems.

Significantly, American support for the pound implied low U.S. interest rates in order to stave off a capital flight from London to New York. But a state-side inflationary bubble finally caused the Fed to tighten interest rates. Reaching a high of 386 in 1929, the Dow Jones Industrial average fell to 40 in three years. Global protectionism, the Depression and a trade collapse of 66% ensued. Both Britain and the United States left the gold standard in 1931 and 1933 respectively and the other countries operating on a "dirty float" arrangement abandoned gold by 1937.

Conferences in Brussels, London, Lausanne, Geneva and Locarno failed to reinstate a pre-war stable monetary system to allow for the resumption of trade. The collapse of the monetary system would also coincide with the demise of the liberal state as totalitarian regimes erupted out of war's wreckage. It would take another war to resurrect the gold standard the world once thought indestructible. **FM**

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Next month in part two of this two-part series, Ann Berg will discuss the interwar period, the Bretton Woods agreement and its collapse. For related stories, go to www.futuresmag.com.