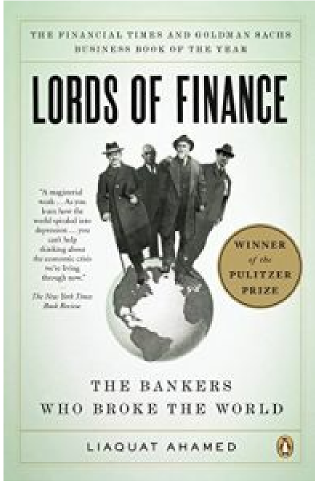

Book Lords of Finance

The Bankers Who Broke the World

Liaquat Ahamed
Penguin Group (USA), 2009

Recommendation

Who would have thought that a study of central bankers could be a page-turner? Investment manager Liaquat Ahamed spins a fast-moving yarn about central bankers' disastrous monetary policy decisions in the 1920s and early 1930s. The story itself yields little suspense – you already know how it ends, but Ahamed uses thorough research and gripping detail to paint a complete picture of how the world economy collapsed. The Great Depression preceded today's credit default swaps, collateralized mortgage obligations and arcane derivatives, so the book's lessons for the modern crisis are mostly as referential cautions. *BooksInShort* recommends this absorbing book to readers who want a deeper understanding of the gold standard, and the events that led to – and out of – the biggest economic crisis of the 20th century.

Take-Aways

- The Great Depression was an avoidable disaster caused by central bankers' decisions.
- Clinging to the gold standard in the 1920s was a crucial mistake.
- The immense cost of World War I set the stage for the Great Depression. Governments printed currency to cover expenses.
- An unrealistically high reparations bill from Britain and France after World War I led to extreme inflation in Germany. In 1923, a loaf of bread cost 140 billion marks.
- Britain suffered deflation, which crippled exports and sent unemployment soaring.
- France undercut British and German exports by keeping the franc low.
- In 1927, US central banker Benjamin Strong cut interest rates to prop up the British pound – and sparked a US stock market bubble.
- The stock market crash in 1929 led to the collapse of US and German banks.
- When Britain went off the gold standard in 1931, the US in 1933 and France in 1936, their economies rebounded.
- At the time, bankers had little concept of active monetary policy and only a rudimentary understanding of how their decisions would play out.

Summary

A Manmade Depression

The 1920s and 1930s were a time of bust, boom and bust. Massive unemployment was common; stock markets and currencies crashed, soared and crashed again. For a time, Germany's currency became so valueless that consumers shopped with wheelbarrows of cash. US banks were so untrustworthy that many people buried their cash in their yards. The nadir came in the early 1930s, the depths of the Great Depression, which people now mistakenly see as the inevitable result of an unfortunate confluence of events. In truth, the Depression was the direct result of poor decisions by the central bankers of the four great powers of the time: the US, Britain, Germany and France. They cut rates when they should have raised them and froze when they should have acted. They stuck with the gold standard long past its time. These bankers sometimes acted out of foolishness or ignorance, but their misguided policies led directly to the Depression.

> "The 1920s were an era, like today, when central bankers were invested with unusual power and extraordinary prestige."

The story of that global economic collapse is tied in no small part to the gold standard, a bit of orthodoxy that central bankers clung to fervently. It linked a currency's value to a corresponding amount of gold. A dollar was worth 23.22 grains of pure gold, while a pound equaled 113 grains. In the early 20th century, the central banks of the four major Western economies held stores of gold that backed their paper money and gave it value. In 1914, 59 nations used the gold standard. Backing a currency with gold signaled that a country was a serious player in the world economy. Gold was scarce, so governments on the gold standard could not increase the amount of currency they had in circulation by any significant amount. More than one observer commented on the irony: Gold was dug out of the ground in Africa, only to be shipped a great distance to be put in central bank vaults deep underground. The gold standard checked inflation, but it was no cure-all.

> "Central banks are mysterious institutions, the full details of their inner workings so arcane that very few outsiders, even economists, fully understand them."

By 1914, the gold standard was a long-established economic tradition, but central banking was a new concept, particularly for the world's largest economy, the US's. In spite of its growing importance as an industrial and financial hub, it suffered an endless series of financial panics. During a spate of bank runs in 1907, Pierpont Morgan of J.P. Morgan & Co. served as the US's *de facto* central banker. While bankers, economists and politicians pushed for an orderly way to handle crises, Americans were so suspicious of centralized power that they refused to create a central bank. In 1913, President Woodrow Wilson overcame these doubts and signed the Federal Reserve Act, creating a system of 12 regional banks overseen by the central Federal Reserve Board. The New York Fed was to become the most influential regional bank. New York bankers tapped Benjamin Strong to head it. He took a salary of $30,000, far less than he could have made in the private sector.

> "As the lights started to go out over Europe that fateful first week of August [1914], every banker and finance minister seemed...fixated not on military preparations...but on the size and durability of his gold reserves."

Though sickly, Strong was a natural leader. He was one of four central bankers who played crucial roles in the years leading up to the Great Depression. The others were the mercurial, manipulative Montagu Norman of Britain, the ever-suspicious Émile Moreau of France and the abrasive, arrogant Hjalmar Schacht of Germany.

> "Among the first casualties of war is not only truth but also sound finance."

At the dawn of World War I, gold was a crucial commodity, an asset with the intrinsic value that paper currency lacked. Germany began hoarding gold in anticipation of a costly war. The Reichsbank held $500 million worth, the Bank of England $200 million and the Banque de France $800 million. Europe's citizens valued gold highly. Some thrifty French savers kept gold coins under their mattresses. On July 29, 1914, amid scandal and impending war, some 30,000 people formed a mile-long line outside the Banque de France to trade banknotes for gold. While the bank honored those requests, it also safeguarded the gold it needed to finance the war. In August 1914, it emptied its Paris vaults and secretly moved its gold to other locations in France.

> "Germany's annual GDP before the war had been around $12 billion. To burden it with a debt eight times its annual income would have been the height of madness."

Conventional wisdom was that any war would be short. Too much lucrative international trade was at stake for Europe's powers to engage in a long war, or so economists and bankers believed. European central bankers girded for war by protecting their gold reserves – seemingly forgetting that, historically, a lack of gold was no impediment to waging long, costly wars. In the fog of war, governments pulled out all the stops – raising taxes, borrowing or printing money. As the war dragged on, the gold standard became a prominent casualty. Central bankers abandoned their peacetime rule of issuing only currency backed by gold. During World War I, currency in circulation doubled in Britain, tripled in France and quadrupled in Germany, where this was particularly disastrous. It spent $47 billion on the war, but raised only 10% of that amount from taxes. While the war crippled the European powers, America's economy boomed. It became a major supplier of materials and supplies to the combatants. By war's end, the nascent Fed had amassed the world's largest supply of gold.

> "Germany's financial problems were mostly self-inflicted. Nevertheless, reparation payments made...a difficult fiscal situation impossible."

The war had cost Europe some $200 billion. Foolish wartime monetary policies left it with towering debt and devalued currency. Atop that already-rickety scaffolding, the victors were determined to impose a crushing financial punishment on Germany. The British wanted $100 billion in reparations – eight times Germany's gross domestic product. The French, feeling menaced by their German neighbors, wanted more. The lonely voices of reason included John Maynard Keynes, a young Cambridge economist. In his 1919 book, *The Economic Consequences of the Peace*, he said Germany could afford to pay no more than $6 billion. In 1920, a Reparations Commission presented Germany with a bill for $33 billion; countering, Germany offered to pay $7.5 billion. The British proposed $12.5 billion, a figure the Allies accepted. But, the Germans remained convinced that they couldn't pay and quickly fell behind. Keynes pushed unsuccessfully for a more reasonable reparation plan, but the issue loomed for years. In several acrimonious summits, all sides refused to budge. Germany's fiscal humiliation left it ripe for Hitler's toxic reign.

Loaf of Bread? That'll Be 140 Billion Marks

Onerous reparations helped spark dizzying inflation and currency devaluation in Germany. In 1914, a dollar was worth 4.2 marks; by 1922, 7,200 marks and in August 1923, the dollar was 620,000 marks. By November 1923, a dollar equaled 630 billion marks, then 1.3 trillion. A kilogram of butter cost 250 billion marks, a loaf of bread 140 billion marks. Shoppers lugged currency in wheelbarrows, laundry baskets and baby carriages. Government printers worked round the clock to churn out currency. The Reichsbank hired private printers. Towns began issuing their own currency.

> "The almost theological belief in gold as the foundation for money was so embedded... that few could see any other way to organize the international monetary system."

Between the time that a German bought a cup of coffee and finished drinking it, "the price might have doubled." The events of late 1923 marked "the single greatest destruction of monetary value in human history." The mark's collapse created a boon for foreigners who could purchase a Berlin apartment for a few hundred dollars. But children starved and, in November 1923, Germans rioted. Schacht became currency commissioner. He oversaw the creation of a new currency, the Rentenmark, replacing the Reichsmark. He shrewdly waited until the mark fell to 4.2 trillion to the dollar before introducing the new currency. This allowed Germany to buy back its debt at a discount. Germany's currency quickly regained its stability. In a couple of years, its stocks boomed, earning Schacht the sobriquet "Miracle Man."

> "In the early summer of 1928, with the Dow at around 200...the market truly seemed to break free of its anchor to economic reality and begin its flight to

> the outer reaches of make-believe."

Germany's woes were especially severe, but Britain and France were hurting, too. The balance of financial power had tipped to the US, which insisted that Britain and France repay their war debts. By demanding full payment, America fed a downward spiral in Europe though it ultimately renegotiated. If America wouldn't let Britain off the hook, then Britain couldn't show mercy to France and Germany. If France couldn't get a break, it was adamant about extracting reparations from Germany.

> "Because...an active monetary policy...was so novel and the knowledge of how the economy worked so primitive, debates...within the Fed became highly confused and at times even incomprehensible."

Bolstered in part by Germany's worthless currency, Strong and Norman clung to the gold standard. This ingrained, nearly religious belief left them unable to recognize its inherent problems, such as gold's scarcity. Before the war, the four Western powers held $5 billion in gold. By 1923, that had risen to only $6 billion, yet prices had increased 50%. Thus, gold's purchasing power had declined significantly. The concentration of gold in the US also was an issue. This seemed beneficial to America, but Europe's lack of gold diminished the economic viability of its trading partners. In that way, the world had become a poker table where one player had all the chips. Strong feared that the influx of gold would create a lending boom and out-of-control inflation, so he kept incoming gold out of circulation. He also realized that the Fed could affect the supply of money in the US banking system by buying and selling government securities. Strong's hands-on approach helped define the role of central bankers for decades to come.

Questioning the Gold Standard

Even as Germany stabilized, Britain fell into an economic pit. London was burgeoning, but the industrial heartland suffered double-digit unemployment as the textile, coal and shipbuilding industries languished. To reverse the damages of wartime inflation, Britain followed disciplined fiscal policies that deflated its economy. The result was a strong pound and high interest rates. France's weaker currency made its exports more competitive. With Britain's economy struggling, Winston Churchill, Chancellor of the Exchequer, considered taking Britain off the gold standard. He studied it intently and consulted Keynes, but ultimately sided with the gold bugs in the Treasury and the Bank of England. Churchill would come to regret that decision.

> "Breaking with the dead hand of the gold standard was the key to economic revival."

In 1926, France was facing its own currency crisis, although not as severe as Germany's. France's culture of scandal (even the central bank was caught cooking the books), deep political divides and heavy war debts weakened confidence in the franc. With the franc plunging to new lows, Émile Moreau became governor of the Banque de France. Though he lacked any personal charm, he stabilized the franc by keeping it low, and turned France's economy around without mirroring Britain's painful deflation or Germany's disastrous inflation. The weak franc let French exporters undercut their rivals. Moreau's strategy worked short-term, but it eventually helped destabilize the world economy, and it led to constant quarrels with Norman, who griped that France was undermining the pound.

The US Stock Market Crash

By the late 1920s, bankers were dealing with a new threat – rising equity prices. In August 1927, Federal Reserve Chair Strong cut US rates hoping to bolster England's pound. His decision backfired. The US stock market soared 20% in two months, setting the stage for a bubble and crash in 1929. Rather than helping the pound, Strong's decision led to an equity bubble that vacuumed capital out of every nation in Europe. Strong died in 1928 at age 55, leaving his successor, George L. Harrison, to deal with the stock market bubble. Norman persuaded Harrison that raising rates would pierce the bubble without harming the US economy. But Harrison couldn't act alone; each time he moved to raise rates, the Fed's governors in Washington overrode him. The idea of an active monetary policy was so new that no one knew what to do. As the US central bankers bickered, the stock market crashed. Only after the crash did the Fed begin easing rates, but it stopped too soon.

> "While...Wall Street had prophesied chaos, Roosevelt's instincts were vindicated. Devaluation changed the whole dynamic of the economy."

Following the US stock market crash, German banks collapsed; then US banks fell. President Herbert Hoover was reluctant to intervene. However, his successor was more of an activist. In 1933, Franklin D. Roosevelt's first official act as US president was to close every US bank. He planned for the bank holiday to stop the run on US banks. Without cash, Americans extended credit to each other and bartered. Boxing match promoters in Manhattan sold tickets in exchange for anything worth 50¢. The box office took hats, shoes, cigars, soap and even foot balm.

> "The Great Depression was not some act of God or the result of some deep-rooted contradictions of capitalism, but the direct result of a series of misjudgments by economic policy makers...by any measure the most dramatic sequence of collective blunders ever made by financial officials."

In a radio broadcast, Roosevelt persuaded depositors to reverse the run on banks. Then he took the US off the gold standard. Britain had abandoned it in 1931, but bankers and investors still were shocked that the US would abdicate. Roosevelt's gambit worked – stocks doubled in three months, prices soared and borrowing costs plummeted. Not only did Roosevelt go off gold, he began buying it. For three months, he met with his advisers over breakfast to set the commodity's price. One morning, it was $31.36 an ounce, another $31.82. The seemingly precise figures were, in fact, random. As odd as this episode seemed, Roosevelt's broader point was completely accurate: The gold standard had outlived its time. Going off gold helped Britain, too. Its devalued currency spurred exports, lowered interest rates and led it out of the Depression. France clung to gold until 1936, making it the last country to emerge from the Depression.

About the Author

Liaquat Ahamed has been a professional investment manager for 25 years. He worked for the World Bank, and now advises hedge funds and serves as a Brookings Institution board member. He holds economics degrees from Harvard and Cambridge.