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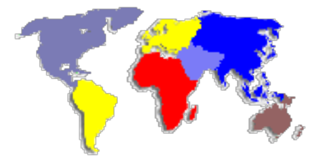

Finance after WW I

The Bank of England and the Federal Reserve System

On September 25, Mr. Greenspan went to court and had his remembrances - at the opening of the new HM Treasury Building in London ▸▸ he had this to remark on a key element of UK/US special relationship:

... I am daily reminded of the special relationship the Federal Reserve has had over the decades with decisionmakers from the British government. Literally twenty feet from my desk are plaques commemorating the numerous World War II meetings in our Board Room between the combined military chiefs of the United States and Great Britain that in the words on one plaque, „... set the pattern for allied collaboration and the successful prosecution of World War II."

But the Federal Reserve's association with Britain's monetary authorities goes back even further. The tie between the Bank of England and the Federal Reserve was cemented during the 1920s in that extraordinary relationship between Benjamin Strong, the President of the New York Federal Reserve Bank, and Montague Norman, the Governor of the Bank of England. Their correspondence yields quite fascinating insight into the way they interpreted events that are now important history. The ties developed then between the Federal Reserve and British monetary authorities endure to this day.

Federal Reserve Chairman Greenspan chose to address the subject of collaboration between Montagu Norman and Benjamin Strong in the most polite manner. Even though Mr. Greenspan`s short speech stands out as one which is understandable, a rare exception for him, the history of this special relationship between Norman and Strong nevertheless can be accounted quite differently. The following essay, reprinted by permission from economic historian F. William Engdahl, provides a number of clues on what went wrong in the period before the Great Depression of the 1930s and what disrupted and buried the „new economic era" (SvZ)

American Exceptionalism – Serious Distortions of the New Economic Era

Montagu Norman and Benjamin Strong in the 20s

By F. William Engdahl (*)

It's impossible to say whether, had he lived and remained vigorous to the end of the 1920's, Junius Pierpont Morgan would have permitted the policy pursued by the House of Morgan after his death in early 1913. Morgan died some months before the Federal Reserve opened its doors in 1914, a Federal Reserve which largely owed its existence to Morgan's support. Indicating the degree of personal authority the 75-year old Morgan commanded, the Wall Street Journal in February 1912, noted:

"The condition that has developed in Wall Street in the past fifteen years is to a considerable extent a personal one, and the authority which centers in the hands of Mr. Morgan, a man seventy-five years of age, is by no means something which can be passed down to his successors. Such men have no successors; and their work is either left undone after they are dead or the world devises other means and other works to take its place."

Morgan died some months after being forced to testify before the populist Pujo House Banking Committee hearings into allegations of monopoly practices in finance. Apparently, those hearings shattered the older Morgan. His testimony that, for him a person's personal character was the most important consideration of creditworthiness, was ridiculed by populist media, denouncing the banker as head of a so-called Money Trust. Clear is that the J.P. Morgan & Co. run by the

successor partners, such as Henry P. Davison, Willard Straight (who died at the Versailles Peace talks), or Thomas W. Lamont, and later J.P. Morgan jr., linked the fate of Wall Street finance, and with it, the American finance and economy, which it dominated, to the future of postwar England, through various financial entanglements.

The nature of those entanglements abroad, during and after the World War, was highly problematic for the United States, and, as it happened, for the world. The domino-style failure of those credit links to Europe and beyond in 1929-31, allowed a reactionary isolationist backlash to influence the nature of American engagements abroad, down to the time of the Second World War. Worse still, it turned a manageable American stock market crash into the worst deflation crisis in American history, and created the backdrop for a transformation of the American system in a direction of state central planning and direction, which was to have negative consequences for decades after.

A too Strong New York Fed

After 1914, under the guidance of a Morgan man, Benjamin Strong, first and, by far, the most powerful President in the history of the New York Federal Reserve Bank, U.S. monetary policy and capital flows in the critical years up to 1929-1931, were, in effect, guided by the Bank of England under its head, Montagu Norman. The banking capital flows of the twelve regional Federal Reserve banks were channeled into New York under Strong's influence.

It was a lop-sided domination by New York, opposite to the original intent of the Federal Reserve Act of 1913, which envisioned a division of powers among the regional Federal Reserve districts and the Washington Reserve Board. The Federal Reserve Act of 1913 had been passed by Congress primarily to prevent the damaging effects of periodic banking panics such as in 1907, from causing broader domestic economic depressions.

The banks centered in New York, in turn allowed the wealth created by American industry and agriculture during the 1920-1929 period, to be channeled via Wall Street, into foreign credit markets, in a way which ultimately turned a US stock market bubble collapse into the most severe economic depression and deflation in modern times.

One consequence of the destructive European War of 1914-1918, was the unprecedented accumulation of the gold reserves of Europe's central banks into the vaults of the Federal Reserve, as debt-strapped European belligerants, from England to France to Italy and beyond, were forced to finance American war supplies with their gold. After the conclusion of Versailles, this left the United States as the possessor of the vast bulk of world monetary gold, a 400% increase in U.S. gold reserves. Gold was the commodity which until 1914 and outbreak of war, had been the basis of the international monetary system. By 1920, the United States Federal Reserve held fully 40% of the world's monetary gold reserves.

There is much historical debate over the personal motives of Benjamin Strong in assisting Montagu Norman to bring England back onto the Gold Standard during the early 1920's, it is clear that Strong shaped Federal Reserve policy from New York with the clear priority of reestablishing the international Gold Standard of pre-1914, likely as the centerpiece of his vision of a U.S.-financed European postwar economic reconstruction.

Much evidence suggests that Strong was a highly vulnerable and naive victim of a sophisticated British charm offensive—that he got played, big time. Strong spent his annual Summer holidays in England with Norman throughout the 1920's, until his death in 1928. In his later memoirs, the ill-fated Herbert Hoover bitterly attacked Strong, for much of the damage of the Great Depression. In 1941 Hoover wrote, in reference to Strong's direction of Federal Reserve policy, "There are crimes far worse than murder for which men should be reviled and punished." Hoover called Strong, "a mental annex to Europe," a veiled reference to Montagu Norman. Hoover had been close friends with Strong in the early 1920's but later broke with him on Strong's policy of support for unrestricted bank lending to Europe.

Hoover further charged that by shaping New York Fed interest rates to facilitate maintaining the British return to gold after 1925, Strong artificially depressed U.S. interest rates at a time the stock speculation fever was getting out of control in 1927, in effect adding fuel to the fire which led to the spectacular 1929 collapse.

During the Great War, Strong, as head of the New York Federal Reserve, made

several trips to London to meet with Bank of England and City banking figures. As powerful head of the New York Federal Reserve, Strong pushed through a fateful precedent with the Federal Reserve Board, over strenuous objections from some Board members such as Paul Warburg and Adolph C. Miller. Strong won the ability to finance Allied war munitions purchases as early as 1915, despite official U.S. neutrality. J.P. Morgan became the banker to the British and later French governments, and the role of the New York Fed in discounting their acceptances enabled the war to continue until American entry in 1917.

This set the precedent that the New York Federal Reserve would take leadership of all international financial dealings of the Fed system and its member banks. Until passage of the Banking Act of 1935 which explicitly placed power with the Washington Board of Governors, and a Federal Open Market Committee in which rotating regional presidents participated, the New York Fed controlled U.S. international monetary and banking policy, to disastrous result. Significantly, the 1935 Act was largely the work of the new Federal Reserve Board chairman, an Ogden Utah banker, Marriner Eccles, a far cry from the New York bankers which had dominated the Fed policy since 1914.

In 1915 Strong had told the Senate his estimate, that the United States would emerge after the war as the only country possessing sufficient reservoirs of credit. He proved right. How those reservoirs were deployed was the problem.

The Bank of England Gold Exchange strategy

Deliberate manipulation of a national currency is an old device for monarchs and governments to deal with unpayable debt obligations, but in the 1920's the Bank of England and the UK Treasury added a subtle refinement to the game. They called the new system Gold Exchange Standard.

England's development of the role of gold in the 1920's was the central part of their postwar economic strategy. It was also the heart of the entire credit pyramid which then built up from 1925 until its ruinous collapse in 1929-1931. More than any issues of German reparations or Allied war loans, the faulty Gold exchange standard of the Bank of England and UK Treasury was the decisive factor in causing the worst global economic deflation in history. The specific role of gold has been far too little discussed and too poorly understood. It certainly was poorly understood by Benjamin Strong and his colleagues in the New York banking community, even the House of Morgan.

England had fought the bitter Boer War some two decades earlier to secure for the Bank of England control of the world's largest known gold reserves in the Witwatersrand. Now, following the prolonged European war, that gain of gold was gone, and with it, City of London control over world credit, the heart of British geopolitical influence.

In 1919, at the beginning of postwar battles over Versailles Allied war debt, German reparations and other issues, the British government was forced to formally take Sterling off the Gold Standard and abandon the pre-war dollar parity of $4.86 to the pound. With most of its non-Empire trade with America in chronic deficit, Britain could no longer afford even the illusion it was able to maintain its pre-war role as the center of a world Gold Standard.

Britain took the step with great reluctance. In 1919 the strongest economic power was clearly no longer the British Empire, but rather, the United States. Abandoning gold, however temporarily, was a de facto admission of this grim reality.

The United States had emerged from the war in a most powerful position, the creditor to all major European countries. America's gold reserves had multiplied fourfold during the war, giving it the world's largest monetary gold reserves. Britain, by contrast, had massive foreign debts, mostly to the United States. Its currency had sharply depreciated, and its reserves of gold had fallen dangerously low.

Following the war, fears at the Bank of England and leading City of London circles, were that New York would replace the City of London as the center of world finance. In this situation, the role of gold was considered a decisive factor. In 1919 the United States had resumed pegging the dollar to gold, having suspended it for two years when America entered the war in 1917. Unlike Britain, America had no problem to return to the Gold Standard.

South Africa threatens to go it alone

The looming danger, as seen from Britain, was that South Africa, the world's

largest gold producer, would ship its future gold mine production directly to New York, rather than through the City of London, making New York, not London the world's principal gold market. That would rob the Bank of England of its most powerful weapon. The financial center of the world would definitively shift from the City of London to New York, with devastating consequences for England's influence in world events.

In a March 1919 letter to Lord Cunliffe, then Governor of the Bank of England, written just after England had abandoned fixed $4.86 exchange, the London Gold Producers' Committee, a British group which controlled the minting of South African and other gold, argued, "Owing to our unfortunate industrial position, the American exchange will remain below the gold parity (with Sterling) for some years, and it is difficult to imagine any conditions arising which would put it above gold parity. Such being the position, it is inconceivable that the South African Gold Producers will not take immediate steps to arrange for the shipment of their commodities to New York, which must for some years be the best market, or that the South African Government will not give them every assistance in doing so."

The London committee further warned, "If the stream of gold from South Africa is once diverted to New York, it will not be so easy later to turn it back again, as, if New York becomes the best and freeest market for bullion, it will be a powerful influence in establishing New York as the central money market of the world."

To prevent such a devastating result, the Bank of England and the City of London establishment went to extraordinary lengths to exert control over South African government policy. The Bank of England pressured UK shipping companies to grant reductions in freight rates between South Africa and London, in order to penalize the cost of shipping gold to New York. It also set up a close monitor of any increase of US shipping ties to South Africa.

But the most stringent control was accomplished through the direct intervention of the Bank of England, with the help of a friendly government in South Africa. South Africa's Prime Minister in 1919 was Round Table inner circle member, Jan Smuts. Smuts had spent the war years in London, as a member of Lloyd George's Imperial War Cabinet, at the same time he retained his cabinet post in the government of South Africa. He was an ardent defender of the interests of the Empire, and one of the main architects of the League of Nations concept at Versailles, in short, a man who could be trusted to back English interests in the most difficult of situations.

Smuts had become South Africa's Prime Minister in August 1919, just as Sterling suspended its fixed tie to the dollar and to gold.

In April 1919, the Bank of England drafted an agreement with South African gold mine producers, insuring that all gold produced in South Africa be sold through the Bank of England, excepting that needed for local currency. The British Parliament also passed a law in 1920, the Export Control Act, which restricted free export of British gold.

This dual control on gold flows into and out of London, was to the benefit of the London gold banks, among them the Rothschilds, also the largest financial backer of South African gold mining companies. London's ability to remain off the gold standard while selectively denying control of major gold supplies to her rivals, above all, New York, was an objective of the highest strategic importance for the future of the Empire.

That agreement between the Bank of England and the South African Chamber of Mines, signed in July 1919, appeared to give the City of London what it urgently needed, continued exclusive control over South African gold output, and the ability to prevent direct South African gold shipments to New York.

South Africa, with the strong backing of Smuts and Lord Milner in London, had assured the ability of the City of London to resume its prewar role at some future date, as the financial mecca of the world.

A central figure in the effort to relink South Africa and its gold to London, was Sir Henry Strakosch, who served as an advisor to the Bank of England, and a close intimate of Governor Montagu Norman, as well as of Lord Rothschild. Strakosch, a prominent spokesman for City of London banking interests, was also Managing Director of Union Corporation, a leading mining company with major investment in South African gold production. Strakosch was invited by Smuts to advise his government on South Africa's relation with Sterling.

Strakosch, later to play a key behind-the-scenes role as Winston Churchill's financial patron in the late 1930's, was back and forth in the early 1920's

between Smuts in Pretoria and Montagu Norman in London, working to keep the country and its finances firmly in the imperial system. As Strakosch put it, his goal was to have South Africa "march as far as possible in step with Great Britain on the road towards an effective gold standard."

That march was abruptly interrupted in 1924. It had been forced at a great economic price to the domestic South Africa economy. By linking the Rand to Sterling and placing an embargo on gold sales other than to the Bank of England, South Afirca's largest export earner, gold, suffered. Many mines had become unprofitable. Inflation soared because of the Sterling link, as the English inflation increased dramatically after the war, and living standards of ordinary South Africans dropped sharply during the period of abandoning the gold standard. Strikes of mineworkers demanding higher pay became frequent.

In early 1922, as miners called a general strike throughout the Rand, Smuts declared martial law and ordered brutal military repression, ending in the death of 700 white mineworkers, and winning Smuts the nickname, "man of blood." Opposition inside South Africa to the British Sterling link became a heated political issue.

Under such growing internal pressure, the South African mines consented to hold to their agreement with the Bank of England on embargo of free gold exports only until June 30, 1925, putting a severe time pressure on London to prepare a return to the Sterling Gold Standard.

A return to gold at the pre-war $4.86 parity in 1925, meant a severe deflation of the British economy, politically explosive, with soaring unemployment and other consequences. Sterling was at the time trading at a 30% discount or some $3.50 to the pound. Delay had been the tactic used to try to keep South Africa in line, until the British economy was in a stronger position to return to the prewar gold price. Britain had set her own deadline for lifting her restriction on free flows of gold under the Export Control Act, for 1931, ample time, it was thought, for preparing the step.

Under Smuts' pro-Empire rule, London's delaying tactic had not been that difficult. But national elections in South Africa in June 1924 abruptly changed that. Smuts' pro-London government was defeated, in favor of a coalition of the Labour Party and the Nationalist Party headed by Boer nationalist militant, General J.B.M. Hertzog.

Hertzog campaigned against the country's loss of national economic control and the economic damage caused by Smuts' support of Sterling. Once in office, one of Hertzog's first acts was to create a commission to advise his government on whether South Africa should break with Sterling and re-establish the South African Pound on an independent gold-backed basis. For the first time, the Bank of England and Strakosch had not been consulted prior to a major South African gold decision. Alarmingly for London, the special commission was to be headed, on the new government's insistence, not by an Englander, but by an American, a gold and monetary expert, Princeton University professor, Edwin Kemmerer.

Kemmerer was an internationally known advocate of the gold standard. Alarm bells began to ring, not only in the Bank of England, but throughout the British establishment. An unanticipated threat to the strategic interests of the British Empire had come from South Africa, and some in the United States seemed to be playing a vital supporting role.

Kemmerer's final report to the Hertzog government stated the problem clearly: "Should South Africa decide to tie up definitely with Sterling, hoping that Sterling will return to the gold basis soon, but being prepared to follow Sterling wherever it may go? Or, should she decide to definitely go with gold?" Kemmerer's answer was to recommend, that South Africa go back on the Gold Standard by July 1, 1925, with or without Britain.

That would mean, of course, an American-dominated Gold Standard. Kemmerer argued gold resumption would increase foreign investment in South Africa's economy, control the rampant inflation, and benefit the important mining industry, all of which was true, as London knew all too well.

In January 1925, Hertzog's government announced it was implementing in full the recommendations of Kemmerer. In London, this was regarded as a near casus belli, pulled off by the upstart Americans, one which held the gravest implications for future British power. In 1925, South African gold mines produced fully 50% of the world's annual newly mined gold, with the output increasing rapidly each year.

For well over a century, the ability of the City of London to stand as the center

of international finance had depended on its controlling the physical trade of gold through London. The world economy in the 19th Century rose or fell, as the supply of such gold to London bullion banks such as Rothschild's & Sons, rose or fell. The true reason the London gold standard of the period to 1914 appeared so successful, was London's ability, first, to capture the vast bulk of Californian and Australian new gold discoveries after the 1840's, By 1900, London's central role in expanding global demand for increased monetary gold was again secured, after a Boer War, by the huge new supply from South Africa's Witwatersrand.

Indeed, the British economy underwent a 23 year-long economic slump, recorded in English economic history as the Great Depression, from 1873 to the mid-1890's, owing to a gold shortage in hands of the Bank of England. The depression ended only when the South African gold potential was discovered.

The one and only prospect for Great Britain and the Bank of England to reconstruct a decisive influence in the post-1920 world was through its earlier role in international financial lending, based on its manipulation of the world gold bullion supply to its advantage. As in their cricket games, so in gold dealings by the London bullion banks and the Bank of England, the British "cheated at the edges." A leading English economist, Paul Einzig, writing in The Economic Journal of the Royal Economic Society in March 1931, described the game well:

"So long as the gold is actually brought to London before it is sold, the Bank of England is at an advantage as compared with other potential buyers, for, in acquiring the gold, the latter have to pay the cost of transport, etc. from London to their centre, while the Bank of England obtains delivery free of charge. Thus, so long as Sterling is at par (with gold), the chances are that the gold will find its way into the Bank of England...foreign buyers may be unable to compete with the Bank...Thanks to this advantage, the gold stock of the Bank is in normal conditions replentished out of the newly-produced Rand gold, so that there is no need for raising the exchange by means of high interest rates above gold import point to that end. It would be desireable, therefore, to prevent a change in the system of transport of South African gold..."

Much of the history of the British Empire, and British foreign diplomacy, especially in the period of "New Imperialism," from the 1850's through the 1920's, traced back to this subtle, little-appreciated manipulation of physical gold production flows, into and out of the London bullion market, manipulating London's expertise and role as the leading world gold market. Direct South African shipment of their gold to New York or Paris or other centers, would have dealt a devastating blow to the plans of the City of London and British financial institutions to rebuild their dominance after Versailles.

Churchill preempts a U.S. gold standard

London's response was swift. In late January 1925, Chancellor of the Exchequer, Winston Churchill, whose career had begun in South Africa during the Boer War, issued a memorandum arguing for England's early return to gold, in order to preempt a feared American monetary coup. Bank of England Governor, Montagu Norman, agreed.

Adding to the sense of urgency in England was the fact that a few months earlier, American bankers, led by Morgan-associate Charles Dawes, had been able to arrange a stabilization of Germany's currency, following the devastating Weimar hyperinflation of 1922-23. Under the Dawes Plan, Germany returned to a U.S.-led gold standard, aided by a $100 million loan from J.P. Morgan & Co. to back the new Reichsmark. The United States and Germany, thus both were tied to the same gold standard, about to be joined by the world's largest gold producer, South Africa. Britain was sitting squarely on the outside.

Were South Africa to join in an American-centered gold standard, the prospect facing London was that growing world trade, especially were Germany to revive Continental European trade, would by-pass the City of London and relegate England into a has-been power, irreversibly. That would leave New York the unchallenged center of world financial power. That was a change which the British establishment was not quite yet ready to accept.

On April 28, 1925, Churchill as Chancellor of the Exchequer, came before the House of Commons to announce the government's decision, with full support of the Bank of England, to return to the Gold Standard. Further, Sterling would be fixed at the same parity level it had on the eve of the Great War in 1914, at $4.86 to the Pound. This, despite the manifest decline in British industrial productivity over the decade since 1914. This, despite the fact the pre-war parity level priced British exports so high in dollar terms, that Britain was priced out of desperately needed export markets. This, despite, the enormous rise in Britain's public debt, inflation, its huge trade deficits, mostly with America, and everything else which

should determine a nation's proper currency value. It was a power political decision. Its success depended on Norman's ability to manipulate Benjamin Strong and his friends in New York banking.

Churchill and Montagu Norman fixed Sterling at that inflated rate, and rejoined the link to gold. Their intent was to re-establish the role of the City of London at the center of the world financial system, whatever the price to domestic British industry and the British population. Commenting on his actions, Churchill remarked, "If we had not taken this action, the whole of the rest of the British Empire would have taken it without us, and it would have come to a gold standard, not on the basis of the pound sterling, but of the dollar."

Strong's fatal mistake

Benjamin Strong, head of Bankers Trust in 1914, when friends from J.P. Morgan convinced him to take the new post as head of the New York Federal Reserve, considered himself a believing Christian. Strong as a young man was also part of a group of ardent Anglophiles, called the Family, who in the early 1900's believed fervently that Britain was the best, and most reliable international ally of an emerging, inexperienced United States world economic power. Strong was firmly convinced that Britain's decades of unquestioned success with the Gold Standard provided the basis for a fruitful cooperation in rebuilding postwar Europe and reestablishing world trade, all to the best benefit of the United States. Strong was no isolationist, but he, like other New York bankers, had a certain awe for the sophistication and knowledge of international finance and political affairs held by those in London. In the first years of the Federal Reserve, no one, including Strong, and no one in New York banking had actual experience with a gold standard or its effective operation.

Documentary evidence, including the papers of Strong in the archives of the New York Federal Reserve, suggest Strong genuinely and naively believed in the importance of an Anglo-American partnership in restoring the world to some form of the pre-war order. The Gold Standard, as economic orthodoxy dictated, and Strong believed, would have to be the heart of such an international financial reconstruction.

What Strong failed to appreciate in 1925, when he decided to follow Montagu Norman's appeal, urging J.P. Morgan and other New York banks to support the return of Sterling to gold, was how the Norman and the London banks would shrewdly pursue their own agenda, while appearing the strongest friend and backer of the United States, and of the New York Federal Reserve chief. The center of the scheme was the Bank of England and UK Treasury's plan to reshape the gold standard after 1925.

Before 1914, the world trade system had been based on an international gold standard, which, while not perfect, was more or less self-correcting, in that international trade rested on market supply-demand principles, with imbalances settled in gold, a system apparently separating money from the State. As England was the preeminent financial center during this period, London dominated the market. But the market was regulated by inflows or outflows of a country's private as well as public gold reserves, not by its manipulation of foreign exchange levels. A country with chronic inflation would lose gold, forcing it to impose higher interest rates to hold its reserves, resulting in a domestic credit contraction. Holders of its paper currency could always redeem in gold on demand. The corrective was more or less automatic.

However, in 1925, Britain could not, and did not, return to the strict pre-war Gold Standard. Rather, she adopted a clever modification of that standard, which also played to the strategic goals of the far less experienced men dominating New York finance, and of Ben Strong in particular. The new standard was called a Gold 'Exchange' Standard.

Under the Gold Exchange Standard, the United States would, de facto, act as the ultimate backing for the inflated currencies of Britain, the rest of Europe, and the world. Britain, in particular, would keep its reserves not in gold, as it had before 1914, but mainly in dollars, while the countries of Continental Europe, still struggling with after effects of the war, would keep their reserves, not in gold, but in Sterling. This new scheme, in effect, permitted Britain to pyramid its inflated currency, Sterling, and its credit, on top of dollars, while British client states could pyramid their currencies in turn, on top of Sterling. It meant in effect, only the United States after 1925 would remain on a strict gold standard, and all others would redeem on paper currency.

League of Nations key role in British gold scheme

At the heart of the London construct for rebuilding its financial role was Britain's domination of the League of Nations bureaucracy. England dominated the powerful Financial Committee of the League. Montagu Norman, in turn,

dominated the League's Financial Committee through his two close associates, Sir Henry Strakosch and Sir Otto Niemeyer. British economist, Sir Ralph Hawtrey, from the UK Treasury, played a key role, calling for a general European adoption of the new Gold Exchange Standard.

Norman and the British used the League to pressure European member states to establish central bank collaboration with the Bank of England, based on not the classical Gold Standard, as noted, but on a Gold Exchange Standard which would permit the countries to continue inflating and deficit spending, while maintaining a facade of monetary stability. As well, European countries were pressured to return to gold at highly overvalued parities in order that their exports not unduly threaten British export.

Using promise of US bank credits together with its political pressure, exercised through control of the League of Nations Financial Committee in Geneva, London devised a system much like that of the IMF after the 1980's. Emile Moreau, Governor of the Bank of France, and bitter opponent of Norman, described the system in his diary in 1928:

"England having been the first European country to reestablish a stable and secure money had used that advantage to establish a basis for putting Europe under a veritable financial domination. The Financial Committee (of the League of Nations) at Geneva has been the instrument of that policy. The method consists of forcing every country in monetary difficulty to subject itself to the Committee at Geneva, which the British control. The remedies prescribed always involve the installation in the central bank of a foreign supervisor who is British or designated by the Bank of England, and the deposit of a part of the reserve of the central bank at the Bank of England, which serves both to support the pound and to fortify British influence. To guarantee against possible failure they are careful to secure the cooperation of the Federal Reserve Bank of New York. Moreover, they pass on to America the task of making some of the foreign loans if they seem too heavy, always retaining the political advantage of these operations. England is thus completely or partially entrenched in Austria, Hungary, Belgium, Norway and Italy. She is in the process of entrenching herself in Greece and Portugal. She seeks to get a foothold in Yugoslavia and fights us cuunningly in Rumania." Moreau continued, "The currencies will be divided into two classes. Those of the first class, the dollar and the pound Sterling, based on gold, and those of the second class based on the pound and dollar—with a part of their gold reserves being held by the Bank of England and the Federal Reserve Bank of New York."

With encouragement from Benjamin Strong, J.P. Morgan & Co. provided the essential dollar loan to back up the British reentry onto this modified gold standard in 1925. Afterward, similar Morgan bank credits were extended, always on suggestion of Montagu Norman and the Geneva Financial Committee he dominated, and always first endorsed by the New York Fed's Strong. Belgium, Poland and Mussolini's Italy as a result, all came back onto gold at overvalued parities.

Soon after England returned to gold at the inflated $4.86 level, the Bank of England attempted to pursue major deflation of domestic prices and wages, in order to keep exports competitive despite the overvalued Sterling. The protest of trade unions and a general strike soon made clear Britain would be able to hold the new gold value of $4.86 only with help from the United States. Strong, who rarely consulted with the Federal Reserve Board in Washington, let alone other regional Fed presidents, created a significant American monetary inflation and credit expansion in the late 1920's, to support the pound at the overvalued parity, and with it, to support the British monetary role in Europe. In easing monetary conditions in the U.S., however, Strong also created a stock market, and real estate inflation boom.

Montagu Norman had convinced his friend, Benjamin Strong, that European recovery and, ultimately, US export strength, depended on the Federal Reserve's maintaining artificially low interest rates to encourage gold outflows into the relatively more attractive Sterling. That in turn would provide the basis of supporting the entire Continental European and colonial gold system and, with it, much of world trade, so Norman argued. Artificially low Federal Reserve interest rates fuelled the blooming margin lending trade in Wall Street stocks, in turn fuelling the creation of the unprecedented Wall Street stock rise of the late 1920's. As well, depressed U.S. interest rate yields compared with very attractive European rates of typically 6 to 7%, encouraged American banks to extend increasing sums of short-term credit to the new gold standard countries of Europe and beyond after 1925.

In July 1927, in a shift of U.S. monetary policy to serve British needs, Strong convened a secret central bank conference on Long Island, at the request of Montagu Norman. There, Strong agreed to a major U.S. credit expansion via rate cuts, over the objections of the central bank heads of Germany and France,

to support Sterling, and halt a drain on London gold reserves. The Chicago Federal Reserve, not tied as Strong was to Montagu Norman and European credits, strongly objected to the Fed's interest rate easing, and refused to cut its rates, with the Chicago Tribune calling for Strong's resignation. Strong countered, arguing his easy money move was aimed at aiding Midwest farmers. Strong prevailed.

The drain of British gold was halted and the Sterling crisis eased as a result of the 1927 U.S. rate cut of Strong. The London Banker magazine later hailed Benjamin Strong for the "energy and skillfulness he has given to the service of England."

Under Norman's gold exchange architecture, the United States was the sole link of all these countries to gold and so-called hard money. Were the dollar also to inflate, as it did under Strong after 1925, the dollar also would begin to become unreliable, and the entire edifice, the pyramid of global credit would eventually collapse. This small flaw in the British monetary pyramid became evident when the credit expansion came to a halt in 1929. Before then, a wide spectrum from American banking and business hailed what Strong termed a "New Era" of permanent prosperity and price stabilization. The reality was quite something else, as the Federal Reserve was forced to resort to inflationary credit expansion to try to reflate falling prices in Europe by the late 1920's.

Few voices opposed the Strong policies when they appeared to create unbounded prosperity, rising incomes, booming stock prices and economic growth. Among the few critics of Strong's international credit policies were Barton Hepburn, chairman of the Rockefeller-allied Chase National bank, and H. Parker Willis, editor of the Journal of Commerce, and former aide to Senator Carter Glass. They were joined by several members of the Federal Reserve Board, and by Secretary of Commerce, Herbert Hoover.

For the first several years of the Gold Exchange Standard in the mid-to-late 1920's, the flaw was not that evident. It appeared that the economies of Europe were finally recovering, and that gold had been instrumental in that recovery.

Under the new Gold Exchange Standard, credit flowed out of New York to London and into the dollar-starved economies of Continental Europe after 1925. The House of Morgan, Kuhn Loeb & Co., National City Bank and other Wall Street banks, began to underwrite issue of bonds by various European states joined to the new gold exchange standard. The underwriting banks in turn sold these new bonds, often at interest rates as much as 3% above comparable U.S. Treasury securities, to ordinary American households seeking financial return and security.

Much of the credit from New York banks flowed into Germany after the 1924 Dawes Plan currency stabilization. Within six years, various German municipalities, private companies, States, port authorities and other entities, had issued bonds underwritten by New York banks and sold to American investors in the staggering sum of more than $2.5 billions. Germany in total borrowed nearly $4 billion from abroad in this period to rebuild before she declared de facto bankruptcy liquidation in 1931. In the period from 1924 to 1931, almost $6 billion in American credit poured into Europe. If U.S. war loans by the Treasury and costs of the War were added, a total of $40 billion in U.S. funds had gone into Europe in less than 15 years, fully one-fifth of total American GDP in 1914. The entire edifice was as stable as its weakest link under the post-1925 Gold Exchange Standard of Montagu Norman.

By late 1927, two months after he acted to stabilize Sterling and in the process add fire to the growing Wall Street stock bubble, Strong began to express strong misgivings about the entire edifice which Montagu Norman and the Bank of England had only three years before convinced Strong, was in the interest of reviving world trade and securing monetary stability.

Shortly before his death from tuberculosis in 1928, Strong wrote several letters to his friend, Montagu Norman, and others in the New York Federal Reserve expressing his growing doubts whether the gold exchange standard which Strong had backed on the urging of his dear friend, Norman, had been the right policy for world monetary stabilization. One letter, written in September, 1927, after Strong's decision to support Sterling from a gold drain, reveals Strong's growing apprehensions about the nature of America's postwar monetary entanglements:

"Banks of issue (central banks - f.w.e.) now hold bills and balances in the United States alone exceeding $1,000,000,000, not to mention a sum at least approaching that now held in London, and considerable amounts in other gold standard countries. In fact, as I have written you, I am inclined to the belief that this development has reached a point where instead of serving to fortify the maintenance of a gold standard it may, in fact, be undermining the gold standard

because of the duplication of the credit structures in different parts of the world sustained by a few accumulations of gold in the hands of a few countries whose currencies are well established upon gold, such as England and the United States."(emphasis added – f.w.e.)

French 'exceptionalism' pulls down world gold standard

Did the New York Stock crash of October, 1929 in fact lead to the Great Depression and its international ramifications? Despite claims to this effect, it did not. What was called the Great Depression, as Herbert Hoover rightly insisted in his memoirs, actually originated outside the United States, with the collapse beginning early 1931, of the rotten economic and political structures of Europe. That collapse process was directly tied to developments with the Gold Exchange Standard.

To his credit, Hoover, in the early 1920's as Commerce Secretary had aggressively and repeatedly attempted to restrain the unrestrained U.S. bank lending into Europe, trying to persuade his then-friend, Benjamin Strong, and the Federal Reserve to intervene, to no avail. Hoover's internationalism, while flawed, owed more to the traditions of Quincy Adams. Having served in Europe as head of the European Food Relief in 1919 he knew first hand the political problems of a major, unqualified American entanglement, via bank loans, to Europe's fate.

By October 1929 there had built up a record $8 billion of loans on stocks on the New York Stock Exchange which had to be liquidated, most loans to buy stocks on margin. With active monitoring by the Federal Reserve's new Governor Young, President Hoover and Treasury officials, most of those loans had been liquidated in an orderly manner down to a level of $3 billion outstanding without triggering broader panic within weeks. As the stock panic subsided, the Hoover Administration acted on a variety of fronts to deal with the spread of unemployment and economic recession, as unemployment rose to 2 million by early 1930.

The October crash hit seven months into Herbert Hoover's Presidency. No previous President had ever intervened into a market crash, and the conventional view was that such things should be let to self-correct, free of government meddling. Hoover, to his credit, realized the situation was unprecedented, above all, as he had repeatedly intervened since 1926 as Commerce Secretary to try to counter Benjamin Strong's easy money actions in support of the bank of England Gold Exchange Standard operations.

Overcoming objections from Treasury Secretary Andrew Mellon, Hoover announced a ten point plan of action in late 1929, among other things aimed to avoid bank panics, to prevent widespread bankruptcies and losses of homes, to aid agriculture, relieve distressed unemployed, and preserve the strength of the currency. Government public works projects were accelerated to give more jobs, and other such steps taken. Herbert Hoover was anything but complacent about what he faced in 1929-1930. The approach was typically Hooverian in that he sought to leverage the potential of government, to support private initiatives, rather than have direct government takeover, which he likened to Italian corporativism. By early 1931 the U.S. economic recession showed signs of stabilizing.

What neither Hoover nor anyone in the Federal Reserve grasped initially, however, was the scale of crisis which was building to a breaking point across Europe. Data on bank lending was primitive to say the least.

In Spring of 1931, the storm in Europe broke the dam. A peculiar form of French 'exceptionalism' played a decisive role in toppling the entire world monetary system, and tipping the world economy into depression, a little-understood function of the fatally flawed Gold Exchange Standard set up by the Bank of England in 1925.

In March 1931, Austria, a tiny 6 million people shard of the prewar Austro-Hungarian Empire, announced it had entered talks with Germany to create a common customs union to spur trade, as depression threatened. Such a union would be a technical violation of the Versailles Treaty, but hardly a threat to world security.

France reacted swiftly and demanded immediate repayment of some $300 millions in short-term credits owed by Germany and Austria to the Bank of France and French banks, to pressure both countries to halt their customs union. The demands triggered a panic flight from the shaky Austrian currency. The largest Austrian bank, Credit Anstalt of Vienna, with loans in Hungary and across the Danube region, and the creditor to a major part of Austrian industry and real estate, with over fifty percent of all bank loans of the country, collapsed by May.

The collapse of the Credit Anstalt led to a depositor panic run on the Danat Bank in Germany and a currency crisis there for the Brüning government, as well. At that point, the Bank of England, Federal Reserve, Reichsbank, and Bank of France, met to discuss an emergency credit infusion to try to stop the spread of currency panic. Hoover had won a one-year German reparations moratorium on payments to try to ease pressure on Germany. It took effect June 30, 1931. That move, however, merely led to panic flight of foreign banks out of German assets, fearing worse to come. Germans began flight capital out of the Reichsmark into dollars, Sterling or Francs or gold. Reichsbank head, Hans Luther, went in July from Paris to Basle to London, warning that Germany's Reichsbank needed an urgent $500 billion loan to avert bankruptcy default. That news spread panic even more.

At that point the French government held the trump card. France had gone through its own currency crises in the early 1920's, and a near hyperinflation. In 1926, the right-wing government of Raymond Poincaré took office, and immediately acted to impose severe budget austerity, tax rises and other moves, to stem capital flight and stabilize the Franc, then still outside the gold system. It announced plans to return to a gold standard at the earliest possible date to further instill confidence. The Franc appreciated 40% in value within weeks of Poincaré's return in 1926 as a result.

In 1928, after two years of building its gold reserves, the Poincaré government and Bank of France, under its new Governor, Emile Moreau, announced France would peg the Franc to gold.

Unlike Britain, however, which for reasons of the power of the City of London, had damaged export competitiveness by pegging to the prewar parity of $4.86, the Bank of France rejoined a gold standard at a parity equal 20% the prewar level. This led to a major French export recovery, rising employment, expanding industrial output and buildup of huge trade surpluses and, with it, foreign currency reserves with foreign central banks, above all the Bank of England. What was good for France in the instance, however, owing to the structure of international debt propped up by the Gold Exchange Standard, was bad for the rest of the world.

It had been the attempt by the bank of France in July 1927 to convert 30 million pounds into gold in order to build French central bank gold reserves which led the Bank of England to call on Benjamin Strong for help to stabilize the pound. The Bank of France, fearing a return of inflation from holding its reserves in foreign paper currencies which were free to inflate arbitrarily, had decided to base its reserves on gold alone, in the manner of the pre-1914 Gold Standard, not the loose paper plus gold reserve standard initiated by the British and other countries in 1925.

France, again, was odd-man out in terms of central bank policy. Moreau, a conservative banker, deeply felt, with just reason, the Gold Exchange Standard of Montagu Norman's Bank of England was dangerously flawed, and threatened a return to hard money policies and fiscal prudence. The only problem was that that Gold Exchange Standard then dominated the world monetary system. That system, and the indebted European economies tied to it, was rotten to the core.

French actions around gold were a mixture of political fears of Germany's resurgence, and fears of a re-eruption of domestic French economic chaos, strikes and recession from a return to easy money policies which led the French government and Bank of France to act alone.

Whatever their motives, from a purely French standpoint, the return to Franc stability in 1926 and the repegging to gold at 20% the prewar parity in 1928, led to a repatriation of French flight capital as well as foreign capital inflows, as the economy prospered. By 1931, full employment had been reached.

As a result of the policy of converting foreign currency assets into gold for the Bank of France reserves, France became the world's second largest holder of monetary gold by 1931, next to the Federal Reserve. In a short five year span, French central bank gold holdings had increased tenfold. Two central banks, the Federal Reserve and the Bank of France in May 1931, between them, controlled fully 75% of the world's monetary gold reserves. The Federal Reserve was severely restricted as to use of its reserves by legislative restrictions inserted by Congress into the Federal Reserve Act of 1913, limits which were only removed in 1933 and 1935, well after the Depression onset.

This left France and the Bank of France in an extraordinarily strong position when the European crisis erupted, a crisis in any case, detonated by French political and financial demands on Germany and Austria.

In July 1931, as Germany pleaded for another $500 million emergency central bank loan from London, Paris, New York, France was the decisive player. She

used the occasion to announce French willingness to participate in another German rescue, only on condition that the German government disband its Steel Helmets quasi-military force, halt further construction of 'pocket battleships' that had been allowed under Versailles, and that Germany abandon customs union with Austria. The German establishment rejected the French conditions as humiliating efforts to reduce Germany to economic slavery.

Hoover, no isolationist

The crisis now was fully focussed on Germany's debt, private and public, which had ballooned since the Reichsmark stabilization created in 1924 by the Dawes Plan. Most American bankers during the 1920's, including J.P. Morgan & Co. and Benjamin Strong, tended to treat Germany as simply another borrower, albeit with slightly higher risk, not that different from lending to American railroads, or floating bonds for American companies. They believed the backing of the world's strongest central bank and its gold would insure any potential risk. After all, Cologne or Frankfurt were government agencies of the German Republic.

Unlike the American bankers, French tended to the opposite, viewing every German loan as a political step in the efforts of the German institutions to ultimately repudiate Versailles and restore prewar German integrity. Unfortunately, the French view was far closer to reality, underscoring the deadly fallacy of Benjamin Strong's decision, almost unilaterally, of linking the financial and credit structure of the United States to the monetary structure of a post-1917 Europe.

By July 1931, the gold reserves of Germany, Austria, Hungary and most of Eastern European countries had been drained, and most banks had been closed.

President Hoover, far from the laissez faire isolationist many New Deal historians had accused him of being, called personally on the U.S. Treasury Secretary and Federal Reserve to determine how badly American banks were exposed to Europe, in order to determine what steps the U.S. should take. A close friend from a major California bank had expressed alarm to Hoover of the widespread practice of American banks to issue "bank acceptances," short-term loans, to German and other European banks. The acceptances were usually 60 or 90 day paper, secured only by bills of lading covering goods shipped, but not yet delivered. Hoover asked the Fed and Treasury for an estimate how much of such unsecured lending to European banks there was.

The Federal Reserve told the President their estimate, a mere $500 million at most, calling it no threat to American banks. Fearing worse, Hoover ordered an independent estimate from his Comptroller of the Currency. Their estimate was an alarming $1.7 billion or more, a sum which threatened the weakly capitalized U.S. banking system, were news to leak out. When Benjamin Strong cut U.S. interest rates in July 1927, to help the Bank of England counter the French gold drawdowns, the lending to Europe ballooned, as European banks were willing to pay a hefty premium of rates up to 7% or more for desperately needed dollar credits. Hoover was also informed by his Comptroller that European banks by July 1931, were already in default on many of these bank acceptances, which American banks had attempted to keep quiet to avoid further panic.

Hoover sent his Under Secretary of Treasury, Ogden Mills, to London to discreetly inquire of Mills' contact at the Bank of England, what the exposure of British banks to such unsecured bank acceptance paper was. The Bank had no idea, but two days later gave an initial estimate even more alarming to the stability of the Gold Exchange Standard. English banks were exposed fully over $2 billions, along with Dutch and Scandinavian banks.

Hoover estimated that Germany, Austria and Hungarian banks alone held as much as $5 billions of such short-term bills—all due in latest 60 to 90 days, a staggering sum no one before had the slightest awareness.

Bankers doing the lending, lent to individual client borrowers, reassured that the credit was ultimately secured by delivery of physical goods. As the flow of trade began to crater across Germany, Austria, Hungary in Spring 1931, deliveries began to collapse with it, and the paper based on it became worthless. This ultra-short-term debt was over and above the $5 billions of longer-term borrowing since the Dawes Plan by German industry, municipalities and governments. Hoover's comments at that point are instructive. In his memoirs, he recounts his reaction on learning the dimension of what was then unravelling with Europe's debt pyramid:

"The explosive mine which underlay the economic system of the world was now coming clearly into view. It was now evident why the European crisis had so long been delayed. They had kited bills A in order to pay B and their internal deficits. I don't know that I ever received a worse shock. The haunting prospect

of wholesale bank failures and the necessity of saying not a word to the American people as to the cause and the danger, lest I precipitate runs on our banks, left me little sleep. The situation was no longer one of helping foreign countries to the indirect benefit of everybody. It was now a question of saving ourselves."

Unfortunately, the time was very late for that. At that point, Hoover, over strong objection from Treasury Secretary Mellon, issued a public call for a "debt standstill" agreement among private banks everywhere holding German and Central European short-term obligations. Mellon, who was in London with Secretary of State Stimson, for a conference called to discuss the unravelling European situation, urged Hoover instead to agree to Germany's request for an added $500 million to hold the line. Hoover replied, that would only bail out the foolish mistakes of private banks, but not solve the larger problem.

In language reminiscent of Treasury Secretary Paul O'Neill, Hoover stated, "The bankers must shoulder the burden of solution, not our taxpayers." Over the strenuous objections of Mellon and Stimson, and the Bank of England, Hoover instead issued his public call for a voluntary bank "standstill agreement." The London conference at that point endorsed the now-public Hoover Standstill, as did the new Bank for International Settlements in Basle, which Hoover asked to oversee the voluntary plan. A group of New York banks told the President they rejected the standstill, pressuring Hoover to agree a new government loan to Germany. At that point, Hoover notes in his account of events, the President replied to the bankers, "if they did not accept within twenty-four hours, I would expose their banking conduct to the American people. They agreed." Few American Presidents have so bluntly faced down the nation's bankers and won.

The Bank for International Settlements, when it issued its final report in 1932, reported that the "total amount of international short-term (private) indebtedness which existed at the beginning of 1931, aggregated more than $10 billion." That was fully twice the staggering amount estimated by Hoover, the Achilles heel of the global credit pyramid erected on the back of the Gold Exchange Standard in less than seven years' time.

The standstill calmed matters briefly, until the Bank of England defaulted on foreign payments on September 21, 1931, and abandoned the Gold Exchange Standard it had set up only six years before.

The Bank of France had begun on July 24, 1931 to withdraw their sizeable gold deposits from the Bank of England, as well as from the Federal Reserve. That withdrawal triggered a crisis of confidence in Sterling. London, as Montagu Norman and the UK Treasury had intended, indeed, had once again become bankers to the world, all based on a Gold Exchange Standard resting on tiny Bank of England gold reserves, and huge pyramiding on the U.S. dollar.

London banks, as noted, also held huge sums of now insolvent short-term loans to Eastern European and German banks. In August 1931, to try to stop the run on Sterling, the Bank of England raised its interest rates. That only made matters worse, as panic spread. The British government borrowed some $650 million from U.S. banks to try to stop the panic, only making it worse again. On September 14 British sailors mutinied, and a week later, September 21, 1931, the Bank of England officially went off gold, forcing the closing of most securities and commodity markets across Europe.

Suicidally, the United States kept its gold discount window open at the Federal Reserve. Instead of injecting liquidity into the system, it withdrew it to hold onto the gold standard for dear life, raising Federal Reserve discount rates from 1 to 3% in October, 1931, pushing the economy deep into depression and deflation.

Sterling floated free, and the devaluation of some 40% boosted British exports and mitigated the effects of world collapse. In rapid succession other European countries left the gold standard, except for France. The United States clung to the deflationary gold parity until April 1933. The conjuncture of these crises led to an explosive increase in the role of the Federal government in American economic life. From the full onset of the Great Depression in 1931 through the peak of war spending in 1944, U.S. government debt rose from 29% of GDP to over 130% of GDP, a level enjoyed today only by Japan. As significant, the share of public spending in the overall national economy rose from 12% in 1931 to over 45% by 1944. The collapse of Benjamin Strong's grand project for making New York the bankers to Europe had fundamentally distorted the structures on which American exceptionalism had been founded. It proved no easy job to reverse that distortion.

(*) F. William Engdahl is a freelance economic journalist and author of „A Century of War – Anglo-American Oil Politics and the New World Order“ (1992); soon to be released in a new German edition titled “Mit der Ölwaffe zur Weltmacht - Der Weg zur neuen Weltordnung”.

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